
# Investment Perspective

## Q2 RECAP - A STORY OF OPPOSING FORCES

David Lundgren, CFA
Chief Investment Officer

Paul Teten, CFA
Chief Investment Strategist

July 2019

# Q2 Recap

What happens when an irresistible force meets an immovable object? Or, more to the point, what might happen when the uncertainty generated by a protracted trade war bumps up against an increasingly dovish Federal Reserve? The market responded to that question throughout the second quarter and ultimately came up with "not much" as an answer.

Which is to say, despite the strong start that Q1 gave to the year, Q2 has given us a bumpy ride that ultimately ended with modestly positive results. Q2's story has been dominated by those opposing forces—trade tensions and a dovish Fed. The end result has been unexceptional gains in the broad-based indices, as modest economic growth tipped the scales in favor of the bulls.

Here, we review the Q2 journey, and then take a look at where we expect the next quarter and beyond to send us.

## Ups, Downs and Averages

In late April, the broad-based S&P 500 Index eclipsed its 2018 high amid a more flexible Fed and expectations that the U.S. and China were on the verge of signing a comprehensive trade agreement.

In early May, negotiations hit a major snag when President Trump tweeted he would levy new tariffs on China. A modest selloff in equities ensued.

The early-June threat of debilitating tariffs on Mexico (since resolved) added to the tentative mood.

Peak-to-trough decline in the S&P 500 Index from April 30 thru June 3 was a modest 6.8%. It's nothing out of the ordinary. In fact, the average annual maximum peak-to-trough pullback in the S&P 500 Index since 1980 has been 14%.

The bulls re-engaged when Fed Chief Jerome Powell hinted the Fed was open to rate cuts if the need arose, and the S&P 500 Index eclipsed its late-April high.

# Hancock Whitney Index Return Summary

| Index | April | May | June | 2Q 2019 |
|---|---|---|---|---|
| MSCI Frontier Markets | 0.2% | 2.2% | 2.3% | 4.7% |
| S&P 500 | 4.0% | -6.4% | 7.0% | 4.3% |
| JPM Emerging Market Bond Global Diversified | 0.2% | 0.4% | 3.4% | 4.1% |
| FTSE World Gov't Bond Index | -0.6% | 1.3% | 3.2% | 3.9% |
| MSCI EAFE | 2.8% | -4.8% | 5.9% | 3.7% |
| MSCI ALL Country World Index (ACWI) | 3.4% | -5.9% | 6.5% | 3.6% |
| S&P MidCap 400 | 4.0% | -8.0% | 7.6% | 3.0% |
| BBgBarc US Corporate High Yield | 1.4% | -1.2% | 2.3% | 2.5% |
| BBgBarc US Aggregate Intermediate | 0.1% | 1.3% | 0.9% | 2.4% |
| S&P SmallCap 600 | 3.9% | -8.7% | 7.4% | 1.9% |
| BBgBarc Municipal 1 - 10Y Blend 1 - 12Y | 0.1% | 1.1% | 0.4% | 1.6% |
| MSCI US REIT | -0.3% | 0.3% | 1.3% | 1.3% |
| MSCI Emeriging Markets | 2.1% | -7.3% | 6.2% | 0.6% |
| Alerian MLP Infrastructure | -1.2% | -1.0% | 2.6% | 0.3% |
| Bloomberg Commodity | -0.4% | -3.4% | 2.7% | -1.2% |

**Q2 2019 produced mostly positive results, but it sure was a bumpy ride.**

### China Barriers Create Economic Hurdles

Despite their obvious influence, we don't believe that tariffs alone can tip the U.S. economy into a recession. Nor do we expect the economy to slide into a recession this year.

U.S. exports of goods and services to China accounted for just 0.9% of U.S GDP last year. China isn't falling off the map, and trade between the two countries will continue.[1] But the latest flare-up in tensions has injected a new round of uncertainty into the economic and stock market equation.

Concern centers around rising uncertainty in the business community and its impact on business confidence—the "animal spirits" that drive economic activity. If business confidences fades, companies could tap the brakes on capital spending and hiring. In turn, that ripple could potentially travel through to consumer confidence and consumer spending.

Unfortunately, there are no modern historical precedents to follow for this particular multi-variable scenario. Hence, the heightened level of uncertainty that has permeated the outlook.

### The Fed to the Rescue

Given the emergence of economic cross currents, Treasury bond yields have fallen sharply, and the Fed has opened the door to a possible rate cut at the July 31 meeting. Yet we believe the Fed is simply playing catch-up to sentiment already embedded in the market.

According to Bloomberg, at the start of the 2nd quarter, the probabilities of a rate cut by July 31 were slightly less than 25% and a rate cut by year end was 64%. As trade talks soured and the tone from the Fed became more dovish, the outlook changed dramatically. By June 30, the odds of rate cut by July 31 were 100% and a more than 50% chance there would be three cuts by end of year. This dramatic change in outlook played a significant role in the June rally for stocks as market participants felt confident that the Fed was ready to help should trade tensions begin to weaken the economy.

## Looking Forward

### U.S. Growth Outlook

With reporting still incomplete for 2Q19 there is nevertheless solid data pointing to an acceleration in final demand in the quarter. The primary evidence is the strength in real personal consumption, which accelerated from a sluggish 0.9% annual rate in the weather-plagued and government shutdown weighted 1Q19, and appears to have grown in a healthy 3.5-4.0% range in the Spring quarter. Bloated inventories resulting from the tariff-beating import surge last fall that caused 1Q19 Real GDP to look a lot stronger than the underlying weak final demand (3.1% v. 1.6%), have worked down and lately manufacturing production has begun to pick up again after a soft patch. Our thesis had been that healthy personal consumption should drive a stronger manufacturing sector this summer and stabilize Real GDP trends around 2.5%. That expectation probably holds in the short-term, but slowing global growth and the risk of unresolved trade frictions have led us to reduced projections for U.S. growth in the second half to around a 2.0% annual rate.[1]

One of the primary supports for U.S. growth has been strong jobs growth, which has grown erratically this year due to a variety of factors, such as weather anomalies, but which has slowed modestly this year. According to the U.S. Bureau of Labor Statistics, underlying trend growth in employment appears to have slowed from a brisk 220K per month pace last year to 170K per month currently, still a rate that provides some opportunity for new entrants to the labor force. Unexpectedly strong payroll growth in June has reinforced our expectation that the underlying fundamentals of U.S. growth remain relatively firm and the Unemployment Rate hovers near the cycle low of 3.6%. Capital spending on equipment and technology has slowed significantly this year, most likely due to the growth-suppressing impact of import tariffs. Global growth has slowed to a rate approaching 3%[1], which worries regulators at the European Central Bank (ECB), the International Monetary Fund and the Federal Reserve as uncomfortably close to stall speed. The ECB and the Fed have signaled that if the trade negotiations aimed at defusing the tariff war don't produce positive results soon, they will move to lower short-term interest rates in an attempt to spur growth and stabilize the global economy.

HANCOCK WHITNEY

## Sino-U.S. Trade Negotiations

President Trump and President Xi of China conferred on trade issues at the G-20 gathering in Japan recently and resolved to resume negotiations toward mutually agreeable trading rules, but importantly did not come away with a breakthrough agreement to end the tariff war in the near term. President Trump asserted that the U.S. would refrain for now from applying additional tariffs on $300 billion of Chinese imports to the U.S. not already sanctioned. The trade negotiation teams are to resume discussions soon and the U.S. has immediately rescinded restrictions on Huawei from purchasing U.S. technology components, a high priority for the Chinese. It should be noted that allowing Huawei to buy U.S. technology is not the same as lifting the prohibition against Huawei supplying technology to the U.S. 5G network roll-out, which remains in effect. No mention was made of the recent addition of several Chinese national champion super-computing companies to the Entities List, the formal vehicle for restricting technology purchases on national security grounds. China played its farm card and promised to resume significant trading relations with the U.S. agricultural sector, completing the mutual easing of pressures on important political constituents. Our assessment is China is likely to continue to threaten to limit operations in China of several U.S. companies active in facilitating trade, until an acceptable agreement is achieved. The lack of a defined timeline to resolve manufacturing and technology trade disputes leaves the business outlook in the trade sector highly uncertain and will likely continue to suppress capital investment planning.

The U.S. has put maximum pressure on the Chinese to halt several objectionable and unfair trading practices, including allegations of intellectual property theft and cyber-espionage. From the Chinese perspective these practices amount to competitive advantages that they are reluctant to give up, unfairly gained from the U.S. perspective. The critical factor that should concern the Chinese most is mobility of the global supply chain, until lately dominance of which has been a Chinese strength, but which has become restive and wary of both tariffs and technology security. Once supply chain operators conclude that the cost and difficulties of moving to a more secure and/or economically attractive host is warranted, and start moving, that trend is very difficult to reverse.

Logic suggests the Chinese have too much at stake to continue to provoke U.S. producers to consider better options for component supply. President Trump, on the other hand, presumably places a high priority on running for re-election with the tail winds of a strong economy behind him, pointing to his incentive to conclude an agreement by year-end at the latest. Nevertheless, the longer it takes the parties to achieve an agreement that both China and the U.S. can live with, the more global growth is likely to continue to grind to a slower pace.

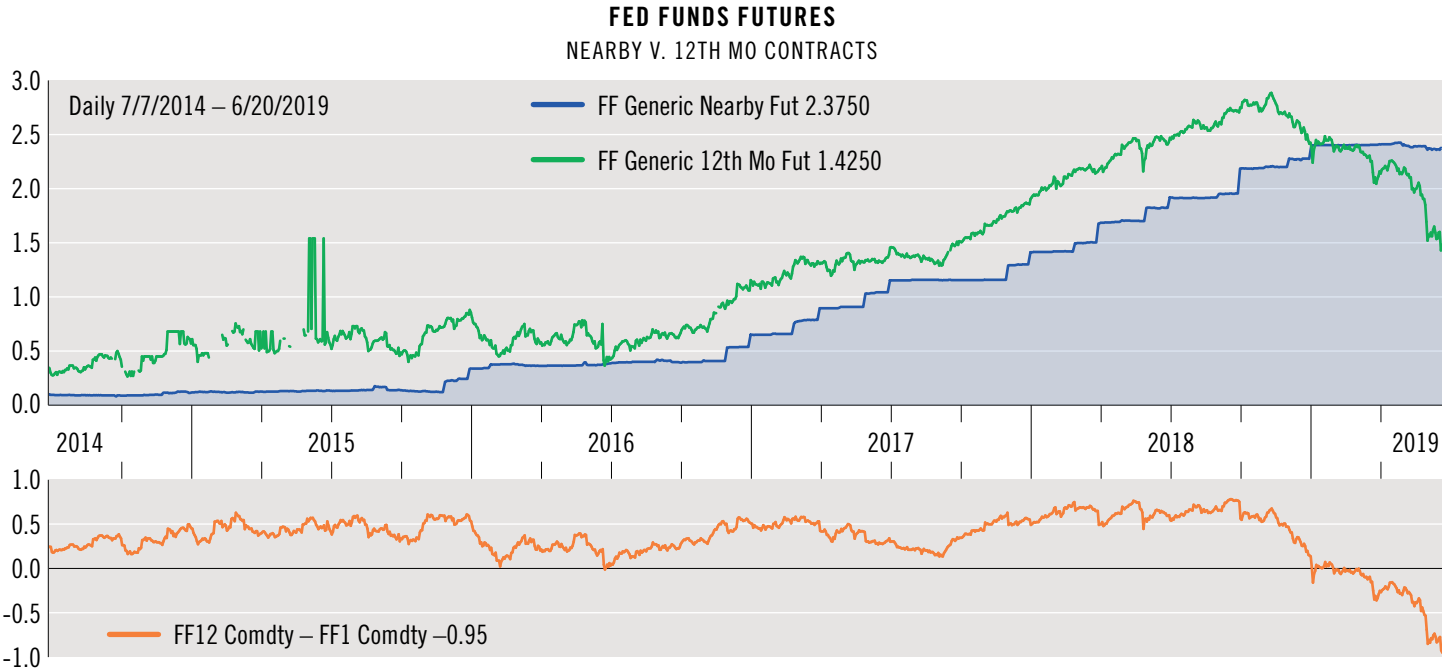
HANCOCK WHITNEY®

## Federal Reserve

Following the Federal Open Market Committee's June 19 meeting Fed Chairman Jay Powell acknowledged that trade frictions between the U.S. and China were the most prominent risk factor for global growth and that the Fed was monitoring those developments closely. The translation is that the FOMC preferred to wait until after the G-20 meeting to learn if a break-through might be achieved which would ameliorate rescue efforts from the Fed to revive global growth. The Fed signaled in June that it was ready to move to provide liquidity on the basis of the marked slowing in global growth, and the markets priced in 100 basis points (bp) of Fed Funds rate cuts in the next 12 months, to about 1.40% from 2.40% today. With the G-20 past, trade pressures have eased modestly but without a clear timeline for resolution of the tariff dispute. Strong payroll growth in June should further cloud the case for a Fed rate cut at the July 31 FOMC meeting, and market expectations for aggressive Fed easing in the year ahead have receded somewhat.

The Fed traditionally has operated monetary policy under the Congressional dual mandate to achieve an optimal mix of low unemployment and low inflation in the U.S. economy, as specified in the Humphrey-Hawkins legislation enacted in 1978. With consumer inflation trending marginally below the Fed's target of 2.0% and unemployment steady near the cycle low of 3.6% in recent months, there isn't a strong case for the Fed to ease based on either growth or inflation considerations. It's clear that the Fed is motivated to ease monetary policy based on its unofficial third mandate, to be supportive of a stable and growing global economy. The Fed typically avoids publicly acknowledging the unofficial mandate but Chairman Powell was explicit in signaling that the Fed is concerned about global economic instability and ready to move to cut rates. The markets did not miss the significance and will be alert to the Fed's continuing sense of responsibility to the global economy. Unresolved trade frictions appear likely to continue to impede the gears of global growth in the near term and we expect the Fed to provide liquidity support to global markets in the form of lower short-term interest rates over the next several months.

## Fed Funds Futures Projecting 1% Lower Rate Next Summer




Source: Bloomberg Finance, L.P.

## European Central Bank

While the U.S. Fed terminated its quantitative easing (QE) program in 2014, and actually reversed it by about $500 billion in portfolio run-off over the last year and half, the European Central Bank (ECB), after delay and some trepidation, finally terminated its QE program at the end of last year. In tandem with the planned end of QE, the ECB guided markets last year to expect that it would move to raise its policy rate around mid-year 2019. The policy rate has been stuck at -40 bp, a negative interest rate, for several years and represents continuing fragility and deflationary conditions in Europe. It would have been a most significant turn of events had the ECB been able to move to normalize interest rates in Europe, but that goal has been overcome by sluggish economic growth and continuing low inflation trends hovering marginally above zero. The ECB has also signaled that it intends to cut interest rates in a renewed effort to spur growth and inflation. Interest rates heading back under the zero line in Europe is one of the main drivers of the decline in U.S. interest rates. German sovereign 10-yr yields also trading at -40 bp are an ominous warning to global markets that Europe has not closed the book on QE and has exhibited little sign of escaping deflationary conditions. That U.S. interest rates will likely remain hostage to weak conditions in Europe is a prime motivator for the Fed to move to try to stimulate global growth over the next year.

## U.S. Equity Markets

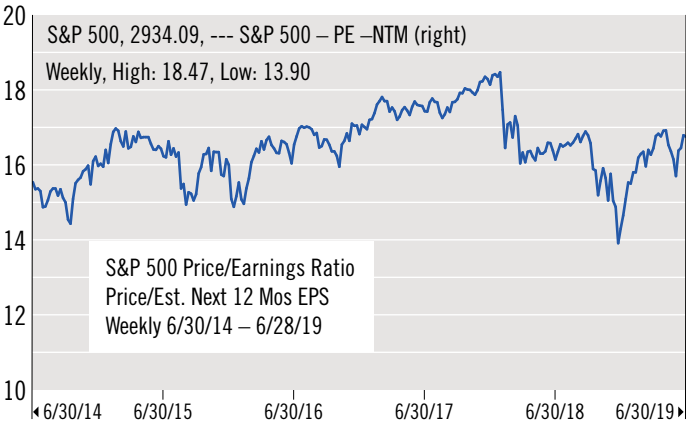
Earnings for S&P 500 companies grew 23% in 2018, boosted from the pre-existing 10% trend by the tax cuts effective January 1 last year. The surge in earnings growth was reflected partly in a strong equity market in 2017 and in the summer rally of 2018. Markets began to focus last fall on the fact that comparisons would be difficult this year and equity prices experienced a nasty correction in the fourth quarter, also burdened by a confluence of several policy concerns (Fed tightening, government shutdowns, Brexit and tariffs). As those policy concerns largely waned in the first half of 2019, the equity markets rebounded smartly, with only the trade disputes with China remaining a significant risk factor, slightly less acute after the G-20 but a continuing concern for global markets.

The overview outlook for U.S. equities is a mixture of pros and cons this summer, dominated by trade frictions driving a global growth slowdown. The U.S. economy is performing better than most of the developed world, but sluggish global conditions and increasing margin pressures are headwinds for U.S. equities. S&P 500 earnings are turning in a paltry performance this year, expected to be up 3%; however, a rebound toward prior trends around 10% growth is expected in 2020. The silver lining is that the earnings surge last year brought price/earnings valuation metrics down to fairly reasonable levels and the rebound this year has pushed valuation levels up to mid-range (see chart). U.S. equities continue to be our favored asset class, reflected in our asset allocation policies. Europe and Japan remain mired in a struggle with deflation, sluggish growth and permanent QE. China's economy is impressive in some respects for the long haul, but it is currently destabilized and slowing. Growth is attractive in the Emerging Markets, however their headwind is the strong Dollar, which is likely to strengthen further if global growth continues to decelerate. In a deflationary world, growth is the antidote; and the best, most politically and financially stable growth in the world is in the United States.

## Strong Earnings Growth Corrected Valuation Challenges

**Market correction revealed attractive valulations for U.S. blue chip stocks**

**S&P 500 PRICE/EARNINGS RATIO (FORWARD)**




Source: Factset

## Control What You Can Control

While external factors such as trade wars and Federal Reserve moves will always have an influence, longer-term stock market performance is truly dictated by corporate profit growth. It's not a coincidence that bear markets closely coincide with recessions, and bull markets line up with economic expansions. We have seen the pattern repeat itself for decades.

Broad-based market indexes have a long-term upward bias—a bias we incorporate into our recommendations. While long-term successful investors expect temporary setbacks, we work to minimize volatility.

That said, control what you can control. You can't control the stock market, and you can't control headlines. But you can control your portfolio.

Your plan should consider your time horizon, risk tolerance and financial goals. Risk can't be eliminated, but we tailor our recommendations with your financial goals and risk profile in mind. Moreover, the plan is designed to remove the emotional component that may encourage investors to sell near the bottom and get overly ambitious when stocks are surging.

If you would like to review your current plan and portfolio with one of our financial advisors, or have specific questions on the market, please contact us to schedule a personal consultation—and let's have a conversation.

HANCOCK WHITNEY®

# About Our Authors

**David Lundgren, CFA** is the Chief Investment Officer at Hancock Whitney Bank and portfolio manager for high net worth and large institutional clients. At Hancock Whitney, David is responsible for directing the bank's investment approach, models and portfolio management; manages a platform of client- focused internal and external money managers; ensures bank meets regulatory requirements. Additionally, he is the fund manager for Hancock Horizon Family of Funds. David has been in the banking industry for almost 30 years, with over 20 of those years as a part of the Hancock Whitney team. Prior to joining Hancock Whitney, he was a portfolio manager at First Commerce Corporation. David has a Bachelors Degree in Finance and a Masters in Business Administration from the University of New Orleans, and he holds the Charted Financial Analyst designation.

**Paul Teten, CFA** is a Chief Investment Strategist at Hancock Whitney Bank, where he supervises the formulation and implementation of proprietary equity and fixed income strategies. Paul has over 40 years of experience in the finance industry, joining the Hancock Whitney team as part of the acquisition of Capital One Asset Management LLC. At Capital One, he served in various capacities over 14 years as Director of Fixed Income Portfolio Management, Chair of the Asset Allocation Committee and Chief Investment Officer. His prior experience includes 5 years of portfolio management for the Bank of America Private Bank and 17 years of fixed income trading and portfolio management at Criterion Investment Management in Houston, culminating in his role as Senior Investment Strategist. Paul earned his Bachelor's Degree in Finance and Master's of Business Administration from the University of Texas at Austin. He is a Chartered Financial Analyst® and remains active at the College of Natural Sciences at the University of Texas and serves on the Board of Visitors of McDonald Observatory.

Sources:
[1] Bloomberg/FactSet