MARKET PERSPECTIVE 2Q 2019

Tariffs Taking Their Toll

CAPITAL MARKETS REVIEW

MARKET MUSINGS

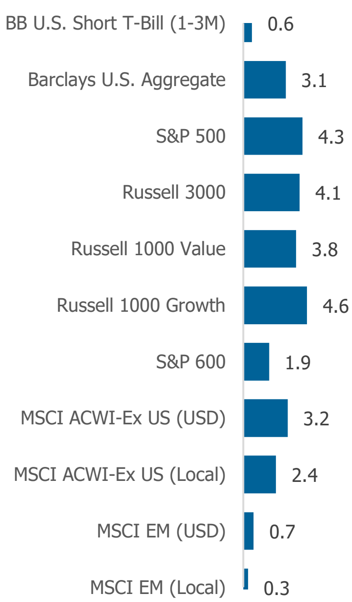
Several key economic indicators are raising concerns in both the U.S. and Europe, driven by tariffs and geopolitical uncertainty. How will central banks respond?

The global economic landscape has been roiled by geo-political events during the second quarter of 2019. Investors are faced with the ongoing saga of Brexit: will they or won't they, and if so, in what form? Tensions in the Middle East are rising. If that were not enough, the main driver of uncertainty remains the topic of tariffs. Not only are markets and the economy dealing with the ongoing trade dispute between the U.S. and China, the U.S. had a brief risk of a tariff war with Mexico, the third largest trading partner with the U.S.

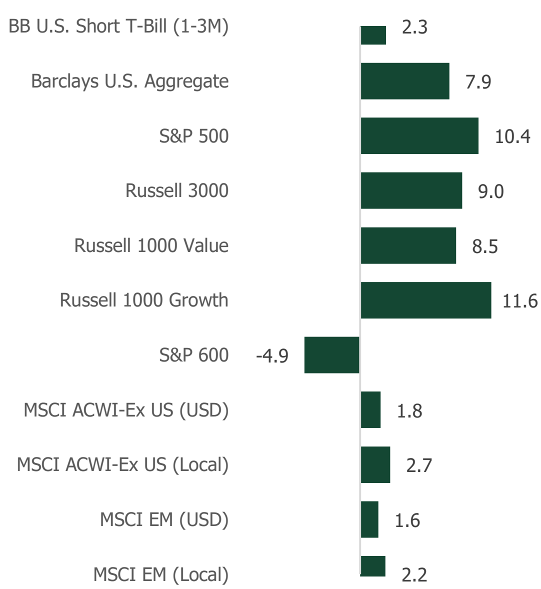
Capital Markets Review

I. GLOBAL OVERVIEW

Market Performance: 3 Month



Market Performance: 12 Month



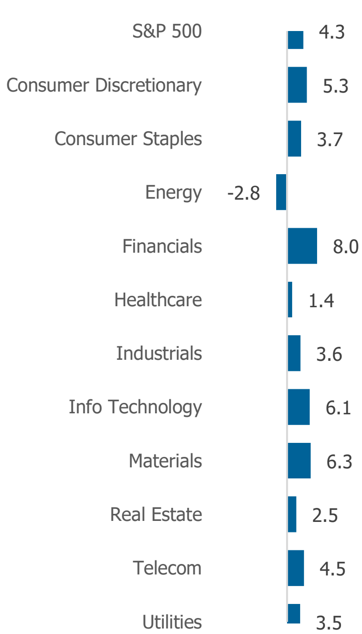
Source: FactSet

Yields declined across the curve in anticipation of future Fed easing.

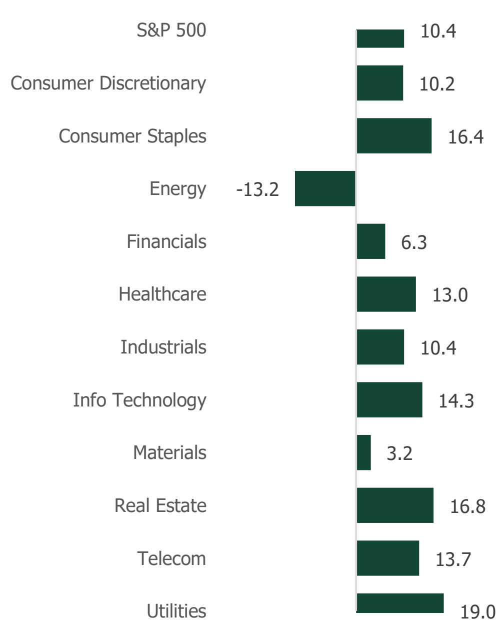
- Fixed income generated strong relative returns during the 3 and 12 months. Small cap stocks have been the notable laggard.

II. U.S. EQUITY MARKETS

Market Performance: 3 Month



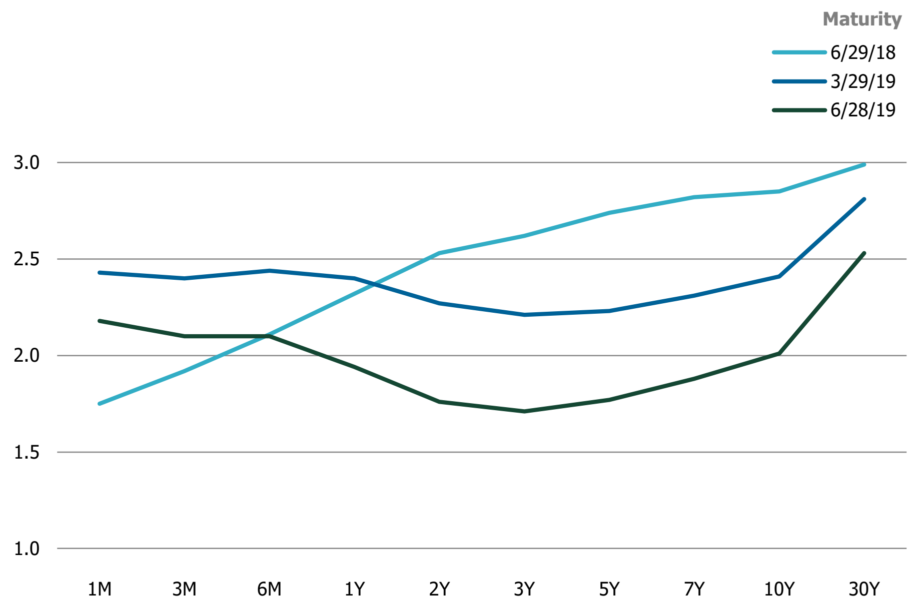
Market Performance: 12 Month



Source: FactSet

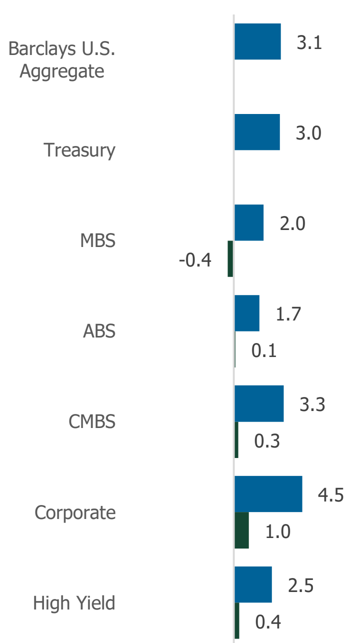
- The energy sector has been weak despite rising Middle East tensions, suggesting weaker global demand growth.

III. FIXED INCOME MARKETS

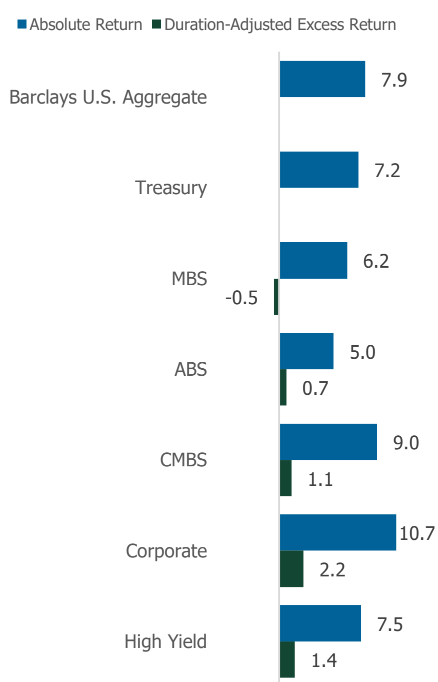


Source: Bloomberg

Market Performance: 3 Month



Market Performance: 12 Month



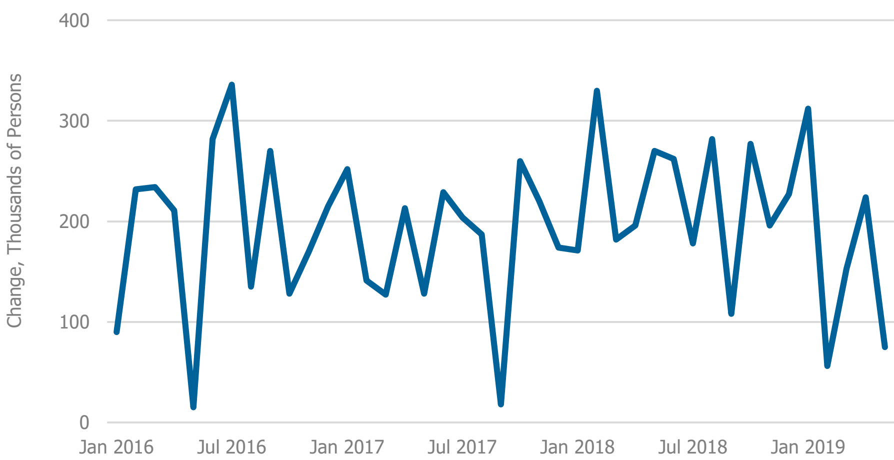
Source: FactSet

Yields declined across the curve in anticipation of future Fed easing.

- The 2-10 spread steepened offsetting the flattening witnessed in the first quarter.
- Sector returns have been strong across the board with the exception of the Mortgage Backed Sector which has lagged due to increased interest rate volatility.

IV. NON-FARM PAYROLLS

All Employees: Total Non-farm Payrolls

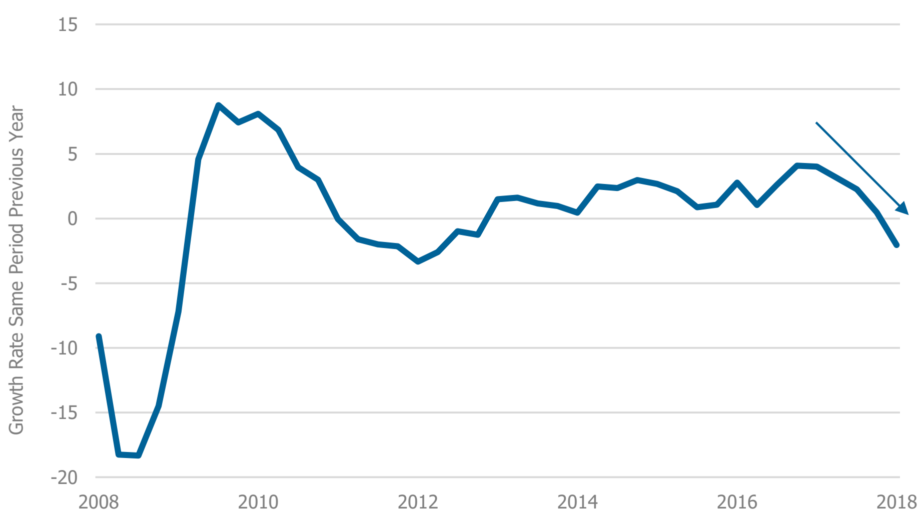


Source: U.S. Bureau of Labor Statistics

- Recognizing this statistic is highly volatile, recent numbers are pointing to a second quarter slowdown versus first quarter.

V. INDUSTRIAL PRODUCTION EURO

Total Industry Production Excluding Construction for the Euro Area

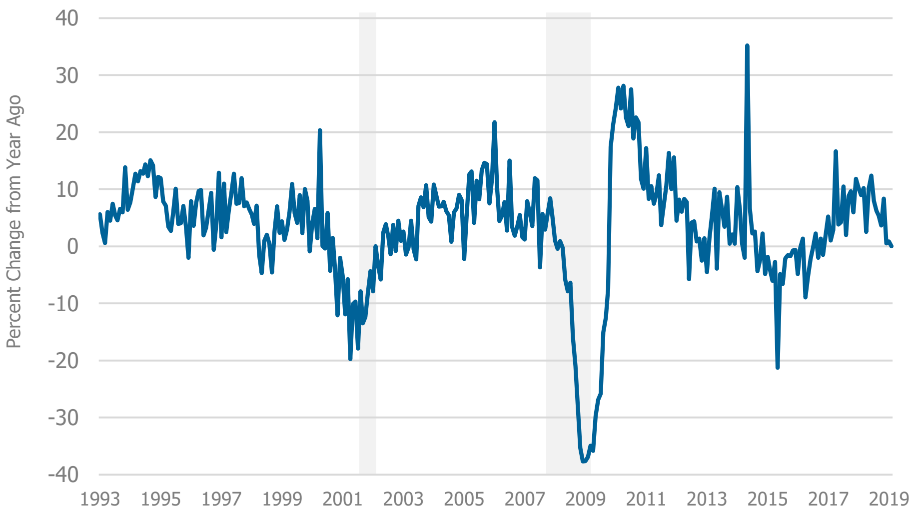


Source: Organization for Economic Co-operation and Development

- Europe is also experiencing slowdown in industrial production as a result of tariffs and slowing global trade.

VI. MANUFACTURERS' NEW ORDERS

Durable Goods



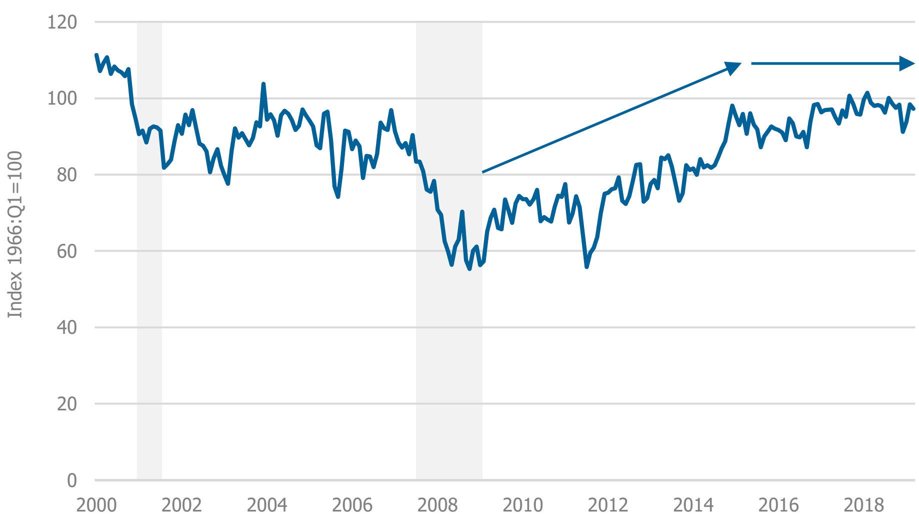
Source: U.S. Census Bureau

Shaded areas indicate U.S. recessions

- Manufacturing, which had shown improvement, has experienced a noticeable slowdown as a result of tariffs.

VII. CONSUMER CONFIDENCE

Consumer Sentiment



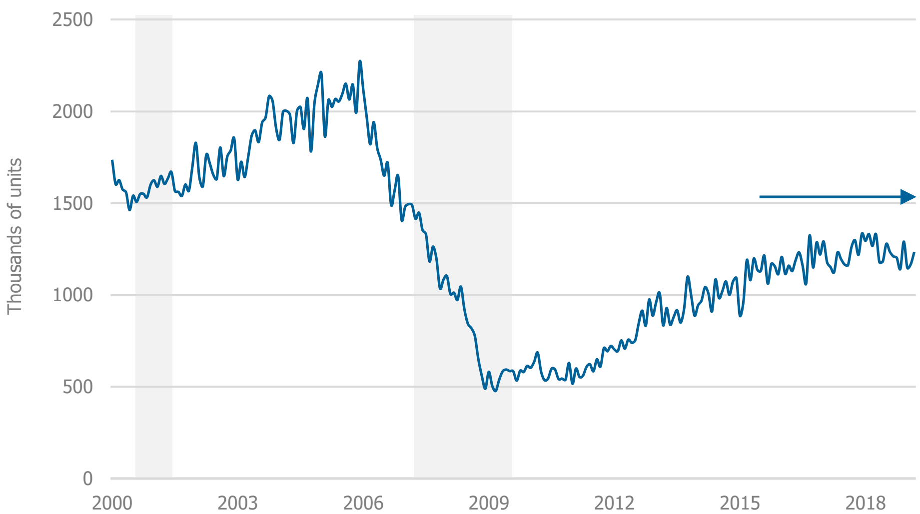
Source: University of Michigan

Shaded areas indicate U.S. recessions

- Consumer confidence has flattened out.
- Given importance of consumer spending to GDP growth, the lack of improvement heightens risks.

VIII. HOUSING STARTS

Total: New Privately Owned Housing Units Started



Source: U.S. Census Bureau

Shaded areas indicate U.S. recessions

- Despite low interest rates, low unemployment and record levels in the stock market, housing starts have plateaued.

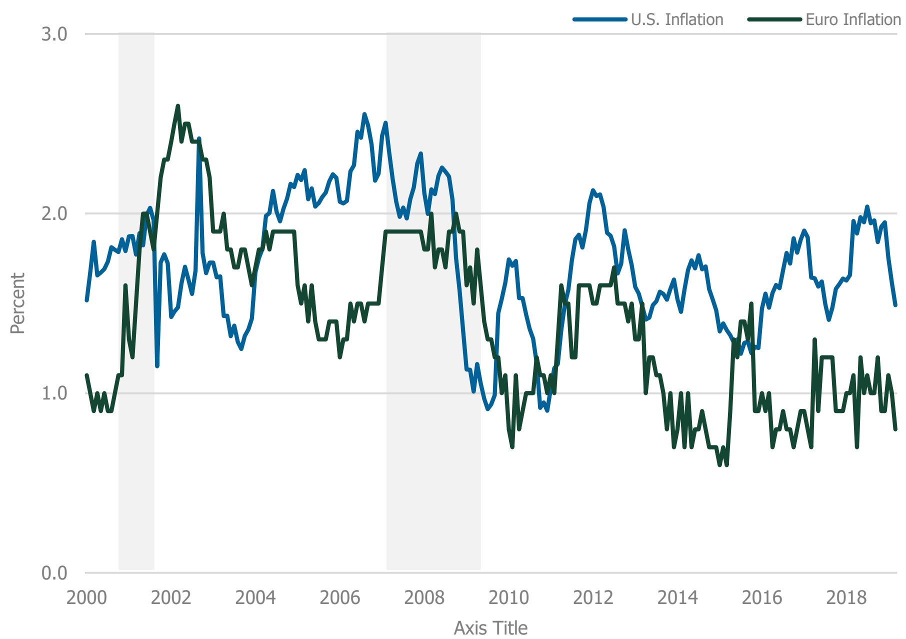
IX. CRUDE OIL PRICES

Brent-Europe

Source: U.S. Energy Information Administration

- Rising tensions in the Middle East have not been able to offset the increase in supply, or more importantly, reduced demand.

X. U.S. VS. EURO INFLATION



Source: U.S. Bureau of Economic Analysis

Shaded areas indicate U.S. recessions

- Inflation remains well contained. The Phillips Curve may have broken down due to globalization.
- European inflation is running well below European Central Bank targets.

XI. 2-10 YEAR YIELD SPREAD

Source: St. Louis Fed

- Curve has steepened modestly during quarter.

Market Musings

The U.S. economy grew at a respectable 3.1% rate in the first quarter of this year, now expectations are being ratchetted down to a 2% growth rate for the second quarter. The growth in non-farm payrolls is a highly volatile, and often revised data point, yet the trend in the past couple months is disturbing (Exhibit IV). Payroll growth averaged 223,000 per month during 2018; the growth has declined to an average of 164,000 for the beginning of 2019.

We have mentioned before how tariffs are a blunt instrument and can easily cause unintended consequences beyond their intended targets. We are certainly seeing this in Europe. Industrial production in the Euro zone has taken a negative turn (Exhibit V). Likewise, in the U.S., manufacturing activity, as measured by durable goods orders, has changed course after beginning a rebound due to the tax reform stimulus in the U.S. (Exhibit VI).

The effects of tariffs are not limited to the manufacturing sector. Consumer confidence, which is a key driver of economic growth, may be reaching a plateau after years of consistent recovery after the Global Financial Crisis (Exhibit VII). More troubling are signs the housing market is beginning to roll over despite low levels of long-term interest rates, confirming declining consumer confidence (Exhibit VIII).

The limited reaction of oil prices to increased hostilities in the Gulf is another indicator pointing to slower global demand growth (Exhibit IX). Typically, one would see an increase in oil prices given negative impact on supply from these developments. The fact prices have not increased leads one to conclude demand is falling to offset expected supply impacts. Inflation, both in Europe and the U.S., is below the 2% Central Bank targets (Exhibit X). Given past monetary stimulus and the increasing levels of public debt to GDP, one would expect to see both higher levels of inflation and interest rates.

We may indeed be in a Brave New World. There is research within the Federal Reserve which is gaining some traction highlighting the need for more flexibility and quicker response when interest rates are low. While not explicitly stating this, the comments coming out of the June meeting suggest the Federal Reserve will change course faster than what we have seen previously, particularly during the Bernanke era. The Federal Reserve (and to a lesser extent the European Central Bank) is faced with ever changing political priorities, strategies and tactics.

The U.S. bond market is certainly factoring in a reduction in short term rates, and it is becoming highly likely the Fed will follow the lead of the market. The yield curve, as measured by the difference between the 2 year and 10 year yields has steepened during the second quarter, and the inversion between 3 month bills and 10 year notes has moderated at quarter end (Exhibit XI). The Federal Reserve may react in time to prolong the economic expansion. Will monetary authorities be forceful enough to curtail the increased political, and hence economic chaos and avert an economic slowdown?

The actions of the central banks continue to make the global equity markets one of the most attractive asset classes! Year to date the S&P 500 has appreciated by 18.5%. Even emerging markets, which has been particularly hard hit by the slowdown in trade and strength of the U.S. dollar, have gained 10.5% year to date.

I had, until recently, thought the phrase “may you live in interesting times” was a blessing to be challenged and intellectually stimulated. Now I have learned it is a curse. We are, indeed, living in interesting times!

John W. Geissinger, CFA
CIO, CBIS

CBIS® Christian Brothers Investment Services