Independence Asset Advisors, LLC

August 2019 Talking Points

August 8, 2019

Dear Clients and Friends,

The S&P 500 dropped 3% in six consecutive losing trading days in early August due to fears of an escalating trade war. We start today with respectable year-to-date gains of 16% and futures are up. Not the end of the world. So, is the stock market finally following the lead of bonds in forecasting very low growth and declining earnings growth?

The S&P 500 total return was 20% through July, its best performance through the first seven months of the year since 1997.

The Federal Reserve cut its Fed Funds rate one quarter of 1% point (25 bps) on July 30th in a pre-emptive move to cushion the economy from a global slowdown and unresolved trade tensions. The Fed also announced they would end the runoff of their $3.8 trillion asset portfolio two months earlier than planned.

New tariffs on China will be a drag on U.S. consumer spending and a further drag on global growth and corporate revenue and earnings growth. This resulted in a five-day equity selloff.

The U.S. equity market posted its worst weekly performance of the year (week of July 29th) on fears of escalating global trade tension and a less dovish Fed. The market was led lower by the higher beta and more cyclically-driven areas of the market such as technology and consumer discretionary sectors. Real estate and utilities benefited from their safe haven status after posting gains for the week.

The 10-year Treasury bond yield dropped below 2.0% (to 1.76% on August 5th), signaling lower growth and inflation expectations.

What we have been hearing from managers regarding the overall economic outlook for the last couple of months:

1. U.S. recession risk pushed out 12 to 18 months "into extra innings" to the second half of 2020 or beyond.
2. Concern for global growth slowdown, especially negative manufacturing growth in key producing nations (including U.S., Germany, and China).
3. Tariffs and slowing global trade are a drag on both U.S. manufacturing (higher input costs) and global growth.
4. U.S. economic data is balanced but fragile:
    a. U.S. economy positives include:
        i. Strong consumer spending (U.S. consumption up 4%);
        ii. Real disposable income rising (+3.4%);
        iii. Low unemployment and continued strong job creation;
        iv. Low interest rate (including low mortgage rates); and
        v. Low inflation.

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b. U.S. economy negatives include:
    i. Low inflation - persistently below Fed target at 1.7%;
    ii. Tariffs and erratic trade policy;
    iii. Manufacturing turned negative (PMI negative);
        1. Key domestic markets like housing and autos are stagnant;
    iv. Exports declined 1.2% year over year, despite global growth; and
    v. Strong U.S. dollar.

5. World economy:
    a. Brexit – big negative for U.K. and E.U.;
    b. Brexit – impact on GBP and Euro currencies vs. USD;
    c. Central Banks – Fed, ECB, PBOC (China) all easing and accommodative;
    d. Slowing China growth (below 6% and trending down);
    e. Low and slowing European growth (1% and trending down); and
    f. Slowing U.S. growth (2% and trending down).

U.S. equity manager comments last week:

1. Inflation remains subdued. Disinflation is the not-so-new enemy of central banks.
2. Real interest rates stay low for (much) longer.
3. GDP appears to be stuck at a lower level (the "great stagnation").
4. The present value of a sustained stream of cash flow (earnings and dividends) is more valuable than in the past.
5. It is more difficult to sustain cash flows with disruptive technologies and asset-lite businesses.
6. The "China Super-cycle" is ending… not because of tariffs, but because China has largely built out its infrastructure from highways, factories and offices to housing. (Negative for commodities and commodity exporters.)
7. Current trends skewed positive, but surprises skew negative (said before new China tariff threat).
8. This business cycle, capital expenditures have stayed low.
9. U.S. households have reduced debt to income every year.
10. Mini-crashes have kept investors cautious, and it is difficult to find obvious excesses in equity market sectors (ex-FANGs), despite easy access to capital.
11. There is less room for error. With inflation dormant and interest rates so low, the equity risk premium is in line with history, but both low dividend yield and low discount rates leave little room for errors.
12. After a record run, the U.S. stock market seems expensive, but there are many great companies that are not overpriced.
13. The U.S. dollar is extremely high relative to major currencies – the largest gap in 30 years versus other major currencies. U.S. companies with significant sales abroad have a currency tail wind. (Exporters a headwind.)
14. If anything is overpriced, it's safety, including Treasuries and other sovereign bonds. More than 15% of global sovereign bonds trade at a negative yield and more than 30% at negative real yields (after accounting for inflation).
15. The Fed can't fight global money flows.

As always, please feel free to contact me with any questions you may have, or if you would like to discuss further.

Kind regards,

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