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When Trade Becomes a Contact Sport

Todd Asset Management Q2 2019 International Market Commentary

	2Q 2019	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
MSCI ACWI ex-US (Net)	3.0%	13.6%	1.3%	9.4%	2.2%	6.4%	6.5%
MCSI ACWI (Net)	3.6%	16.2%	5.7%	11.6%	6.2%	9.9%	10.2

* *Annualized Total Returns.*

Years ago, I lived in a part of the country that was a hotbed of fans for NASCAR, the stock car racing association. After one brutal afternoon when a lot of drivers "traded paint" (slang for sideswiping each other), more than one car wound up spinning into the infield after getting hit. After the race, a sportscaster asked the winner about the contact on the track. His answer… "Well, that's racin!" Examining the quarter we just wrapped up, we could almost make the same observation on trade policies and world markets. Maybe we would say something more like "That's tradin!" but make no mistake, trade negotiations have become a contact sport over the past year. Major concerns for the quarter included:

- The threat of new trade tariffs between the US and China.
- Bond yields declining, and sentiment that economies would weaken.
- British PM May resigning, leading to worries about a disorderly Brexit.
- Softer global manufacturing and weaker business confidence.
- Deflationary concerns in most developed markets.

Major positives from the quarter were:

- Most Central Banks (including the Fed) have pivoted to easing policies. As they undertake stimulative policies, we would expect economies to firm up.
- Chinese fiscal stimulus is expected to counter the negative impacts of the trade tariffs. European populism could lead to further fiscal stimulus. Both would be positives for growth.
- Labor markets remain firm, with wage gains evident in the US and other developed economies. Recessions generally do not occur when jobs are plentiful.
- Market action effectively lowered borrowing rates across all maturities.
- The US and China are expected back at the negotiating table after mutually inflicted trade dispute pain. If President Trump wants to get re-elected, he will need a deal to garner the support of swing states.

Markets started the quarter continuing the advance that had been underway since bottoming last December. Growth concerns were still evident during the first quarter as manufacturing and investment indexes had generally been underwhelming. Chinese manufacturing indexes had weakened in late 2018, showing that the manufacturing economy was stagnating. European and Japanese manufacturing indexes weakened into contraction territory early this year and have stayed there. Uncertainty in the outlook is what is currently driving this weakness as business confidence is lacking given trade uncertainties. Most of those uncertainties have originated in the US.

Global trade has been a sore spot for the US administration, as President Trump believes the Rest of the World is taking advantage of the US. Since being elected, he has been "trading paint" with our global partners, and made negotiating a contact sport. His methods generally bring confrontations to the brink of disaster before finding some way to salvage the negotiations. This is evident by the way he negotiated the US-Mexico-Canada Agreement on Trade to replace the North American Free Trade Agreement in early 2018. We have also seen this play out with European conversations about Auto imports a year ago, and recently with the Mexican and Chinese trade negotiations in the past quarter.

The US initiated trade tariffs of 10% on approximately $200B of product that the US imports from China during 2018. Negotiations for a trade deal ensued. Investors entered the second quarter of 2019 believing a trade deal was near. Most observers recognized that global manufacturing indexes were suffering because of tariff uncertainty, and assumed that a deal was in the best interests of both the Chinese and the Americans. Additionally, Central Banks were backing away from aggressive tightening plans and started to sound more supportive of monetary accommodation as inflation expectations had started to deteriorate in the face of uncertainty. In May, the narrative changed. After the Chinese delegation deleted many significant elements of a proposed agreement, President Trump called off the deal and instituted 25% tariffs on the $200 B of Chinese imports that had been taxed at 10%. The US Trade Representative filed paperwork to institute tariffs on the $300B in Chinese imports that had not been taxed. The US banned installation of Huawei telecom equipment (the Chinese national champion) and proposed banning US companies from supplying them. Many US companies stopped their supplies to Huawei. The Chinese retaliated by floating the idea of banning exports of rare earths to the US. These are used in the production of many electronic products, and could cause serious disruptions for many US Tech companies. Equity markets rioted, bond yields plunged and the month of May was challenging for most stock investors.

Markets bottomed in late May as tensions reached a crescendo. On the positive side, the US and China came to an agreement on Huawei. Countering that, the US turned its attention to border security. Tariffs of 5% were proposed that would increase monthly unless Mexico bolstered their security to prevent immigrants from Central America from crossing Mexico to the US border. Needless to say, the US is Mexico's biggest trading partner, and an agreement was reached to avoid tariffs and increase security.

June saw positive developments on the trade front as the US and China agreed to meet at the G20 meeting and restart trade talks. Economic results remained softer though, and both the ECB and the US Fed committed to easier policies in the future. Bond yields for most countries declined dramatically, as the German 10 year Bund yield declined from .01% to -0.32% during the quarter. French 10 year yields went negative and US yields declined dramatically as well.

Several issues still need to be resolved. Brexit appears to be becoming more disorderly as time goes on and a new British PM is selected. The current front runner is Boris Johnson, an avowed Brexiteer who believes the UK should leave the EU without a deal if an advantageous deal is not on the table. These fears could negatively impact the economic outlook.

Economic conditions are weaker worldwide, primarily due to manufacturing. Services have generally remained firm in most economies, offering a strong base to build on. The trade truce with China, coupled with the stabilization of oil prices coming from the OPEC+ meeting should make for a constructive backdrop for the economy and business confidence. Markets are off their lows, but most participants still act pessimistically. Lower rates and more growth visibility could change that for the better for markets. If the central banks ease, and capital spending picks up in response to tighter labor markets, then a larger reacceleration of the economy could be in the works than the market currently anticipates.

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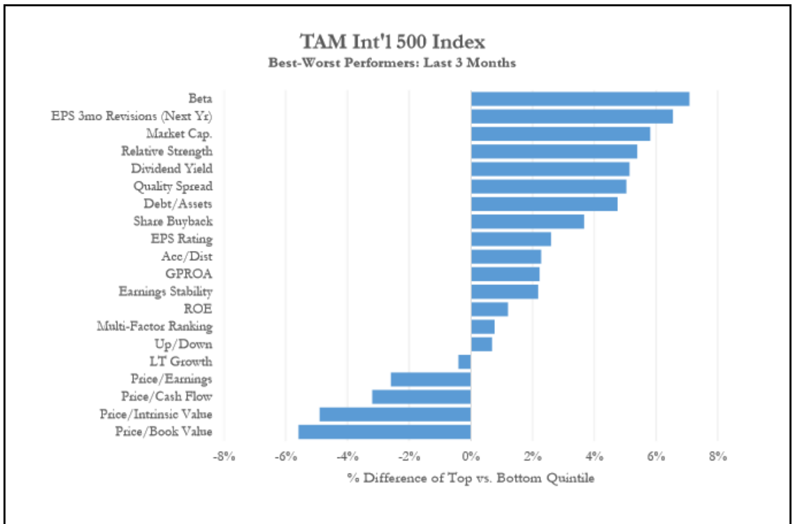
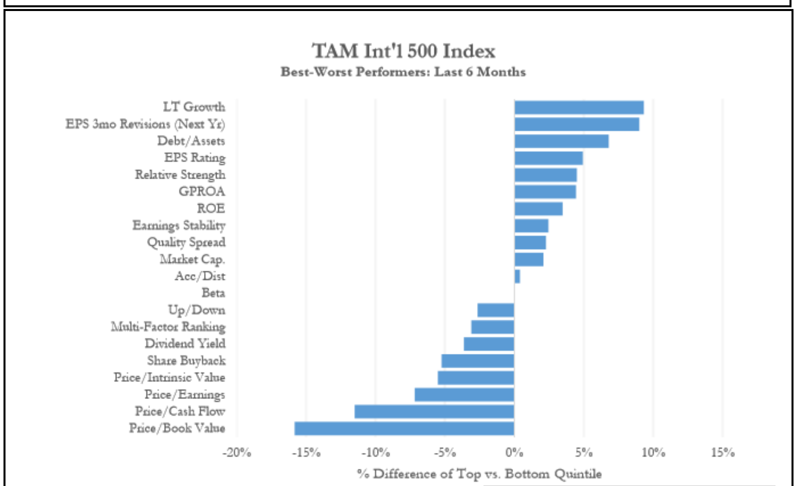
Factor Watch- GAAP now means "Growth at Any Price"

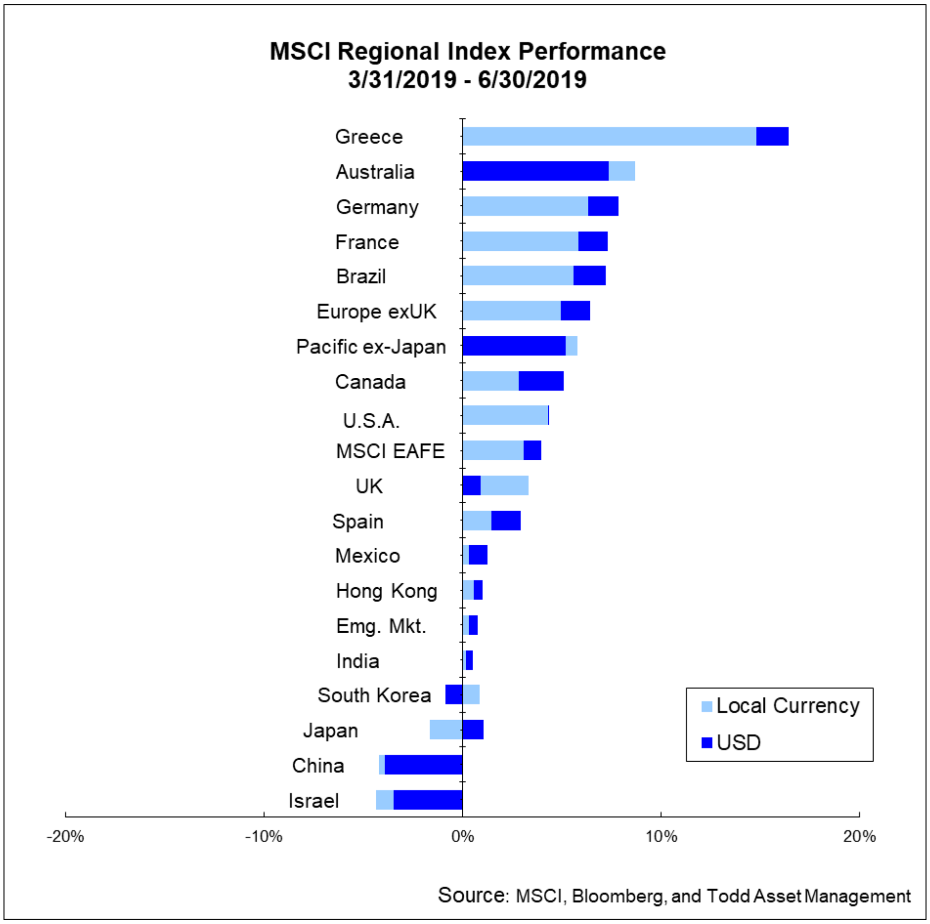
Our customary review of the factors that have helped and hurt performance over the past quarter (top chart) and year to date (bottom chart) periods ending 6-30-19 are presented below. As a reminder, these charts measure the difference between the highest ranking 20 percent of our TAM International index (equal weighted) based on each of these factors versus the lowest ranking 20%.





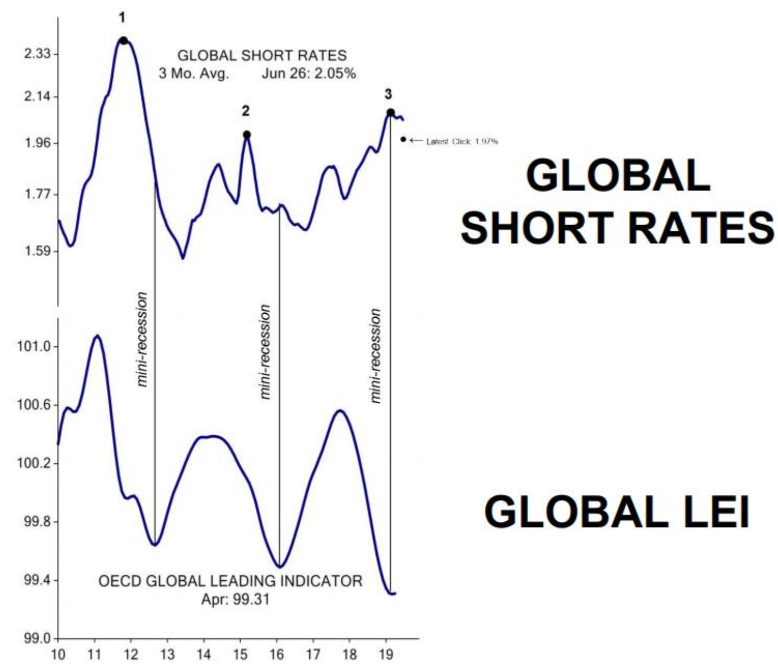
Source: TAM and Bloomberg

Growth at any price seems to be the consistent theme we have seen when we examine both the International and Domestic markets. In an encouraging sign for fundamental investors, more factors are adding value in the most recent quarter. In both the past quarter and YTD periods, valuation measures are at the rock bottom of the rankings. This has been the case for some time now, as investors' angst about economic growth has led them to avoid the economically sensitive cyclical sectors. Investors appear to be willing to pay any price for high assured growth stocks as High Growth has outperformed Low Growth by 10% YTD and Low Price to Book stocks have underperformed expensive ones by 15% as well. Investors seem to be suspicious of value, and consider most inexpensive names to be damaged goods. This mindset began during the early part of 2018, as investor confidence suffered when the Central banks were trying to normalize rates. This led many investors to question if the expansion can continue, so they are not willing to venture into cheaply valued stocks like the Financials or Energy stocks as they have no confidence that their economic underpinnings will last. As some concerns are resolved, we expect a rotation back towards the value oriented stocks.



European markets generally led regional performance during the quarter. Reasons for the strength ranged from Greece electing a conservative parliament after four years of leftists governing, to Germany and France benefitted from the ECB indicating a willingness to ease. Australia benefitted from Central Bank Easing and Brazil benefitted from advancement in their Pension Reform bill. At the other end of the spectrum, Israeli markets sagged after politicians failed to form a government and called new elections. Chinese, markets sagged after the trade dispute became a concern again. Japanese and South Korean markets saw incidental pressure from the Chinese/US trade dispute, and ended the quarter by starting their own trade dispute.

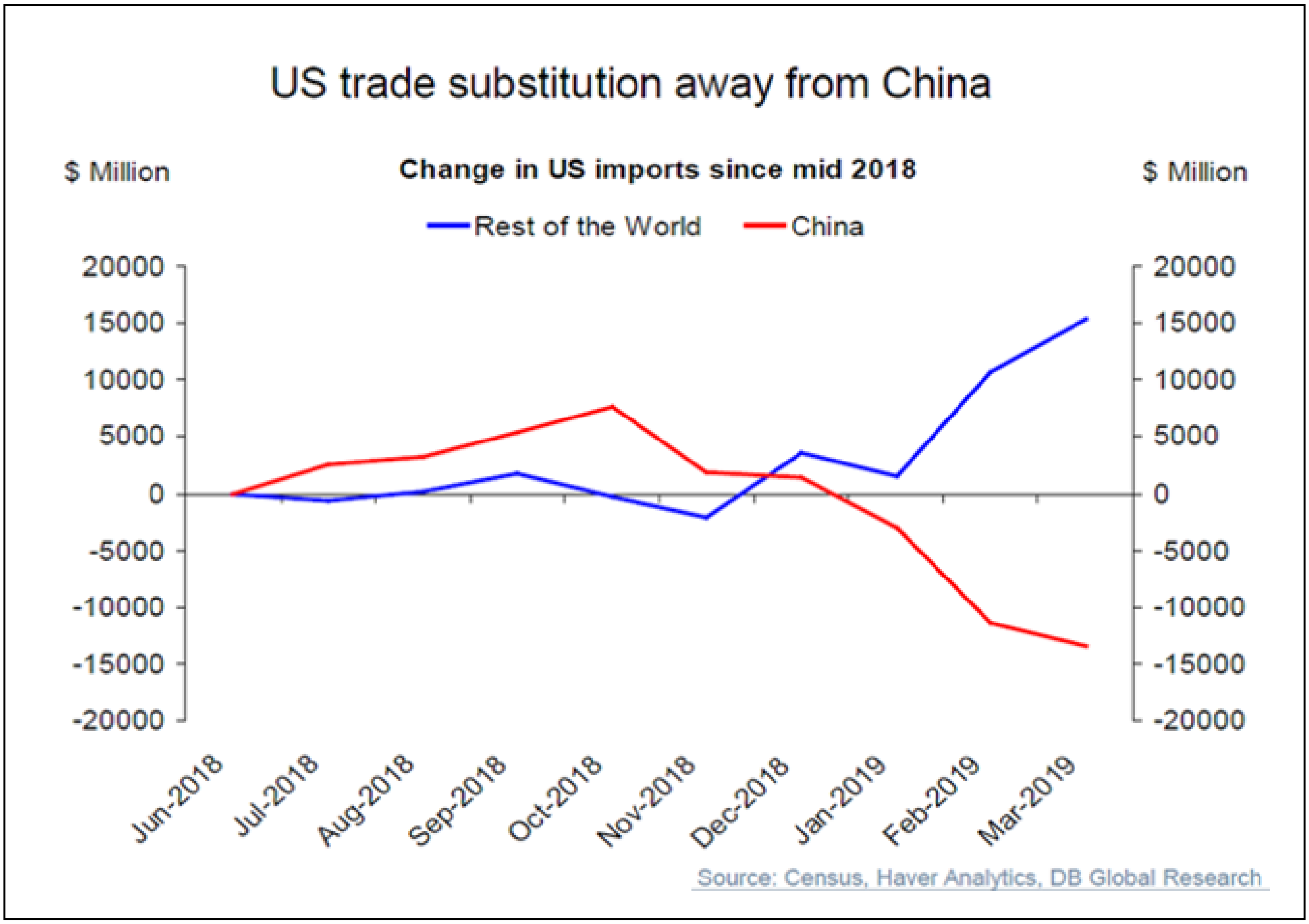
Interesting Charts we saw this Quarter



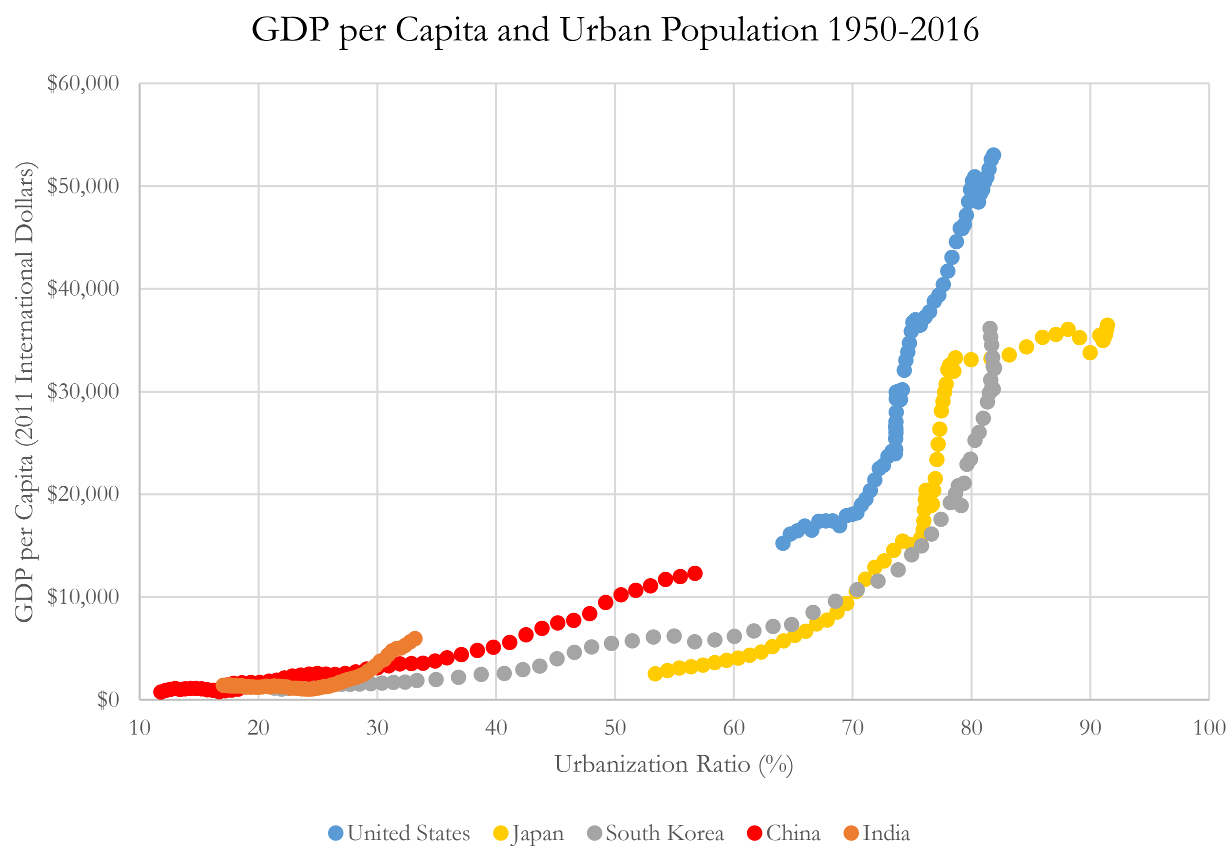
Source: ISI

The chart to the left illustrates the relationship between Global Short Term interest rates and the Leading Economic Indicators (LEIs). Global LEIs have sagged, as the chart to the left from ISI indicates. Since 2010, this is the third time they have sagged into what ISI characterizes as a mini recession. In each instance, rates were in the process of decreasing which allowed for a recovery. Currently, we have seen the Fed, ECB and BoJ promise easier policies, while China is still cutting reserve requirements. This should set the stage for an upturn as the year progresses.

The relative performance of the US versus Europe is at an extreme we have not seen before. We believe a reversion to the mean is likely, and could be dramatic.



Since the trade dispute started, US Imports from the rest of the world have skewed away from China and towards other sources. While overall imports are only down 2% y/y, monthly imports from China are running down 10-30% versus prior year periods since November of 2018. Supply chains are shifting to other countries, and this shift is unlikely to end even with a trade agreement. This should benefit some other emerging market players in Southeast Asia and Latin America, but it probably forces China to pursue more stimulus and further open their markets to the rest of the world.



Source- TAM, UN World Urbanization Prospects, 2018

The chart above plots the progression of per capita GDP versus the percentage of the population living in an urban center. While no time is attributed to the observations, the left side of the data starts in 1950 and the right side ends in 2016. Higher rates of urban concentration correlate with higher per capita GDP. Intuitively, this makes sense as urban dwellers are more likely to be in higher producing services or manufacturing positions as equipment and productivity allows for fewer agricultural workers. China is still only at 56% urban population. Historically, when that concentration gets north of 70%, GDP per Capita increases dramatically. China does need to continue to open their economy to garner the full benefits from this, and they may have a reason to do so based upon the prior chart. If there is a silver lining for China from the trade dispute, it might come in the form of being forced to open their economy more to the outside world to sustain their growth and realize this progression.

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Summary

Heightened concerns were evident during the second quarter as the US/China trade dispute took center stage and bond yields plunged globally while investors worried about deflation. Looking forward, there are a number of worries still present. The potential for a disorderly Brexit leads us to think that a recession is possible, but we do not think it is probable at this point. The US and China are still stimulative. The European Central Bank is becoming more dovish, and their proposed new leader, Christine Lagarde, is a politically savvy financier. Europe needs a dose of fiscal stimulus, as their monetary policy has reached its limits. In her prior role as the head of the International Monetary Fund, she designed growth friendly policies that were implemented by Spain, Portugal and Ireland, three of the fastest growing economies in Europe. She likely knows what needs to be done to get Europe growing again, let's hope she can convince the bureaucrats at the EU to implement some pro-growth reforms. While we are worried about the possibility of a disorderly Brexit and Japan instituting a Value Added Tax, we want to see how those developments play out a little longer before working them into our forecasts. In the absence of those, we still believe some form of trade deal is likely between China and the US. It would be in both of their interests, and if President Trump wants to win re-election, we believe an agreement would have to be made over the next few quarters. As we get closer to that, our sense is that it would be a positive development for the world growth outlook and markets. It could also spur a rotation towards International investing and away from the US, especially if the dollar weakens.

As always, if you need any additional information, please feel free to contact any of us.

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07/19/19
MSCI ACWI ex-US (Net) – 234
MSCI ACWI (Net) – 261

MSCI ACWI ex-U.S. (net) Index is a float-adjusted market capitalization index that is designed to measure the combined equity market performance of developed and emerging market countries excluding the United States. The ACWI ex-U.S. includes both developed and emerging markets. For investors who benchmark their U.S. and international stocks separately, this index provides a way to monitor international exposure apart from U.S. investments. The Net Index takes into account the impact of foreign tax withholdings on dividend income.

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