Investment Perspective

FUNDAMENTALS HAVE TAKEN A BACKSEAT TO TRADE HEADLINES AND GEOPOLITICAL ISSUES

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Traditionally, economic fundamentals — economic activity, corporate earnings, interest rates and inflation — are the medium to long-term drivers of stock prices. However, over the past 18 months and certainly within the third quarter of 2019, these fundamentals have taken a backseat to trade headlines and geopolitical issues — much more than have historically been the case. Here, we'll take a closer look at how these factors have been driving market volatility.

Ups and downs even out

Stocks rallied early this year when the Fed shifted gears, communicating it was on hold, and favorable trade headlines hinted at measurable progress. While we've since seen pullbacks, they haven't amounted to anything out of the ordinary — two drawdowns totaling less than 7% each.[1] (Both were tied to an escalation in U.S. - China trade tensions, which we'll delve into below).

Figure 1 illustrates both the volatility we've seen and the impressive year-to-date performance. But you can also see that the broader market today is hovering near the same level as one year ago.

Figure 1

S&P 500 Index

Data Source: St. Louis Federal Reserve Oct. 1, 2019

Figure 1 also provides an overview of how headlines related to news from the Federal Reserve and U.S.-China trade negotiations have impacted market performance. Let's take a closer look.

In fourth quarter 2018, trade tensions and fears that the continued Fed rate hikes would lead to recession instigated a significant sell off in equity market. However, performance rebounded in first quarter 2019, when the Fed shifted to a less aggressive stance on rate increases and U.S.-China trade negotiations seemed on a positive path.

Sentiment favoring a much-anticipated trade deal evaporated in early May when China backtracked on previously agreed-upon terms. The U.S. retaliated by slapping on new tariffs. The added uncertainty dampened bullish sentiment, leading to a 6.8% drawdown.

In early June, the Fed shifted course again, hinting that it was open to actually reducing interest rates. Coupled with a de-escalation in trade frictions, stocks rallied to new highs in July. The rally abruptly came to a halt in August when the U.S. slapped new levies on China again. Tit-for-tat retaliation created a new round of uncertainty — until tensions between the two countries once again subsided, lifting sentiment in September.

There is no question that the trade war has dampened business confidence and caused an observable suppression in capital spending across many economies. The resulting global slowdown has infected the otherwise relatively healthy U.S. economy, which has downshifted to more moderate growth rates.[1]

It's difficult to model how the trade war may ultimately impact U.S. economic growth because we lack a modern precedent. Nonetheless, analysts fret over the possibility that the freeze on investment planning could result in cutbacks on hiring, impacting consumer confidence and spending. It's a plausible scenario that is consistent with some of the signals we've seen lately in payroll growth and retail sales.[1]

The ongoing trade war is impacting China as well. U.S. imposed tariffs and sanctions have put a dent in Chinese competitiveness, and global supply chains are considering alternatives for off-shore production.

Revived negotiations this month have focused on a narrow agreement to resume U.S. agricultural exports to China in exchange for termination of tariffs on Chinese consumer electronics imports. While a "skinny deal" that addresses farm exports is politically appealing, the price is high from the U.S. perspective and would likely insure that a comprehensive agreement including protections against intellectual property theft and forced technology transfers will not happen before next year's elections. Without those protections in place, a narrow deal would be considered weak in the U.S., and President Trump has shown no inclination to abandon those primary objectives in the negotiations.

In addition, China is likely monitoring the U.S. presidential polls and the current impeachment inquiry. As the 2020 election approaches, it increasingly appears that China may decide to wait out the election and the impeachment inquiry and not pursue serious negotiations until after a new administration is possibly in place. The risk for China in that scenario is tariff escalation and continuing agitation to the global supply chain.

Other significant geopolitical headwinds

While U.S.-China trade negotiations have had the largest impact on market performance over the year and the third quarter, other geopolitical issues have added to volatility.

- The recent attack on Saudi oil facilities took nearly 6% of the global oil supply offline in mid-September.[1] Oil prices temporarily jumped, but market reaction was muted, as investors saw little potential for longer-term economic damage, reassured largely by growing U.S. domestic production.
- Meanwhile, the UK faces an October 31 deadline to sign an agreement with the EU. While some progress has been achieved in resolving the thorny problem of the Irish border, it's not clear that the complicated riddle has been solved. Prime Minister Boris Johnson has threatened to lead the U.K. out of the E.U. in a chaotic hard Brexit if no compromise with the E.U. is achieved in the near future. The situation is fluid and unfolding but expectations are more likely to see another extension in the deadline to give the U.K. time to hold an election, avoiding additional uncertainty and volatility in the near term.
- The presidential impeachment inquiry remains top-of-mind for many investors. One possible casualty — the recently signed trade agreement with Mexico and Canada designed to replace NAFTA, formally the USMCA and known as NAFTA 2.0. During the 1973-74 Watergate hearings, stocks entered a downdraft as the U.S. entered a steep recession, driven by restrictive monetary policy and accelerating inflation. But during the Clinton impeachment hearings in 1999, stocks surged amid strong economic growth, stable interest rates, and low inflation. Although there are differences, today's economic environment more closely resembles the late 1990s. The President's potential removal from office appears to be a low probability at this point, however if that assessment were to change, the markets would likely begin to discount less friendly policies toward economic growth.
- Elsewhere, the Fed's messaging regarding cutting the Fed Funds rate has been guarded, however their actions are more clear in moving the policy rate closer in sync with the decline in global interest rates that has occurred this year. The Fed has reduced rates twice in Q3, and Fed Chief Jerome Powell hinted that the Fed is eyeing another reduction at in late October. In late September, at quarter-end, short-term credit markets experienced hiccups that required Fed-injected liquidity to restore order. We aren't overly concerned, and as expected a new Repo facility has been inaugurated by the New York Fed, which executes open market operations, to augment liquidity conditions as necessary. Interest rate gyrations are normal at quarter-end and our assessment is that the source of the disruption largely relates to regulatory and capital adequacy requirements, as opposed to a systemic and more concerning liquidity shortage. At this point we are inclined to agree with Chairman Powell that the new Repo facility does not qualify as renewed quantitative easing.

HANCOCK WHITNEY

Consumers shoulder U.S. economic growth

So far this year, we've seen job growth, low layoffs, modest wage gains, lower taxes and falling interest rates support consumer confidence and spending. September's drop in the unemployment rate to a 50-year low of 3.5% was encouraging.[1]

However, the reports aren't all roses and sunshine. Although job growth has prevented the jobless rate from rising, growth has moderated in response to a slowdown in U.S. activity. For instance, as Figure 2 shows, non-farm payroll growth has slowed since Q1, in line with slowing trends in Real GDP growth from 3% last year to 2% this summer.

Figure 2

Nonfarm payrolls - change from year ago

Data Source: St. Louis Federal Reserve

Furthermore, given the current weakness in manufacturing, sluggish capital spending and modest housing investment, we don't believe consumers can carry the economy indefinitely. Spreading recessionary conditions in Europe, slowing growth in China and potentially escalating tariffs could eventually take a toll on consumer sentiment. Still, the primary driver of household consumption is employment, and while payroll growth has decelerated it remains sufficient so far to accommodate new entrants to the work force. Housing is responding in modest fashion to falling mortgage rates, and the consumer confidence remains elevated.[1] Our expectation continues to be that U.S. Real GDP growth is trending in a 2.0-2.5% range, at least through 3Q19, with a sense that growth is migrating to the lower end of the channel. Important signals on employment, consumer spending and manufacturing in September pointed to the possibility of growth slowing further, under 2% on a Real GDP basis. We continue to monitor these signs closely.

The outlook for the rest of this year and into 2020 is burdened by continuing trade frictions and domestic political volatility in both major parties. The longer the tariff escalation agenda persists the greater the risk of global economic destabilization. While Presidential election cycles often present choices and outcomes that cause market reactions, the 2020 elections appear to present the potential for disrupting and surprising outcomes.

Bottom line

Between traditional economic fundamentals and the more prominent role that geopolitics is playing in market performance, the economic environment is nothing if not uncertain. This can be unsettling to any investor but you're not alone. There are actions you can take to mitigate risks. If you would like to review your current plan with a financial specialist and discuss how best to position your portfolio for this environment, please contact us to schedule a personal consultation. We're here to help.

Index Return Summary as of September 30, 2019

Index Name	3Q 2019	Year to Date	Last 12 Months
Equity			
S&P 500	1.70%	20.55%	4.25%
Dow Jones Industrial Average	1.83%	17.51%	4.21%
MSCI All Country World Index (ACWI)	-0.03%	16.21%	1.38%
MSCI Europe, Australasia and the Far East (EAFE)	-1.07%	12.80%	-1.34%
S&P MidCap 400	-0.09%	17.87%	-2.49%
S&P SmallCap 600	-0.20%	13.46%	-9.34%
Equity Satellites			
MSCI US Real Estate Investment Trusts (REIT)	7.69%	26.82%	18.31%
MSCI Frontier Markets	-1.09%	10.66%	5.87%
MSCI Emerging Markets (EM)	-4.25%	5.89%	-2.02%
Alerian Master Limited Partnership (MLP) Infrastructure	-5.07%	11.79%	-6.43%
Bloomberg Commodity	-1.84%	3.13%	-6.57%
Fixed Income			
JPMorgan Emerging Market Bond Index (EMBI)	1.50%	12.99%	11.57%
Bloomberg Barclays U.S. Intermediate Aggregate Bond	1.38%	6.18%	8.08%
FTSE World Government Bond Indes (WGBI)	-0.11%	5.39%	6.78%
Bloomberg Barclays Municipal 1-10Y Blend 1-12Y	0.81%	4.73%	6.42%
Bloomberg Barclays US Corporate High Yield	1.33%	11.41%	6.36%

Source: Morningstar

About Our Authors

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Sources

[1] Bloomberg Finance, L.P.