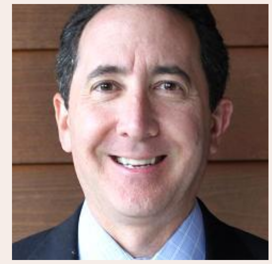
Monthly Commentary

September 2018

By Peter Boockvar
Chief Investment Officer – Bleakley Advisory Group



Over the past few months I've discussed the differential in stock market performance between the United States and the rest of the world. The US markets have had a great year so far, while international markets, generally, have been more challenged. The discrepancy between the two has reached its widest level in quite a long time. More recently, within the US stock market, we've begun to see meaningful divergences between sectors. We've also seen significant discrepancies between both growth and value strategies, as well as between the different categories of market capitalization, namely the large cap and small cap categories.

"Six stocks in the S&P 500 are collectively up about 30% year to date, the other 494 stocks are up about 3%."

In September, the S&P 500 rallied .4%, while the tech-heavy NASDAQ was lower by .8%. The small cap Russell 2000 index was down by 2.5%[1]. The FAANGM stocks (Facebook, Apple, Amazon, Netflix, Google and Microsoft), in particular, have also started to diverge. I highlight this group of companies because just these six stocks make up 17% of the S&P 500[2] index. Further, these six stocks are collectively up about 30% year to date, while the remaining 494 S&P 500 stocks are up about 3%.[3]

The interest rate complex saw another rise in interest rates during September. We've seen both market based interest rates, as well as the fed funds rate controlled by the Fed continue to rise. As of September 26th, the fed funds rate now sits at 2-2.25%, up 25 basis points from the prior meeting and 1.5-1.75% at the start of 2018[4]. The US 10 year treasury yield ended the month at 3.06% vs 2.86% at the August close and up from 2.40% in early January[5]. An increase in mortgage rates also followed. The yield curve, which has seen a dramatic trend of flattening over the past year, was little changed on the month. Higher interest rates were also seen in Europe and Japan[6].

Commodity prices rose in September with the continued increase in oil prices being the main focus. The end of the nuclear deal with Iran and new sanctions placed on them has sharply limited their ability to export oil. This supply worry was not offset by an increase in production from Saudi Arabia. WTI ended the month up almost 6% and begins October at the highest level in almost four years[7].

A sharp drop in emerging market currencies, especially the Turkish lira and Argentine peso was a top story of August, but the situation stabilized in September. Central banks in both countries more aggressively raised interest rates and the Chinese yuan didn't break below the August low vs the US dollar.

1-7 Bloomberg

Equities & Indices

Importantly in September, overseas markets did stabilize along with their currencies as stated above. The MSCI world index ex US bounced .4% to trim its year to date loss to 4.5%[9]. Helping this rebound was the 3.5% rally in the Shanghai composite index[1]. European stocks eked out a modest gain[10]. Overseas, growth worries continued and are something we are monitoring closely, but markets there have gotten cheap and have already reflected some of this concern. The price to book ratio of the S&P 500 is more than double the MSCI world index ex US, and that is a record differential[11].

"Overseas markets & currencies did stabilize in September, however growth worries continue and are something we are monitoring closely"

Interest Rates and Monetary Policy

The rise in interest rates is something that we've discussed just about every month this year and reflects the change in tide from a world where central banks were easing to one in which they are trying to reverse their highly accommodative policies. The Fed is in the lead in this area, as they've already hiked rates three times this year and could add a 4th in December. Beginning October 1st, the Fed will increase the monthly shrinkage of its balance sheet by $50b per month, which will reflect the maximum level. This policy has been joined by the European Central Bank which is making progress in exiting from its Quantitative Easing purchase program.

"The Fed has already hiked rates 3 times this year and could add a 4th in December."

ECB purchases peaked at 80b euros per month in Q1 2017 and then fell to 60b beginning in Q2 2017. Purchases further dropped to 30b euros per month year to date, and as of October 1st will get cut to just 15b euros per month. The purchases are scheduled to officially end by the end of 2018. At some point in the summer of 2019, the ECB will attempt to get out of their negative interest rate stance. Globally, there remains more than $6 Trillion of negative yielding bonds, most of that in Europe[12].

8-12 Bloomberg

973.575.4180
Bleakley.com

Interest Rates and Monetary Policy

Back in August, the Bank of Japan announced that they will allow a slightly steeper yield curve out to 10 years in order to placate their banking system which has been hurt by having no yield curve. While this was good to see from a normalization standpoint, in that the BoJ has been buying less Japanese bonds, the result has still been a rise in rates. As of this writing, long term Japanese bond yields are at one year highs.

Here are some other factors that are currently driving a rise in US interest rates:

1. Nominal GDP is running at a range of 4-6% depending on one's estimate for the rest of the year[13].

2. Inflation expectations remain near multi year highs along with the rise in oil prices, wages and tariffs[14].

3. Huge Treasury supply needed to finance growing US deficits.

4. Foreigners continue to be only very modest buyers of US Treasuries[15].

5. Pension funds front loaded many of their purchases of longer term US Treasuries this year before the September 15th deadline to qualify for a 35% tax deduction vs the now less generous 21%[16].

Commodities

Oil prices ended up the month of September higher by almost 6%. The front month WTI futures contract was near a four year high[17]. As stated earlier, worries about supply is the main reason, as the Iranian sanctions kicked in and have yet to be offset by greater supplies elsewhere. Demand also remains pretty good.

Coincident with the bounce in overseas markets, especially China, copper prices rose by 5% after declines seen in 7 of the previous 8 months[18]. Consider copper a poster child for global economic activity. The precious metals complex was mixed, as gold fell almost 1% while silver rallied about 1%[19]. The weakness seen this year is because of the rise in the US dollar, but the euro heavy dollar index was unchanged in September after five straight months of gains.

13-19 Bloomberg

Economic Outlook & Tariffs

Looking at the GDP estimates from the New York Fed and the Atlanta Fed, expect GDP growth for Q3 to be in the range of 2.5-3.5% and likely a similar rate in Q4. This comes after a solid 4.2% pace in Q2 and 2.2% in Q1[20]. Growth in the final quarter of the year could be distorted by the rush to secure product and deliveries ahead of the possible increase in the Chinese tariff tax rate by year end to 25% from 10%. On the other hand, seeing an agreement on a new NAFTA (although it's not much different than the original) with Canada and Mexico helps to ease concerns with two of our biggest trading partners. With respect to tariffs, it all now comes down to when the US and Chinese come to an agreement of some sort. A deal of substance will address the main US worries over the Chinese stealing our technology. A deal of just optics will only address our trade deficit with them which is not economically relevant. Either way, we of course hope for something sooner rather than later so we can get rid of all of the tariffs announced from both sides.

"The softness in the US economy is being seen in residential housing and auto sales. Both of course are highly interest rate sensitive."

The US consumer is on firm footing with a very healthy labor market and rising wages becoming more apparent. After years of a very low percentage of the profit pie going to employees, that tide has now turned in their favor. The softness in the US economy is being seen in residential housing and with a peak in auto sales. Both, of course, are highly interest rate sensitive. The rise in funding costs, combined with record high housing prices and an all-time high in the average price of a new vehicle, are a turnoff for consumers.

Conclusion

As we look to the last quarter of 2018, it's clear that year to date, the US fiscal stimulus put in place this year via a lower corporate tax rate, reduced individual rates (offset somewhat by the end of the SALT deduction), corporate incentive to increase capital expenditures along with regulatory relief has offset the growing monetary headwinds. Those headwinds have been impactful though on overseas markets. We hope this fiscal offset can continue, but we remain eyes wide open as the ECB and BoJ pick up their pace of tightening along with the Fed.

20 Bloomberg

Bleakley FINANCIAL GROUP™

973.575.4180
Bleakley.com