June 4, 2019

Overview

A violent and unexpected setback in the trade negotiations between the US and China sent equities sharply down across the globe in May.

The S&P's 500 dropped 6.35%. The Nasdaq Composite swooned 7.79% while the Russell 2000 (US Small Caps) slumped 7.78%.

Most international markets replied in kind. The S&P EPAC BMI (developed markets) was down 5.61% while the MSCI EM (emerging markets) dropped 7.26%. Interestingly, the Frontier 100 Index rose 1.70%, as some smaller developing countries are seen by investors as potentially benefitting from supply chain adjustments away from China (large corporations are considering moving their manufacturing operations away from China in favor of other smaller countries).

Below is the graph of the broad emerging market ETF (VWO-blue) vs. that of the Frontier Market 100 (FM-orange) during the month of May. Diversification sometimes pays off!

Meanwhile, the US fixed income markets rallied in a classic flight to quality move. The long bond rose 6.28% in May. Intermediate corporate bonds were up about 1.50%. The high yield sector lost its footing, as expected in a "risk off" period, and dropped 1.55%.

In May, our client portfolios were down from 1.68% to 2.90%. This compares to a negative monthly performance of 2.24% for a portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% AGG (US bond aggregate proxy).
On a Year-To-Date (YTD) basis, our portfolios are up from 5.10% to 9.69% (net of fees) vs. 6.97% for our benchmark.

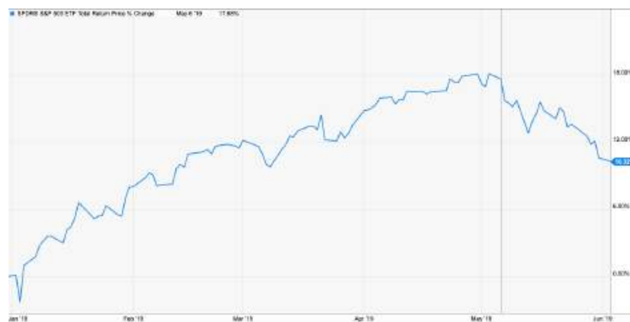
As a reminder, the equity allocation in our clients' portfolios ranges currently from 30% to 60%, depending on their risk profiles.

Market developments

In my last letter, I mused about how fine US economic conditions were, although the skeptic in me did not want to fully believe it. The skeptic was right, the hunky-dory conditions did not last much and a tweet from the US President on US-China trade on May 4th turned equity markets on their heads, worldwide.

What had been, just a few days earlier, described by the US Administration as "great negotiations" with China turned out to be a rather inaccurate, if not misleading, evaluation of the state of affairs between the two countries. Since then pundits of all ilk have attributed this bad turn of events to a mutual "misreading" of each negotiator's intentions. Whatever the cause(s) of this development, markets did not take it lightly.

Below is a chart of the S&P's 500 since January 1, 2019. The vertical line marks the time of the Presidential tweet on the imposition of a 10% tariff on imported Chinese goods.



Other events detrimental to market sentiment during May include: 1) the Iranian war drum beat which started on May 13 (it has since mercifully abated) 2) the Chinese announcement of retaliatory measures (May 15) 3) US sanctions against Huawei (May 20) 4) more US restrictions on access to technology by Chinese firms (May 22), 5) China threatening to limit access to rare earth minerals (commodities used in the production of key technological components), on May 30 6) threat of imposition of tariffs on imports from Mexico over Memorial Day week-end.

The only good news in May, as far as I am concerned, was the results of the European elections. They showed that in spite of a difficult economic and political environment, the majority of Europeans are not ready (yet) to follow the sirens of nationalism and anti-democratic propaganda.

Tilts and Allocations

Market sentiment has rapidly turned from mildly positive in late April to quite negative now due to the threat to global growth that restrictive trade measures (tariffs) represent. The economic data though has not turned bad so far. Consequently, I have refrained from reducing risk in clients' portfolio. Should the situation worsen and manufacturing data (not sentiment), employment and consumption patterns point to a deteriorating situation, I will reduce our equity allocations. Until then, there is no sound basis for doing so.

The political and economic environment stateside and globally is worsening though and the trade conflict between the US and strategic foes and friends alike is a source of major uncertainty and concern.

We are seeing that many corporate actors are moving or considering moving their production units out of China. Depending on the industry concerned, these are no light decisions. They imply moving people, capital, infrastructure and affect capital expenditure decisions (one of the components of growth). Tariffs raise costs to consumers (another major component of growth). The US consumer will be on the losing side should the situation with China remain as is. That in turn, will dent US economic growth. The result of all of this is that the risk of an economic recession in the US by the end of 2020 has substantially increased (Oxford Economics, a leading forecasting outfit, puts it today at 60% from 35% earlier this year).

Until the uncertainty created by US trade policy is lifted one way or the other, investment prudence is a must. Typically, this means doing nothing once a portfolio is properly positioned based on the specific risk/return expectations of each client. This is where I am at for now.

I will change my stance rapidly should corporate earnings start showing signs of weakening.

Concluding remarks

It is amazing how sentiment can change from euphoria to despair and back in a matter of weeks. If markets were not euphoric at the end of April, they were sitting pretty nevertheless. Now, there is talk of recession, trade wars and forecast of weakening corporate earnings.

Reality, as always, is a bit more nuanced. The investment environment has, no doubt, deteriorated but there are plenty of reasons to think that a recession may be farther away than currently expected, including: 1) the Administration's ability to strike a deal with China for "good" long-term strategic and commercial reasons, 2) the Administration's motivation to strike a deal with China for "perhaps-not-so-good" political reasons (a slowing economy would not help in the context of the approaching US Presidential Elections), 3) the Federal Reserve's accommodative stance on interest rates, 4) a still strong employment and consumption environment.

The unpredictability of US policy under the current Administration, when it comes to trade and international relations in general, has long proven irritating, puzzling and on occasion disturbing to most US international allies and adversaries alike (think of the current diplomatic state of affairs between the US and Germany for example). Until late April though, equity markets had largely ignored the long-term risk that this presented for investors, in good part as a result of a robust US economic environment.

This is no longer the case. Fears of a weakening global economic environment are mounting. Together with a largely unpredictable US international policy (on trade and other issues), these forces are proving to be destabilizing to markets. In the best of times, assessing geopolitical risk is a difficult exercise. It is increasingly clear that it remains, nevertheless, a necessary one.

Jeff de Valdivia