May 20th, 2019

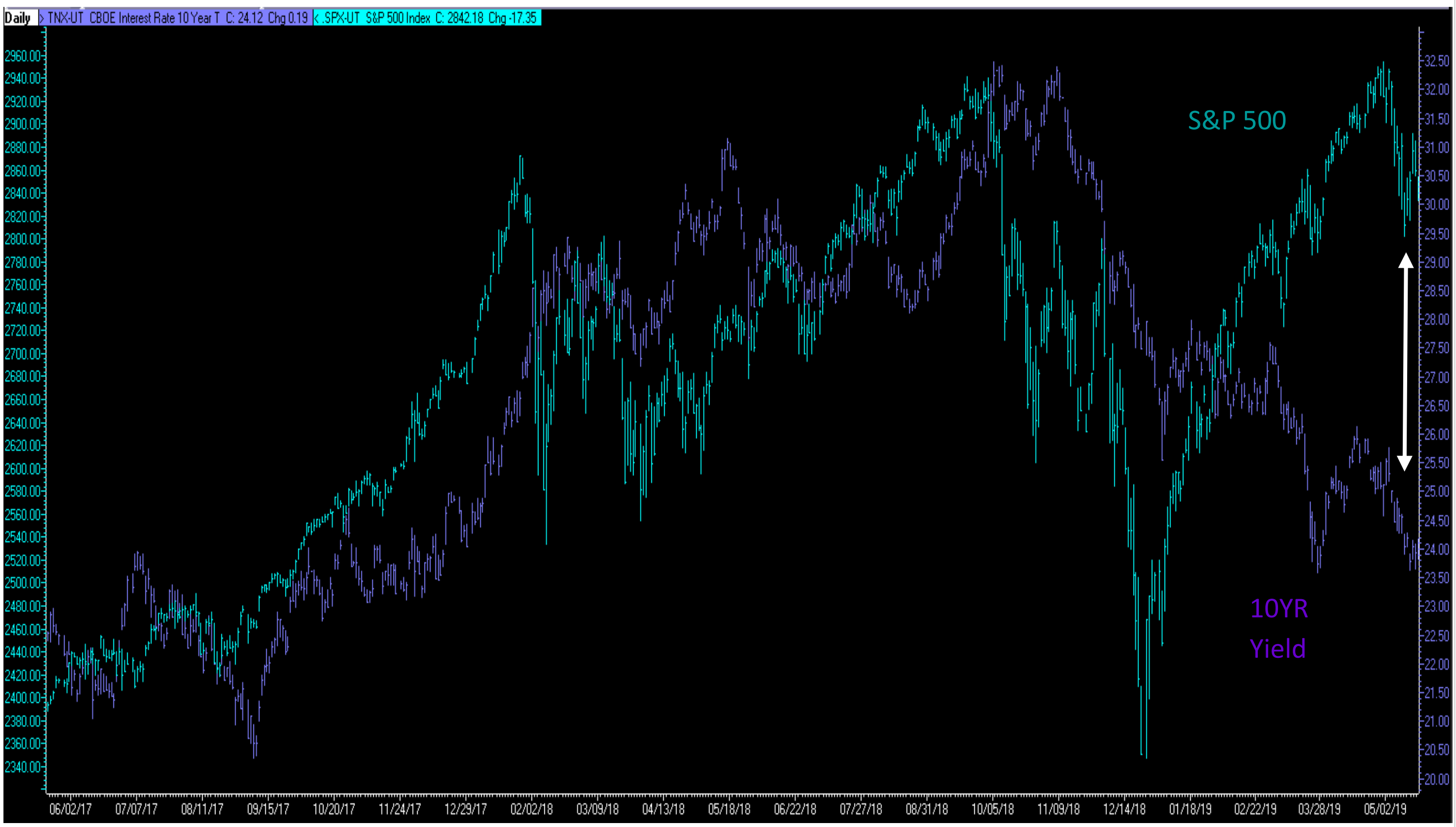
A surprisingly muted response to breakdown in trade talks...
The trade war tension between the U.S. and China has taken center stage as the most important issue for both global growth and asset prices after the events last week and over the weekend indicate the divide between the two nations has escalated materially. Throughout the balance of this year, the narrative surrounding the trade war was all about the talks being "constructive", "progress" being made, and the negotiating parties being "very close to a deal" – it was these phrases that were uttered from both sides in the interest of calming business and investor anxiety as the negotiations were ongoing. It could be argued that these phrases were programed into algorithms and high frequency trading platforms to support risk assets anytime they were used in a statement or shared via Twitter by a key member of the talks – after all, these statements and tweets have tended to be released at times when equity prices were vulnerable or weak economic data was printed. Of course, this is hearsay and conspiracy theory talk, so it's best to keep it in its proper context, but a grand trade deal was used as a carrot for the equity markets since the maelstrom in risk assets at the end of last year.

Now here we are, with the U.S. advising strategic partners to ban Huawei 5G equipment due to security concerns. Additionally, the Department of Commerce added Huawei and 70 affiliates to a list of national security threats. As a result, we've seen several prominent U.S. Tech companies make announcements to adhere to the order: Google will end some Huawei business ties and freeze Huawei smartphones' access to certain Google Apps, Microsoft said it won't support Windows on any computer sold to Huawei, and Intel, Qualcomm, Xilinx and Broadcom have all said they will stop selling chips to Huawei. In order to grasp the significance of these developments, you have to have some context for what Huawei is to China. Huawei is the #1 telecom equipment maker in the world and the #2 smartphone maker (with double digit growth in a shrinking market). It's not a stretch to consider that Huawei is one of, if not the most important companies in China, and these latest actions by the U.S. are a direct threat to their ability to operate around the globe.

I'm not going to get into the political side of the debate or the national security grounds – that is a determination to be made by those with access to much more information than I have or ever will be privy to. That being said, it's my opinion that they are making these decisions based on that intelligence and they are doing so for reasons they have determined are warranted (even if we never know or see all of the angles or are told the whole truth about their motivations). What this boils down to (in my opinion) is that the U.S. just decided to materially crimp one of China's grand champion enterprises. Take for example the decision by Google, which will cause Huawei Technologies to immediately lose access to updates to the Android operating system, and the next version of its smartphone outside of Chain will also lose access to popular applications and services including the Google Play Store and Gmail app. In essence the smartphone that Huawei manufactures no longer has an operating system and as a result they may as well be manufacturing paperweights given a smartphone is useless without an operation system.

I went through all of that to be sure to get the point across that there should be no doubt that this is now a full-blown trade war, and it is likely to take quite a bit of walking back and concessions from both sides to de-escalate the situation. Such a de-escalation is definitely possible, but my guess is that with both sides so dug in that it will take a material breakdown in either's stock market or economy before they'd be willing to reopen two-way negotiations.

Which brings me to the capital markets, and I must admit my surprise that in a week where it became pretty obvious that at best a trade deal is a long way off (and at worst a new cold war is underway), that the S&P 500 lost a grand total of 22 points. Yup, through all the volatility that encompassed last week, the Dow declined -0.7%, the S&P 500 was off -0.75%, and the Nasdaq Composite was hit by -1.27%. Quite an impressive feat, all things considered, and handily above the nearly -4% decline in the Emerging Markets Index (lead by losses in China's Shanghai Composite). Treasury bonds rallied on the week with the yield on both the 2-year and 10-year Notes falling -7 basis points, and both have seen their yields decline -29 basis points on the year. The divergent view between Treasury yields (sitting on their lows for the year) and U.S. equities is becoming pretty extreme, to the extent that either one market has it wrong and a catch up (or down) is inevitable, or some degree of mean reversion is likely. But it's unlikely that the divergence in the following chart can/will persist much longer.



Digging a little deeper into this chart (which begins in June of 2017), I think it's worthwhile to point out and call attention to the following dates:

- January 26th, 2018
- September 20th, 2018
- April 30th, 2019

Those are the days of the last three peaks in the S&P 500 over the last 17 months. I also think it's instructive to look at the levels of both the S&P 500 and the yield on the 10-year T-note on these dates:

- Jan. 26th, 2018: S&P 500: 2,872 vs. 10-yr Treas. Yield: 2.66%
- Sept. 20th, 2018: S&P 500: 2,930 vs. 10-yr Treas. Yield: 3.07%
- Apr. 30th, 2019: S&P 500: 2,945 vs. 10-yr Treas. Yield: 2.51%

While the S&P 500 has made a series of higher highs, the confirmation signal one would want to see out of the bond market would be a series of higher highs in yields as an indication that the bond market expected inflation and economic growth to remain firm or even strengthen. Instead, we've seen yields rollover and especially so since the recent high in the S&P 500 at the end of April, where 10-year yields have slipped -14 basis points to 2.37% – their lowest levels since November 2017 (i.e., prior to the passage of the tax cuts). Since the initial peak in the S&P 500 back in January 2018, of the major equity indices only the Nasdaq (+5%) has generated a positive return. The S&P 500 is down -1% since then, the Dow is down -3.5%, the Russell 2000 Small Cap Index is down -5%, the Dow Transports Index is down -6%, the NYSE Composite is down -7.3%, and the BKX Regional Bank Index is down -17%.

I can understand the appeal of U.S. equities given the U.S. economy is still one of the strongest in the world relative to the other large developed regions like the Eurozone, Asia, and Japan. As a result, there has been a large flow of foreign capital into U.S. assets (both stocks and bonds), and add to this the record setting pace of share buybacks and you have the perfect recipe for risk assets to defy fundamental reality. This relationship can persist for some time, but it's important for investors to be aware of the major variables driving asset prices at the moment, and it's not the fundamentals. Take the semiconductor space for example, which at its peak was up nearly 50% from its December lows, but that rally was occurring in the face of weakening sales, earnings cuts, and bloated inventory stocking. It was a nice run for those in the space while it lasted, but without the support of solid fundamentals, it should come as little surprise to see this index having collapsed -17% inside of the last 30 days.

This isn't so much a harbinger of things to come for the broad U.S. equity markets, but like the growing fragility in the U.S. economy, as an investor you must understand, appreciate, acknowledge, and respect the vulnerabilities if they exist. And yes, I'll reiterate again – even at risk of continuing to sound like a broken record – the vulnerabilities and fragilities in the U.S. economy and corporate earnings are real. We're going from +20% earnings growth in the three quarters ending Q3 2018 to half that at 12.5% in Q4 2018 to 0% or negative earnings growth in the first three quarters of 2019. That's a steep delta. As for the economy, unless we experience a decisive acceleration over the next quarter or two, it looks like the broad swath of economic data peaked over the last six months:

- Household employment peaked in February 2019 – we'll see whether over the next several months the establishment survey corroborates this outcome.
- Industrial Production (IP) peaked in December 2018
- Real Personal Disposable Income peaked in December 2018
- Real Retail Sales peaked in November 2018

It's not by accident or happenstance that I'm referencing these four data points, as they are what the NBER looks at in its recession dating procedure, to wit:

> *"A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.*

The committee places particular emphasis on two monthly measures of activity across the entire economy: (1) personal income less transfer payments, in real terms and (2) employment. In addition, we refer to two indicators with coverage primarily of manufacturing and goods: (3) industrial production and (4) the volume of sales of the manufacturing and wholesale-retail sectors adjusted for price changes. We also look at monthly estimates of real GDP such as those prepared by Macroeconomic Advisers (see http://www.macroadvisers.com)."

I'm not pointing this out to make a recession call, as history has proven that to be a foolhardy endeavor, but rather to alert investors to the yellow cautionary flags that are waving. You don't have to look too hard or far to find evidence that economic growth in the U.S. is slowing. I've pointed out many of these indicators over the last year – admittedly, meaningfully early on some of them – and the latest Cass Freight Shipments report with the corresponding comments is just another example:

APRIL 2019

Cass Information Systems, Inc.

Cass Freight Index® Report

Economic Outlook from Freight's Perspective

Negative Shipment Volume Hits Five Months in a Row

Economic Contraction or Only Retrenchment?

	April 2019	Year-over-year change	2 year stacked change	Month-to-month change
Shipments	1.194	-3.2%	6.6%	-0.3%
Expenditures	2.909	6.2%	19.8%	0.7%

Continued decline in the Cass Freight Shipments Index continues to concern us:

- When the December 2018 Cass Shipments Index was negative for the first time in 24 months, we dismissed the decline as reflective of a tough comparison. When January 2019 was also negative, we again made rationalizations. Then February was down -2.1% and we said, "While we are still not ready to turn completely negative in our outlook, we do think it is prudent to become more alert to each additional incoming data point on freight flow volume, and are more cautious today than we have been since we began predicting the recovery of the U.S. industrial economy and the rebirth of the U.S. consumer economy in the third quarter of 2016."

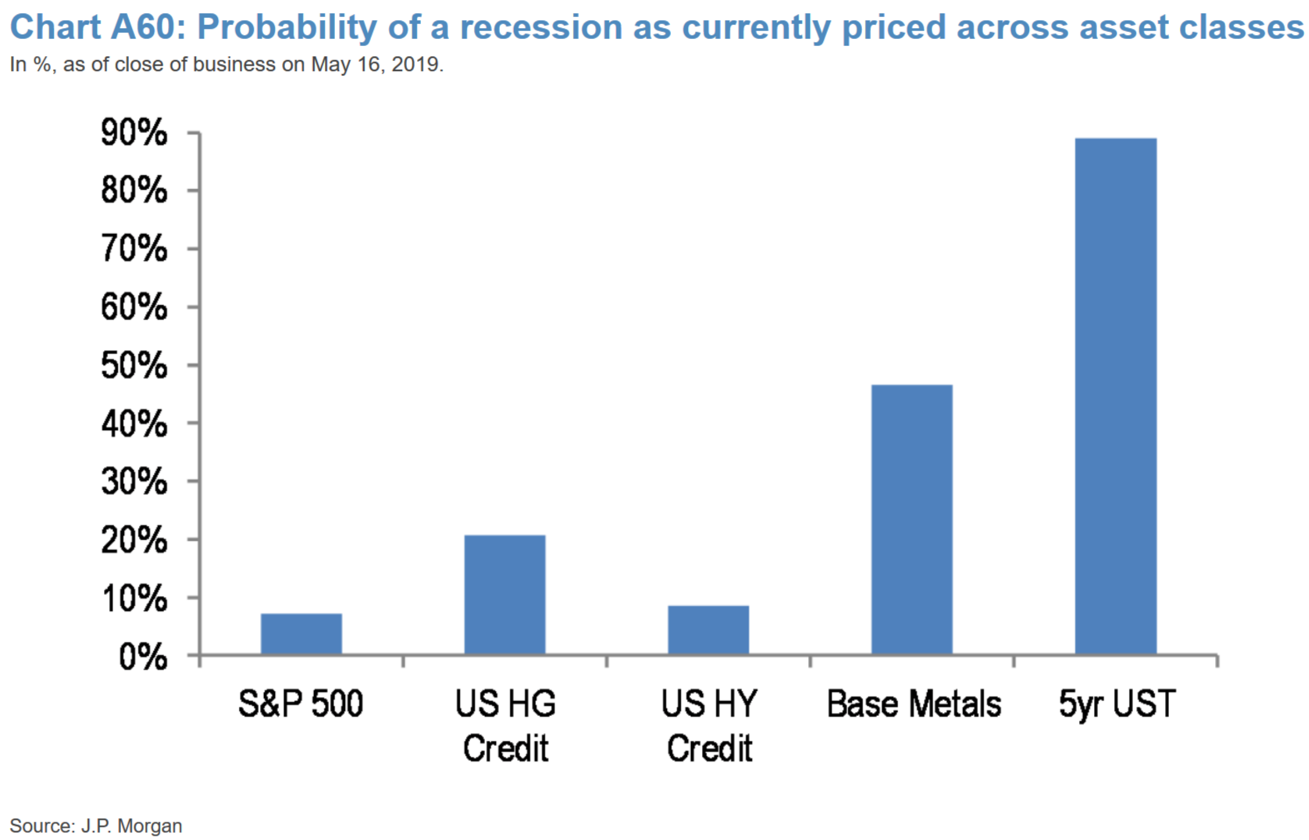
- When March was down -1.0%, we warned that we were preparing to 'change tack' in our economic outlook.

- **With April down -3.2%, we see material and growing downside risk to the economic outlook.** We acknowledge that: all of these still relatively small negative percentages are against extremely tough comparisons; the two-year stacked increase was 6.6% for April; and the Cass Shipments Index has gone negative before without being followed by a negative GDP. We also submit that at a minimum, business expansion plans should be moderated or have contingency plans for economic contraction included.

- The initial Q1 '19 GDP report of 3.2% suggests the economy is growing faster than is reflected in the Cass Shipments Index. Our development of GDP explains why the apparent disconnect is not as significant as it first appears.

- The weakness in spot market pricing for many transportation services, especially trucking, is consistent with the negative Cass Shipments Index and, along with airfreight and railroad volume data, heightens our concerns about the economy and the risk of ongoing trade policy disputes.

Looking at the capital markets today, we have Treasury bonds – the world's risk-free asset – pricing in nearly 90% odds of a recession and the S&P 500 pricing in less than a 10% chance (see below chart from JP Morgan).



And you know what, even with the mixed economic data over the last several months and many of the leading indicators suggesting a high probability of economic growth slowing through the balance of the year, I'm finding it more difficult to have a high level of conviction to say that either market is wrong. I look at last Wednesday when China released three key economic data points for April (Industrial Production, Fixed Asset Investment, and Retail Sales), all of which came in meaningfully below consensus expectations, and then the U.S. followed up with its own disappointing retail sales report, yet both respective equity markets rallied on the day. I can't recall a day in recent memory where the incoming global economic data disappointed to such a degree which would typically warrant a material sell-off in global equites based on the results, but U.S. equities rallied from the opening bell and then went green and stayed that way into the close.

Where does that leave me in regards to my thoughts on the markets and where one should allocate capital? Unsure and with a low level of conviction on any one thing, but with a high level of confidence and comfort that investors should maintain exposure to a broadly diversified portfolio. Based on fundamentals and valuations, it would be imprudent to carry more risk in a portfolio than one has the capacity or ability to take, but on the other hand the meager potential return from low risk investments makes it likewise imprudent to be exposed to too little risk. The one redeeming thing about capital markets over the last 18 months is that the increased volatility, inconclusive data, and extreme sentiment (in both directions) has provided entry points to deploy capital into long-term investment opportunities. So, keep an open mind, remain patient, and understand that tops are processes, because if this is a very extended topping process and at some point in the not too distant future fundamentals do matter again, then there is likely going to be an abundance of opportunity for those willing and able to act upon it.

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