Monthly Update

May 2019

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The month of May was dominated by an escalating trade battle with China, both directly via imposed tariffs and indirectly by the threats of additional tariffs, along with non-tariff barriers that are now part of the discussion. We entered the first weekend of May with the S&P 500 at a record high close of 2945 on the hope that all that was left to complete a new trade deal with China was the dotting of the I's and crossing of the T's[1]. Instead, that weekend we got the message that talks with China fell apart and the last batch of tariffs on China, totaling $200 billion, was going to be raised from a 10% rate to a 25% rate. A few weeks later, the US Department of Commerce put a ban on doing business with the Chinese tech behemoth Huawei, unless a license was granted. This is like the Chinese government putting restrictions on doing business with Apple and thus heightened the tensions between the two countries. All is not equal however, as China has banned the use of Google, Facebook and Twitter for years.

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We did get good news on the trade front mid-month when the US decided to eliminate the steel and aluminum tariffs on Mexico and Canada in order to facilitate a Congressional vote on passing the USMCA (US, Mexico, Canada agreement). Then on the night of May 30th we got a tweet from our President threatening Mexico with a 5% tariff on all imported goods by June 10th "until such time as illegal migrants coming through Mexico, and into our Country, STOP." That tariff will gradually rise until the "illegal immigration problem is remedied.[2]" I'm not going to get into the immigration issue or the politics around it, but note that Mexico is a major trading partner of ours with the automobile industry the dominant product where US manufacturing facilities source 37% of auto parts from Mexico[3]. I believe that these tariffs will not come to fruition. Hopefully, we'll see a separation between tariffs and immigration policy. By the end of May, the S&P 500 fell 6.6% over worries that economic growth will continue to slow as a result of these trade tensions[4]. Coincident with this, sovereign bonds saw big rallies globally with yields falling sharply. The US 10 year treasury yield started the month at 2.50% and ended it at 2.17%[5]. Rate cut odds in the fed funds futures market began May pricing in a 50% chance of a 25 basis point cut by year end[6].

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1. Bloomberg
2. Twitter
3. Department of Commerce
4. Bloomberg
5. Bloomberg
6. Bloomberg

We ended May with those odds at 92%[7]. Corporate credit, sensitive to the cyclical nature of the economy, saw weakening too with credit spreads widening, particular for the high yield space. The Bloomberg Barclays high yield option adjusted spread widened by 60 basis points on the month to the most since February[8].

The Global Economy

After the 3.1% 1Q GDP performance, the pace of growth is expected to slow in Q2. The Atlanta Fed GDPNow estimate is for growth of 1.26% while the New York Fed's Nowcast forecast is at 1.4%[9]. It is best to average the first two quarters and we'll likely see growth between 2.0% and 2.5%. The labor market remains strong, wage growth is consistent, and corporate spending on software has been solid, but consumer consumption has been only ok, while capital expenditures on plant and equipment has been mediocre and trade has moderated. Growth prospects overseas did stabilize in Europe and Asia. China has been trying to stimulate their economy via fiscal and monetary measures and the recent economic data in Europe hasn't softened further. This said, we'll certainly have to see how businesses and consumers respond to what has taken place in May.

The Yield Curve

Reflecting the belief in the moderating pace of growth and trade war tensions, the US Treasury yield curve continued to flatten and, in fact, has further inverted in certain parts. The spread that many believe is most relevant is between the 3 month T-bill and the 10 year note, which is now inverted by 18 basis points versus being positively sloped by 8.5 basis points at the end of April[10]. This now leads to a lot of pressure on the Federal Reserve to cut interest rates this year.

Earnings

We wrapped up earnings season with about a 70% earnings estimate beat rate relative to expectations, which is about the historical norm[11]. These results helped bring earnings growth to slightly above zero vs. the estimates going in, which were expected to be down about 3%[12]. Revenue growth was 2.5% y/o/y[13]. Estimates have fallen for Q2 earnings to little changed y/o/y[14]. Keep in mind though that comparisons are very difficult because 2018 earnings benefited from the drop in the corporate tax rate.

7. Bloomberg
8. Bloomberg
9. Atlanta Fed and NY Fed
10. – 14. Bloomberg

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Commodity Prices

The economically sensitive commodities reacted negatively to the growth worries. Oil fell to $55 a barrel vs $64 at the end of April[15]. Copper, which is highly sensitive to China's economy, fell to $2.66 per pound from $2.90 at the start of May[16]. On the flip side, major rains and flooding that kept many agricultural farm areas from planting corn and soybeans on time led to a rally in both, along with a rally in wheat prices. Corn finished the month at almost the highest in 3 years[17]. Soybean prices, which got knocked down over the past year due to trade issues with China, rebounded to a 6 week high[18]. The American farmer has had a tough 7 years since crop prices last peaked and might finally be seeing some light at the end of the tunnel if the price increases can be sustained.

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Conclusion

By the time you read this we'll likely have clarity on the Mexico situation and I believe we will not see any tariff implementation. Unfortunately, it is likely that the relationship with China will remain adversarial for the foreseeable future unless both sides are willing to make compromises with their trade stance. In the meantime, the US Consumer is on a good footing with a solid labor market and fortunately the US Consumer makes up the biggest component of the US economy. However, clarity on trade remains crucial in order to avoid negatively impacting the consumer's behavior.

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When the news flow is dizzying, investing with a short-term time horizon is very difficult, if not impossible, which is why we do not do it for our clients. We take a long-term view and maneuver through current events in a diversified fashion. Sometimes the road is smooth and sometimes it gets bumpy, but either way, a prudently constructed portfolio that meets the liquidity needs and investment objectives of our clients means that it typically doesn't matter.

Please never hesitate to reach out at any time with questions or for any discussion on the economy or markets.

15. – 18. Bloomberg

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