MARINE BANK
Trust & Investment Management
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OUTLOOKS

September 2019

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ECONOMIC OUTLOOK

Summary

U.S. trade relationships with China have seemingly gone from bad to worse. While the conflict should not be a complete surprise given that President-elect Trump threatened to take this action during the campaign and has since made it one of his signature initiatives, the lack of a clear path forward has been unnerving for the markets.

Given the uncertainty created, trade with China should be examined in the context of the overall economy. The U.S. runs a trade deficit with China of roughly $420 billion. We import about $540 billion worth of goods and export $120 billion worth of goods with China. The actual dollar amounts from trade are relatively small when compared to the size of the two largest economies in the world. The overall economic output (GDP) of the United States was approximately $20.5 trillion in 2018. This compares to China's GDP of approximately $13.6 trillion for the same period. Though very important to some industries, our exports to China only represent about 0.6% of our overall consumer-led economy. This amount is not nearly as critical as the 4% that China's exports to the U.S. represent to their manufacturing-led economy.

Notwithstanding the manageable dollar values of direct trade with China, the disruption of supply chains and trade flows that have been established over decades of globalization has had an outsized impact on corporate managers who now have to source products elsewhere. Other countries are also impacted because they trade with the U.S. and with China and are caught in the snarled web that the dispute has created. Given the global uncertainties, it is not surprising that our measurement of new factory orders turned sharply lower in August reaching a level only seen once since the financial crisis and recession more than 10 years ago.

Fortunately, the labor market remains surprisingly resilient with the employed to working-age population ratio reaching the highest level since 2008. Average hourly earnings also increased at a solid 3.2% rate over the past year. Strong employment and wage gains should keep the consumer strong despite the increasing weakness in manufacturing and trade. Consumer spending is much more important to our overall economy. That said, we will be watching for any signs of weakening in the labor market, as well as for further developments with many of our other close trading partners. We do believe that the Fed will step in with a few more rate cuts to offset some of the global weakness and prolong the already historic-in-length economic expansion.

Positives

Personal income and spending numbers have been positive the last few months

Core PCE inflation below the target level allows the Fed to cut rates

Negatives

ISM manufacturing and new order measures are contracting

ISM manufacturing employment measures dropped sharply last month

Unknowns

Trade conflicts impact for trading partners beyond China

Durability of labor market

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EQUITY OUTLOOK

Summary

August was one of the more volatile months in recent memory with the S&P 500 experiencing 10 different up days of 1% or greater and nine different declines of 1% or more. However, aside from the decline to start the month, the S&P stayed in a relatively narrow band, closing the month 1.6% lower and just off the all-time highs set in July. While equity markets certainly saw larger daily swings than they have in recent months, the headline drivers were essentially the same we have been following for many months. The lingering trade dispute with China, uncertainty around Great Britain's exit from the EU, and a broad global economic slowdown continue to dominate the media.

Given the trade dynamic remains uncertain, it's not surprising that international equity markets joined U.S. markets in decline for the month. The developed MSCI EAFE Index fell 2.6% and the MSCI Emerging Markets Index lost 4.9%. In spite of historically attractive valuations, the current geopolitical environment will likely remain challenging for international investors.

A steep decline in interest rates in recent weeks propelled higher yielding utilities and real estate ahead of all other economic sectors in August rising 5.2% and 5.0% respectively. Energy was the laggard shedding 8.1% during the month followed by a 4.8% decline in financial services.

Now we head into September, which has historically been the worst performing and among the most volatile months of the year. In fact, it's the only month during which the S&P 500 has declined more frequently than it has risen. The same headlines that moved markets last month remain with little prospect of resolution in the near term. We expect continued volatility over the coming weeks as algorithmic and day traders react to the latest tweet. We believe, however, investors with a long-term focus on fundamentals should be rewarded.

Positives

- Accommodative Federal Reserve
- Resilient U.S. consumer

Negatives

- Global economic slowdown
- Investor sentiment overly optimistic

Unknowns

- Stalled trade negotiations
- Brexit path and impact

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FIXED INCOME OUTLOOK

Summary

As measured by the most common indices, the U.S. bond market delivered its best monthly return in over 10 years as rates declined sharply across the yield curve in August. An escalation of the trade war with China is most widely credited for the plunge in rates. The ratcheting of tariffs is likely to cause even more disruptions in global supply chains and dampen economic activity both domestically and in China. Collateral damage across Europe will only exacerbate the problems in that region as they struggle with economic challenges of their own.

The 2-year Treasury note declined 27 basis points (bps) to end the month at 1.50%, nearly the exact same level the 10-year note ended after declining by 52 bps. The closely-watched 2-year to 10-year yield spread actually inverted for the first time since the financial crisis, which sent alarm bells ringing that a recession is eminent. The move-in rates can be deconstructed into two equal parts; a reduction in inflationary expectations and a decline in real yields.

The outlook for slower economic growth usually leads to a decline in inflationary expectations which can be easily measured by the difference in the market's forward contracts for inflation-adjusted bonds and regular notes. Deciphering the reason for the decline in "real yields", the yield after taking out the market's expectation for future inflation, is a bit more challenging. Investors are willing to accept next to no real return for an extended period when risks are elevated or there are simply no other alternatives. While risks to the stock market and the economy are elevated, the aggressive buying of assets by the Japanese and European central banks leave foreign investors with few alternatives. There is now approximately $17 billion of debt around the world which has a negative yield (yes, you pay more today than you receive in the future). Investors in these markets are forced to buy the only remaining large, liquid, high-quality market in existence, which is the U.S. Treasury market.

Yields should remain in this exceptionally low range as long as the trade impasse persists. Given that the Chinese leadership has little reason to give in, the disruption can become even greater, in which case the economic and inflationary outlooks would likely dim further. Given the demand by global investors, there is little reason to fear that interest rates will shoot markedly higher even if there is a near-term truce on trade.

Positives

- Negative yields in other markets make even our low rates attractive
- Inflation rate likely to continue to be below target rate

Negatives

- Longer yields at or near generational lows
- A resolution to trade dispute could unleash economic optimism pushing rates higher

Unknowns

- China's tolerance for pain as their highly-levered economy slows
- Geopolitical risks remain with Iran, North Korea and Russia