# Market Commentary

BENCHMARK FINANCIAL

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## Questions

- The world is awash with negative bond yields. How should advisors respond?
- Am I reevaluating the impact Chinese tariffs might have on the U.S. economy?
- If the Fed cuts rates again will they be making a policy error?

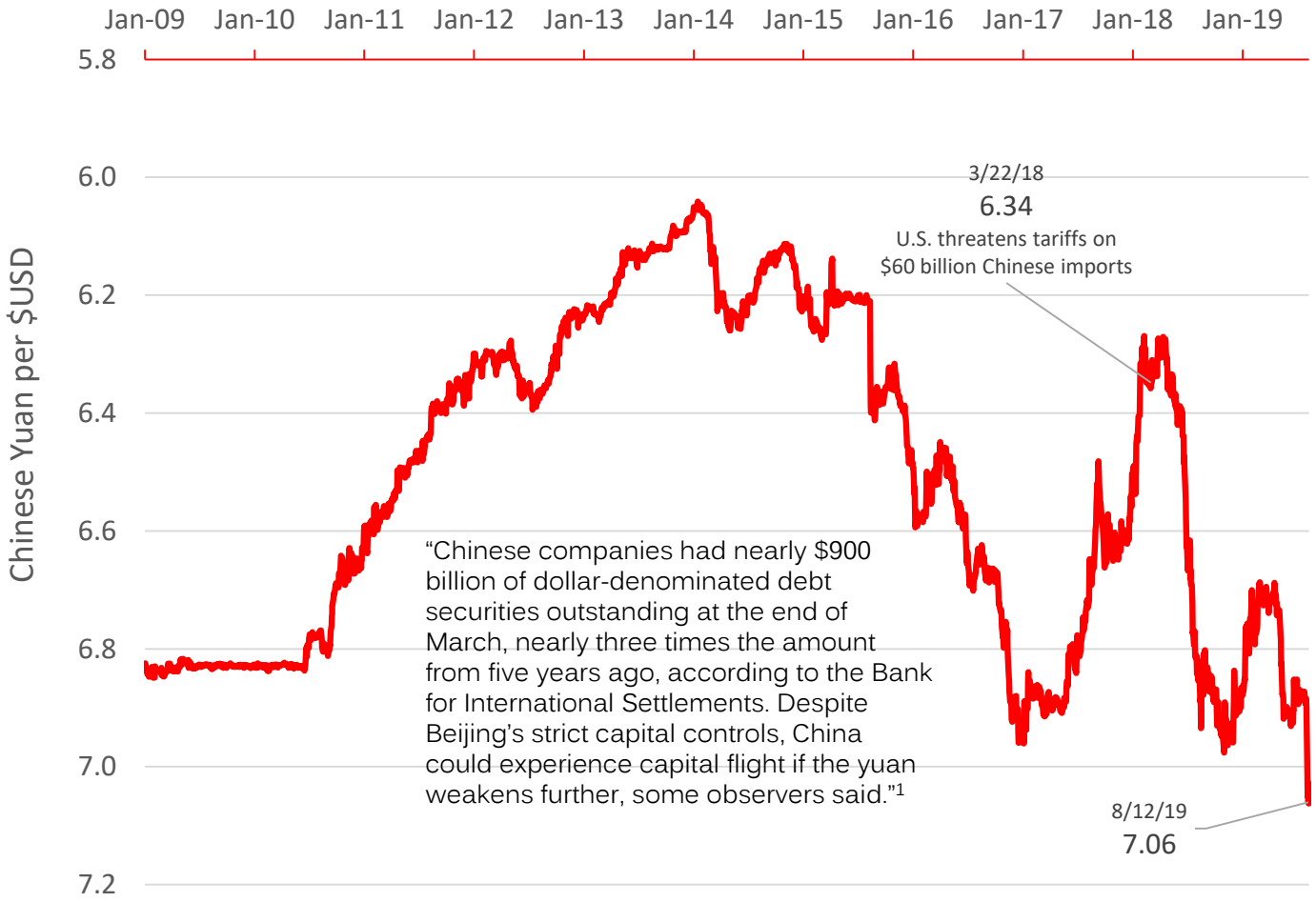
## Answers

- Negative bond yields in Europe and Japan are with us to stay; and they will continue to exert downward pressure on U.S. bond yields. So, in a balanced portfolio we just have to revise lower our expected portfolio returns.
- I still think Chinese tariffs have been way overblown by the media. US nominal GDP is around $21 trillion, while US exports to China totaled just $108 billion (0.5% of GDP) over the past 12 months through June, and imports from China totaled $509 billion (2.4% of GDP) over the same period. U.S. consumers have never been in better shape and I don't see signs of a spending slowdown.
- I don't think the Fed will be making a policy error in cutting rates. I think they made a policy mistake in December when they raised rates. I think an inverted yield curve is a mistake. I think the world is in the process of absorbing and adjusting to the unprecedented reality of negative interest rates, brought about by unprecedented demographics and a global savings glut. The Fed is having to re-adjust its world view.

# Stock Market

- stocks have Powell protection
- adjusting to protracted China trade war
- adjusting to earnings deceleration
- stocks are fairly valued
- inflation is tame

# Stock Market
# Chinese currency – PBOC will support it




The yuan is down - 11.4% from the date of first Chinese tariff threats

Source: Tullet Prebon reported by *The Wall Street Journal* website, August 12, 2019. [1] *The Wall Street Journal*, August 12, 2019.

# U.S. Dollar ($)
# U.S. dollar index – trending sideways


Companies including PepsiCo Inc. and railroad CSX Corp. recently cited the weak dollar as helping lift earnings, providing another level of support for a long stock market rally that many think looks stretched. Morgan Stanley estimates that profits for companies in the S&P 500 increase by 1% for every 2% decline in the dollar.

The dollar's surge created a headwind for S&P 500 earnings in 2014-15.

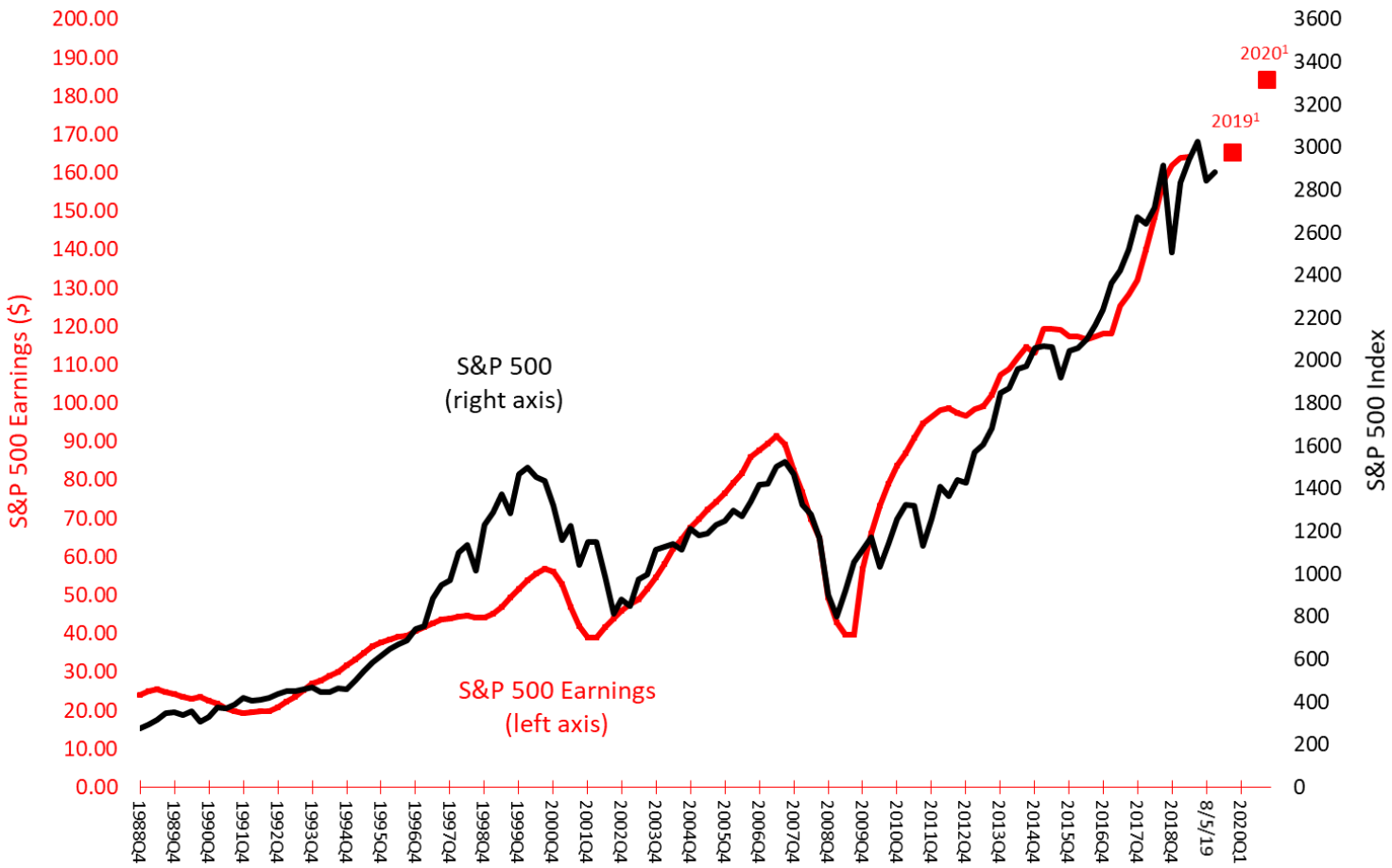
Trending sideways since then.

"... no model projecting directional movements in exchange rates is significantly superior to tossing a coin."

-- Alan Greenspan[1]

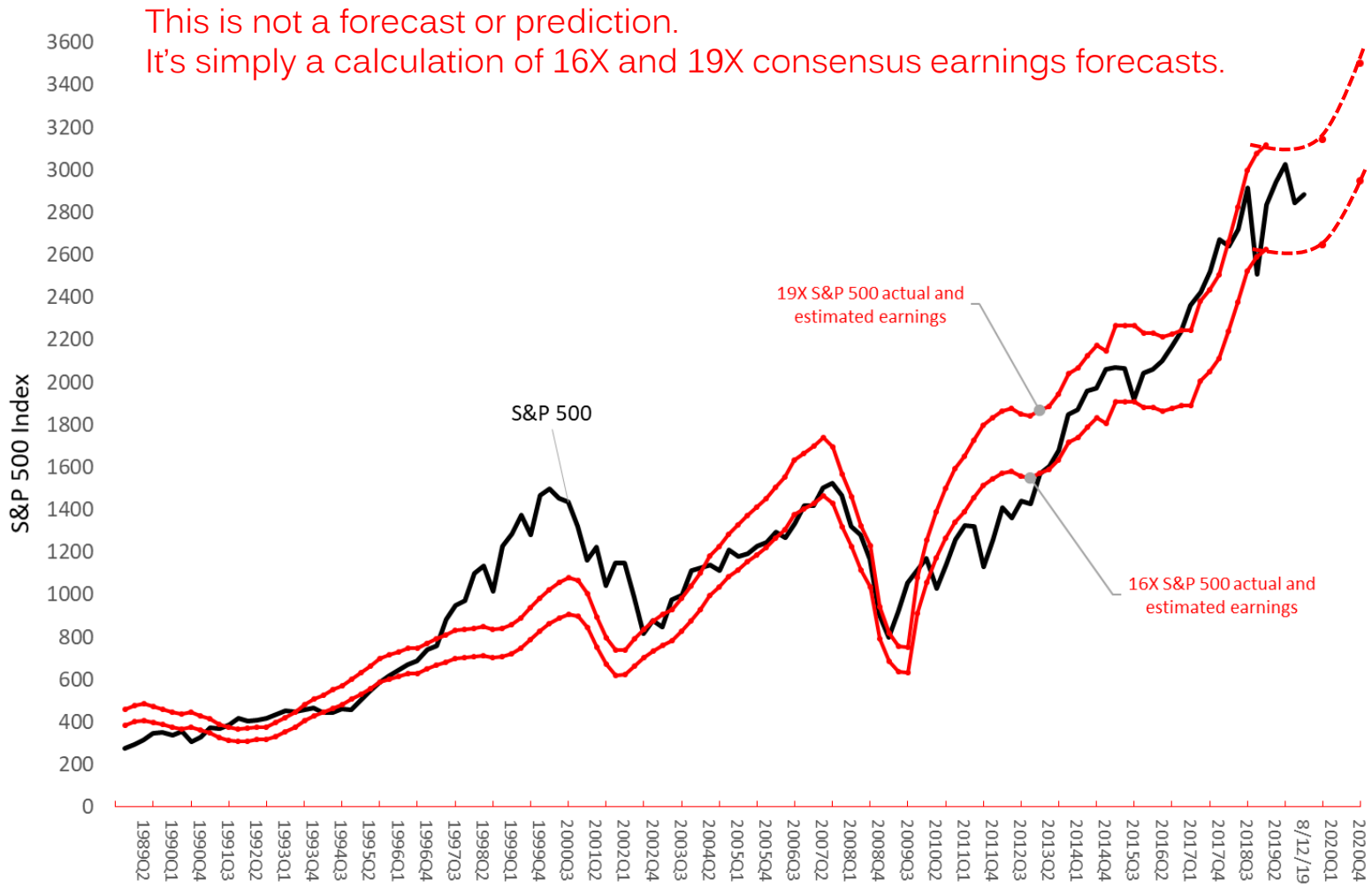
Source: Federal Reserve major currencies index. Monthly data through July 2019. [1]Federal Reserve, Remarks by Chairman Alan Greenspan before the Economic Club of New York, March 2, 2004.

# Valuation
# S&P 500 vs. actual and estimated earnings




[1] 2018 (actual), 2019 (estimated) and 2020 (estimated) bottom-up S&P 500 operating earnings per share as of August 5, 2019: for 2018(a), $161.93; for 2019(e), $165.38; for 2020(e), $184.08. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S for actual and estimated operating earnings from 2015. Standard and Poor's for actual operating earnings data through 2014 and stock price index through August 12, 2019.

# Valuation
# S&P 500 vs. 16X and 19X actual and estimated earnings

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# Fed policy

- engineering the soft landing
- the Phillips Curve is broken
- the Fed's inflation forecasts have consistently been too high
- inflation expectations trending lower for past 15 years
- the Fed manages the yield curve
- the Fed has created every recession since the 1950s
- "the Great Unwinding" – bond yields were supposed to start rising, but they aren't

# Federal Reserve Policy
# July Meeting – still Goldilocks, with uncertainties

July 31, 2019

Federal Reserve issues FOMC statement

For release at 2:00 p.m. EDT

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. In light of the implications of global developments for the economic outlook as well as muted inflation pressures, the Committee decided to lower the target range for the federal funds rate to 2 to 2-1/4 percent. This action supports the Committee's view that sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective are the most likely outcomes, but uncertainties about this outlook remain. As the Committee contemplates the future path of the target range for the federal funds rate, it will continue to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective.

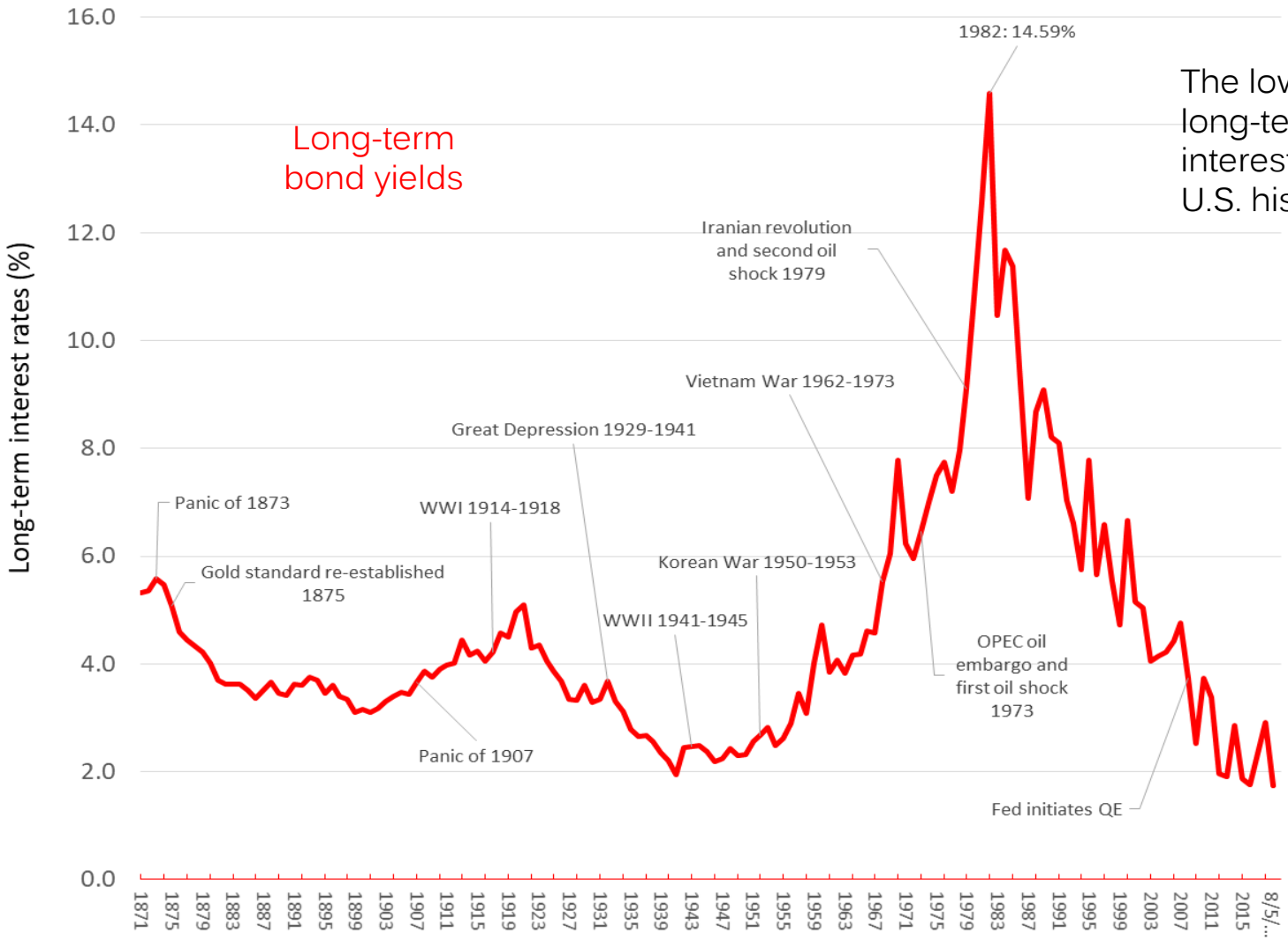
sustained expansion, low inflation, are most likely outcomes

Source: Federal Reserve, July 31, 2019.

# Bond Yields

- lowest yields in history
- yields don’t make sense by historic comparison
- Fed’s QE took yields to those levels
- the ECB continues to pin rates down

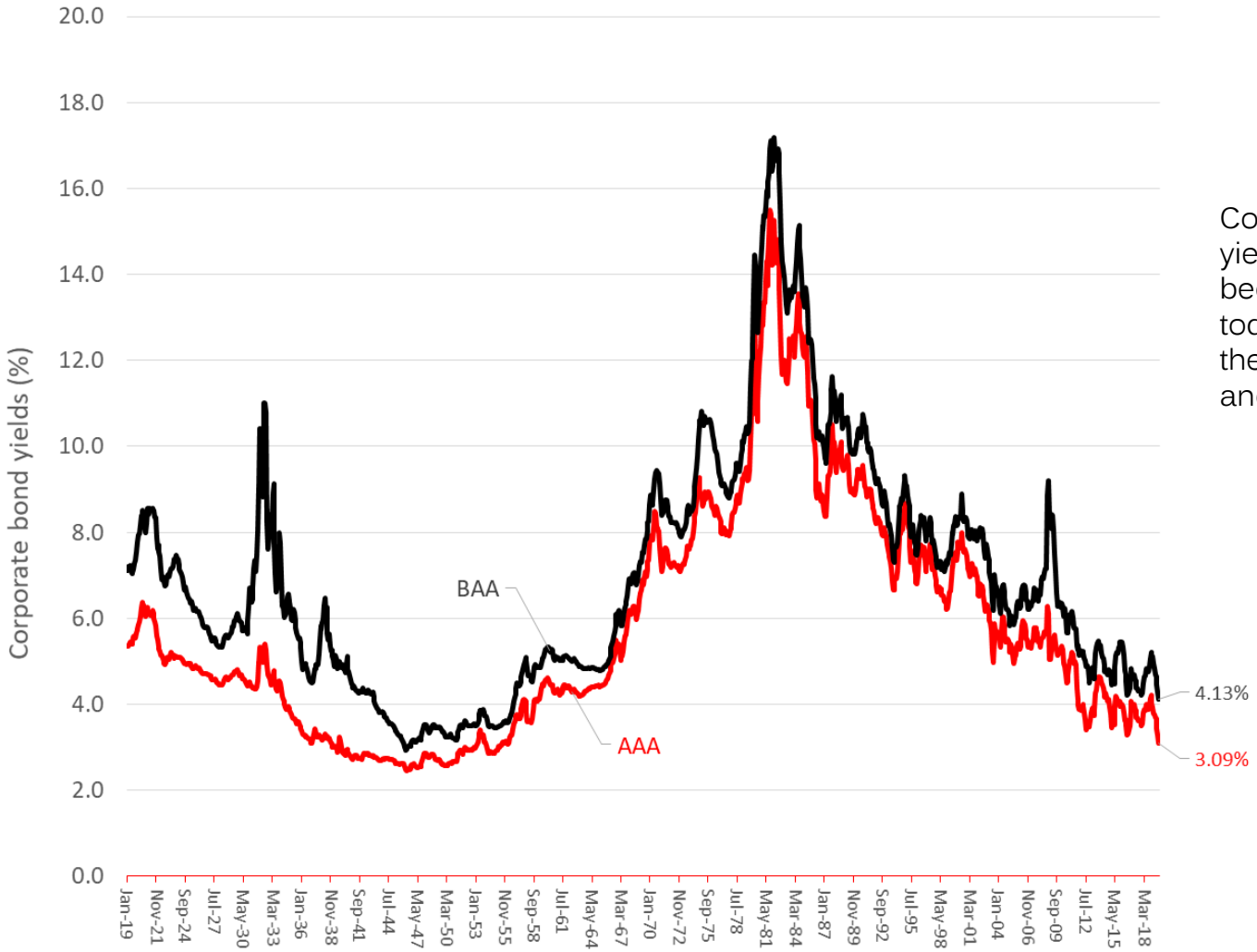
# Bond Yields
# Record low U.S. Treasury Bond Yields




The lowest long-term interest rates in U.S. history.

Source: Online Data Robert Shiller, annual data through 2018; August 5, 2019 data from the U.S. Treasury Department.

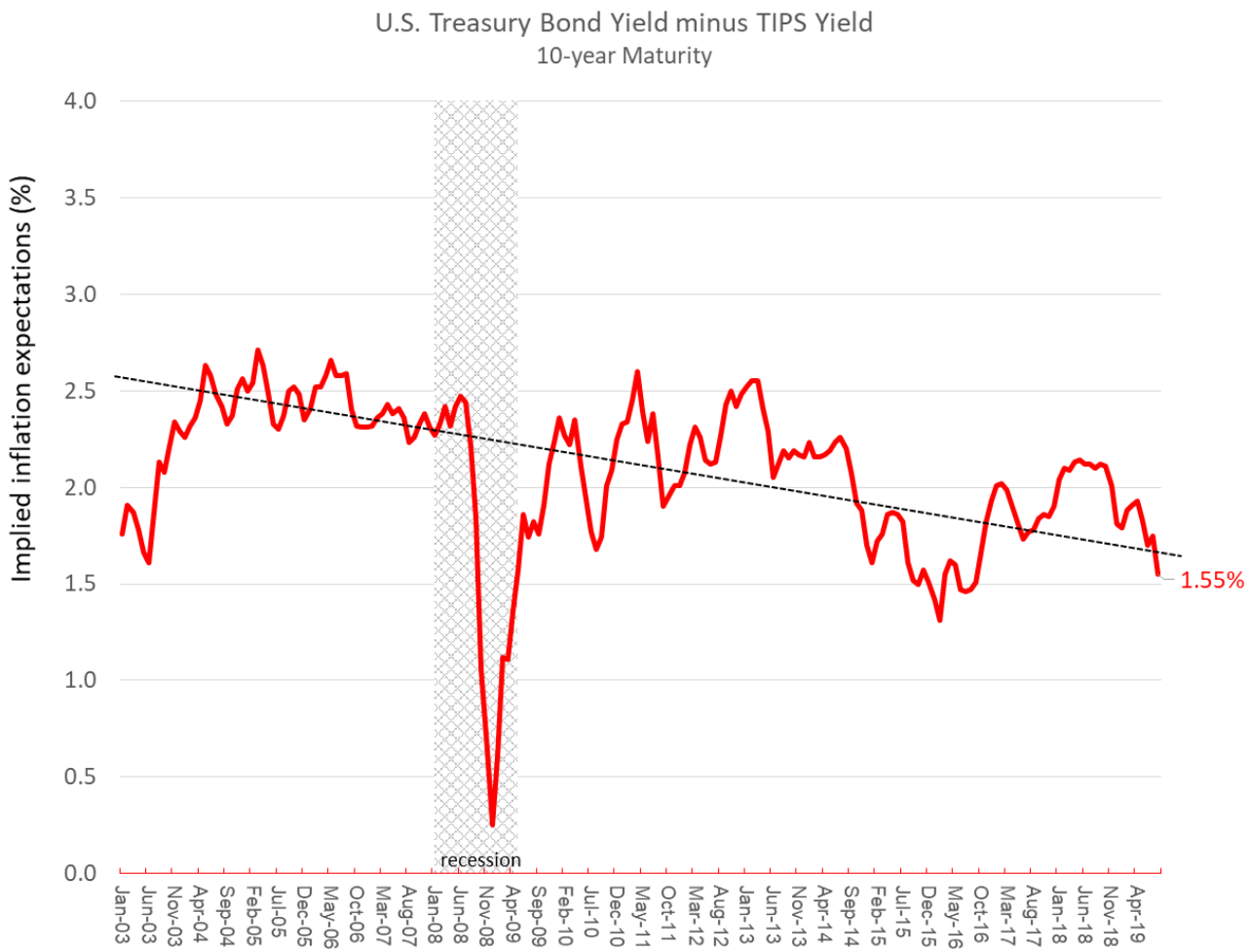
# Bond Yields
# Corporate Bond Yields




Corporate bond yields have been lower than today back in the '30s, '40s and '50s.

Source: Moody's, retrieved from Federal Reserve Bank of St. Louis. Monthly data through July 2019; latest data point 8/8/19.

# Inflation
## Inflation expectations have been declining for 15 years

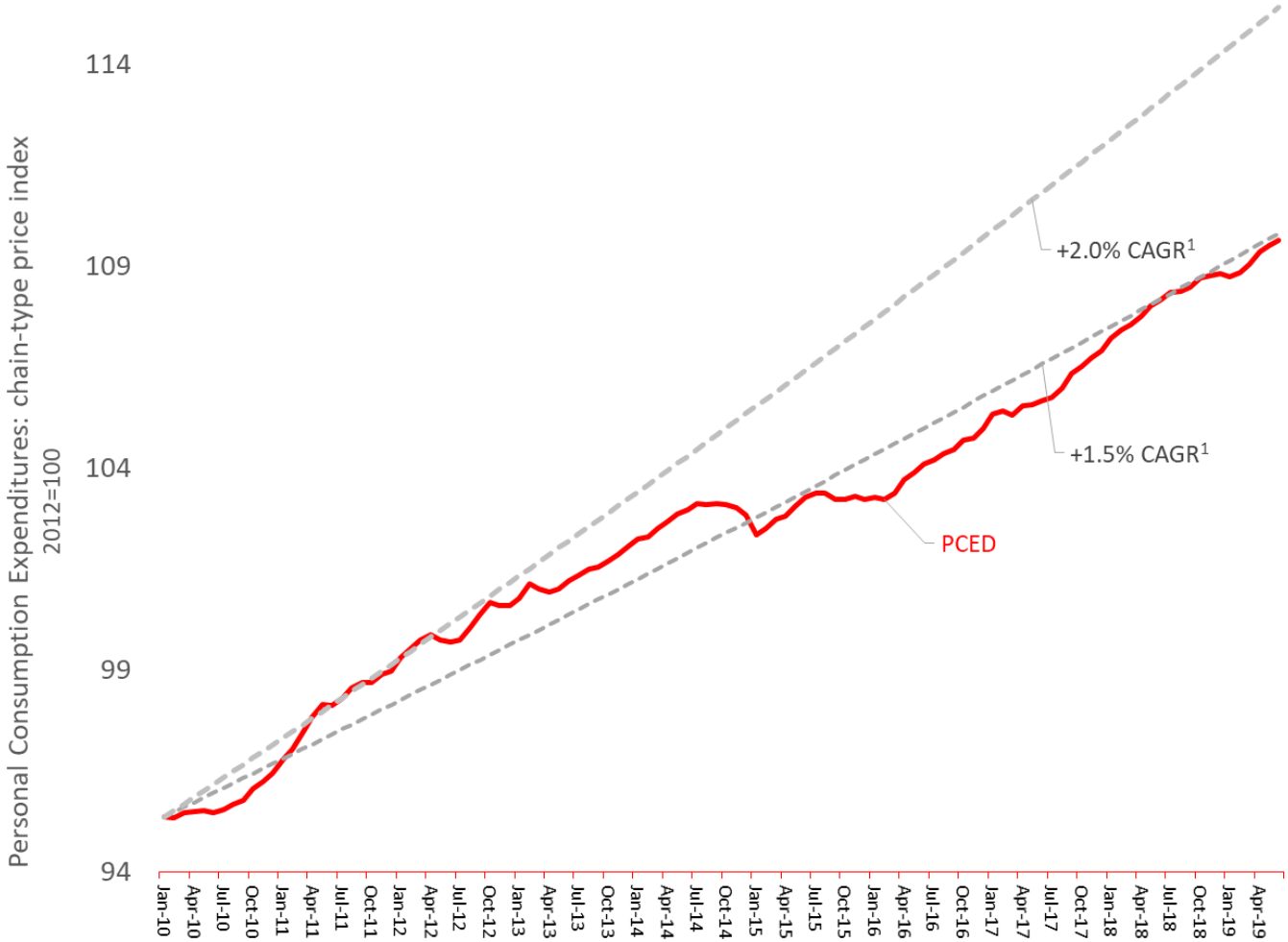



The difference between the nominal 10-year Treasury bond yield and the TIPS yield gives the market's opinion for a 10-year inflation forecast.

It has turned down.

Source: Federal Reserve. Monthly data through July 2019; latest data point 8/5/19. 1.75% 10-year Treasury yield minus 0.20% 10-year TIPS yield.

# Inflation
# Inflation has been trending at +1.5% for years




Inflation has been running way below the Fed's 2% forecast and 2% target.

Source: U.S. Commerce Department reported by Federal Reserve Bank of St. Louis. Data through June 2019.
[1] CAGR = compound annual growth rate.

# Global demographics

- U.S. “echo boom” to drive a recovery in working age population growth
- U.S. working-age population forecasts are favorable compared to other major economies
- immigration accounts for 48% of U.S. population growth
- *working-age population in Europe, Japan and China is already in decline*

## Economy

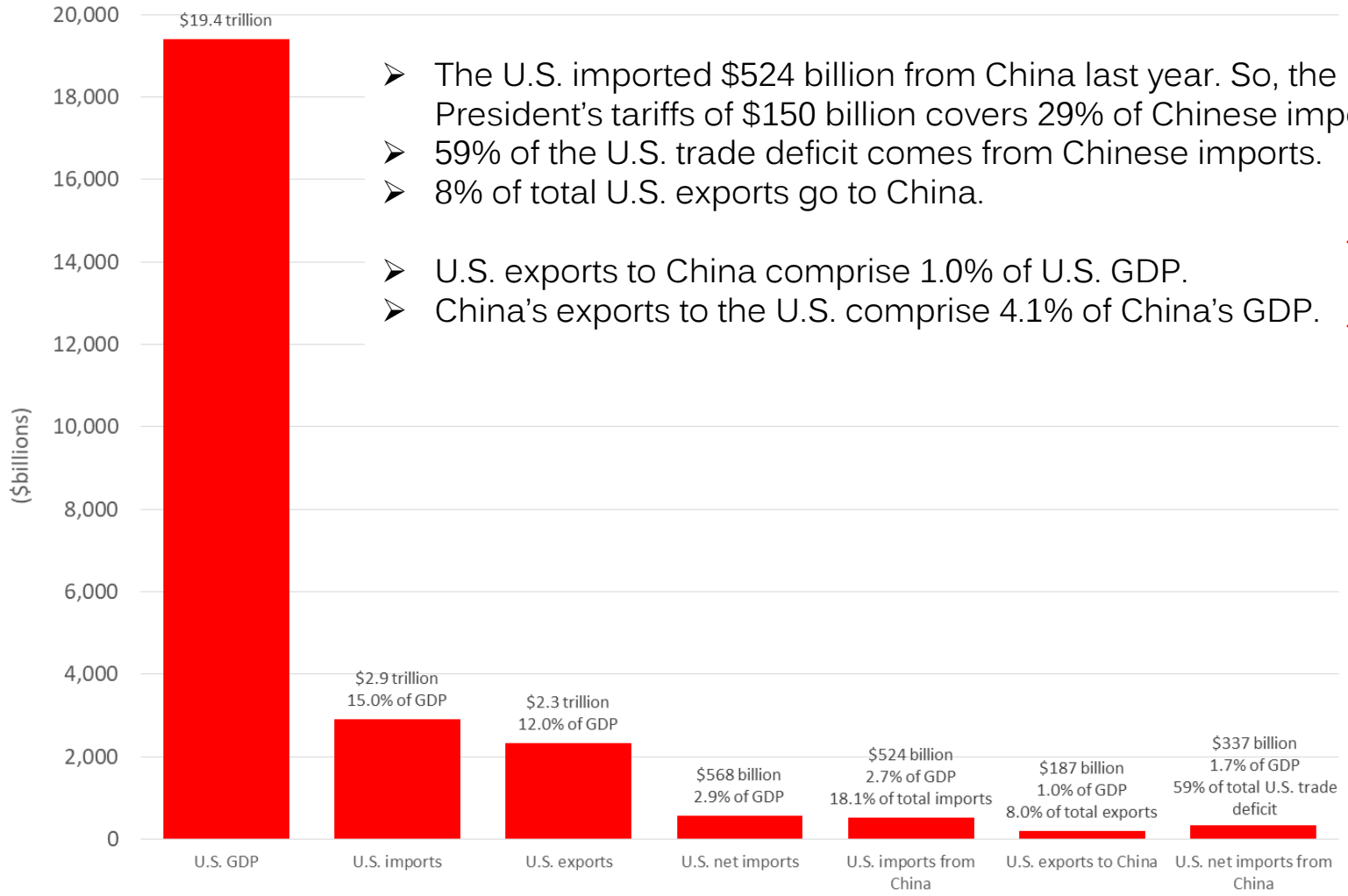
+2.3% Q2 y/y GDP growth right on the 10-year post-recession trend

slowing growth due to weakening manufacturing
continued strength elsewhere

- weaker PMIs, flat LEI

- consumers are in record-strong shape: strong jobs growth, wage gains, job openings, real DPI, household balance sheets, savings rate, financial obligations ratio, consumer sentiment, booming retail sales
- strong small business optimism index
- declining inflation expectations

# Trade
# U.S. imports and exports % of GDP



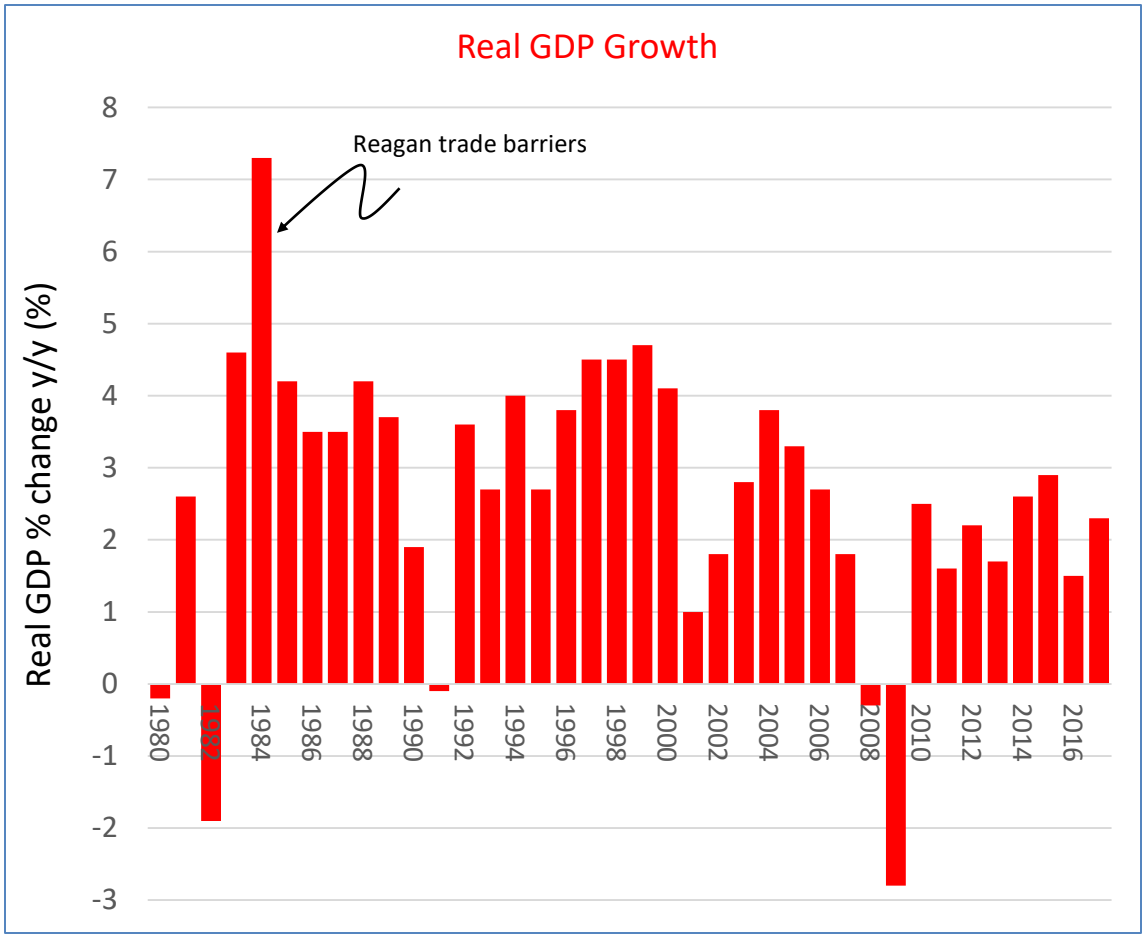

- The U.S. imported $524 billion from China last year. So, the President's tariffs of $150 billion covers 29% of Chinese imports.
- 59% of the U.S. trade deficit comes from Chinese imports.
- 8% of total U.S. exports go to China.

- U.S. exports to China comprise 1.0% of U.S. GDP.
- China's exports to the U.S. comprise 4.1% of China's GDP.

this is key

Source: U.S. Census Bureau. Includes goods and services. Data for 2017. China's 2017 GDP was $12.86 trillion, reported by the South China Post 1/18/2018.

# Trade
# China tariffs on % of U.S. Imports




Source: *The Wall Street Journal,* December 4, 2018.

# Trade
# Goldman Sachs' latest view on China tariffs

May 17

THE WALL STREET JOURNAL.

STREETWISE
By James Mackintosh

## Markets Create Their Own Reality About Tariffs

"Goldman Sachs chief economist Jan Hatzius estimates the overall hit to the U.S. economy is 0.15 percentage point from the tariffs announced so far, rising to 0.25 point if tariffs are extended to all Chinese goods."

August 11

## Trade war is raising the risk of U.S. recession, Goldman Sachs warns

By Mike Murphy
Published: Aug 11, 2019 7:32 p.m. ET

206 Aa

Tensions with China are weighing on the U.S. economy more than expected, analysts say

The trade war with China is having a greater effect on the U.S. economy than expected, and the risk of recession is rising, Goldman Sachs Group Inc. said Sunday.

In a note to clients, Goldman analysts led by chief U.S. economist Jan Hatzius said a trade deal between the U.S. and China is no longer expected before the 2020 presidential election.

Goldman GS, -2.78% said it now expects a 0.6% drag on the U.S. economy due to trade-war developments, up from earlier estimates of 0.2%. "Fears that the trade war will trigger a recession are growing," Hatzius said in the note.

Goldman also lowered its fourth-quarter U.S. growth forecast by 20 basis points to 1.8%, saying the trade war is weighing down the economy.

"Overall, we have increased our estimate of the growth impact of the trade war," Hatzius wrote. "The drivers of this modest change are that we now include an estimate of the sentiment and uncertainty effects and that financial markets have responded notably to recent trade news."

Source: *The Wall Street Journal*, May 17, 2019.

# Trade
# Headline Hype

## Opinion: When the unthinkable happens: U.S.-China trade negotiations break down for good

By Ivan Martchev
Published: Aug 12, 2019 10:15 a.m. ET

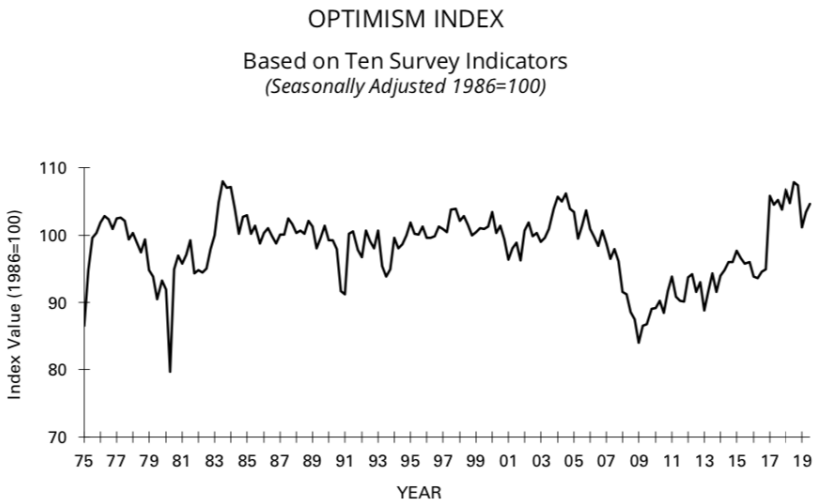
119 Aa

Global trade would collapse, and the Federal Reserve wouldn't be able to save the economy


Source: MarketWatch, *August 12, 2019.*

# Economic Data
# Small business optimism index - strong

**July 2019 Report:**
**Small Business Optimism Continues to Defy Expectations**




## SUMMARY

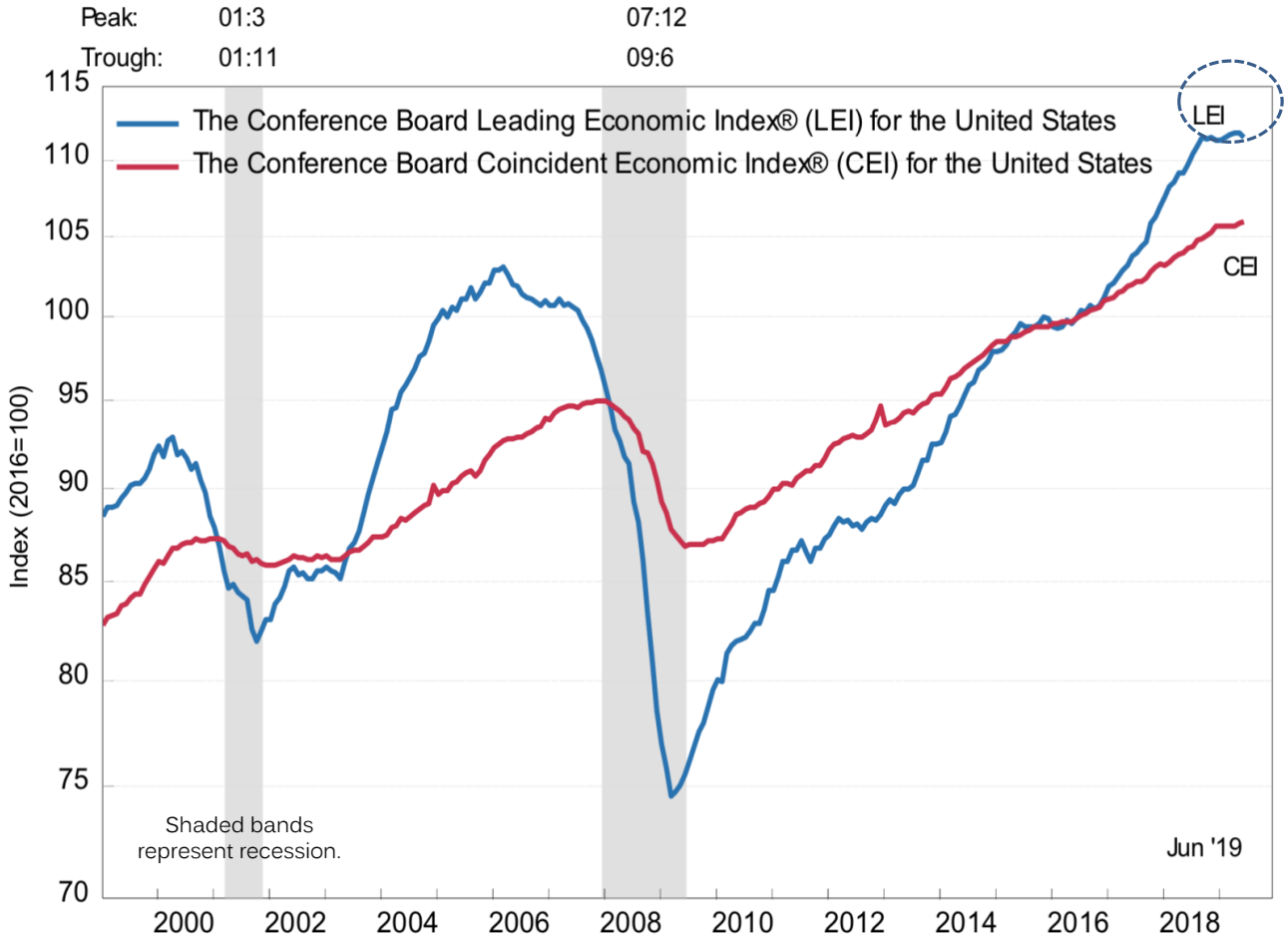
**OPTIMISM INDEX**

The Optimism Index rose 1.4 points to 104.7, an exceptional reading. Seven of the 10 components advanced, two fell, and one was unchanged. This is confirmation that small business owners remain very optimistic about the economy despite all the talk about "slowing."

Expectations for business conditions, real sales, and expansion posted solid gains. Plans to create new jobs and make capital outlays also advanced. Plans to order new inventories posted a solid gain, although there were lingering signs of the excess inventory built in the second quarter. Earnings trends improved, supported by a solid improvement in sales trends. Few owners credited price change (up or down) for changes in earnings. After surging last month, reports of higher average selling prices stabilized, no evidence of a pickup in inflation. Credit conditions remain very supportive, interest rates on loans are historically low, and there are few complaints about credit availability.

Source: NFIB. June data released August 13, 2019.

# Economic Data
# U.S. index of leading economic indicators - downtick



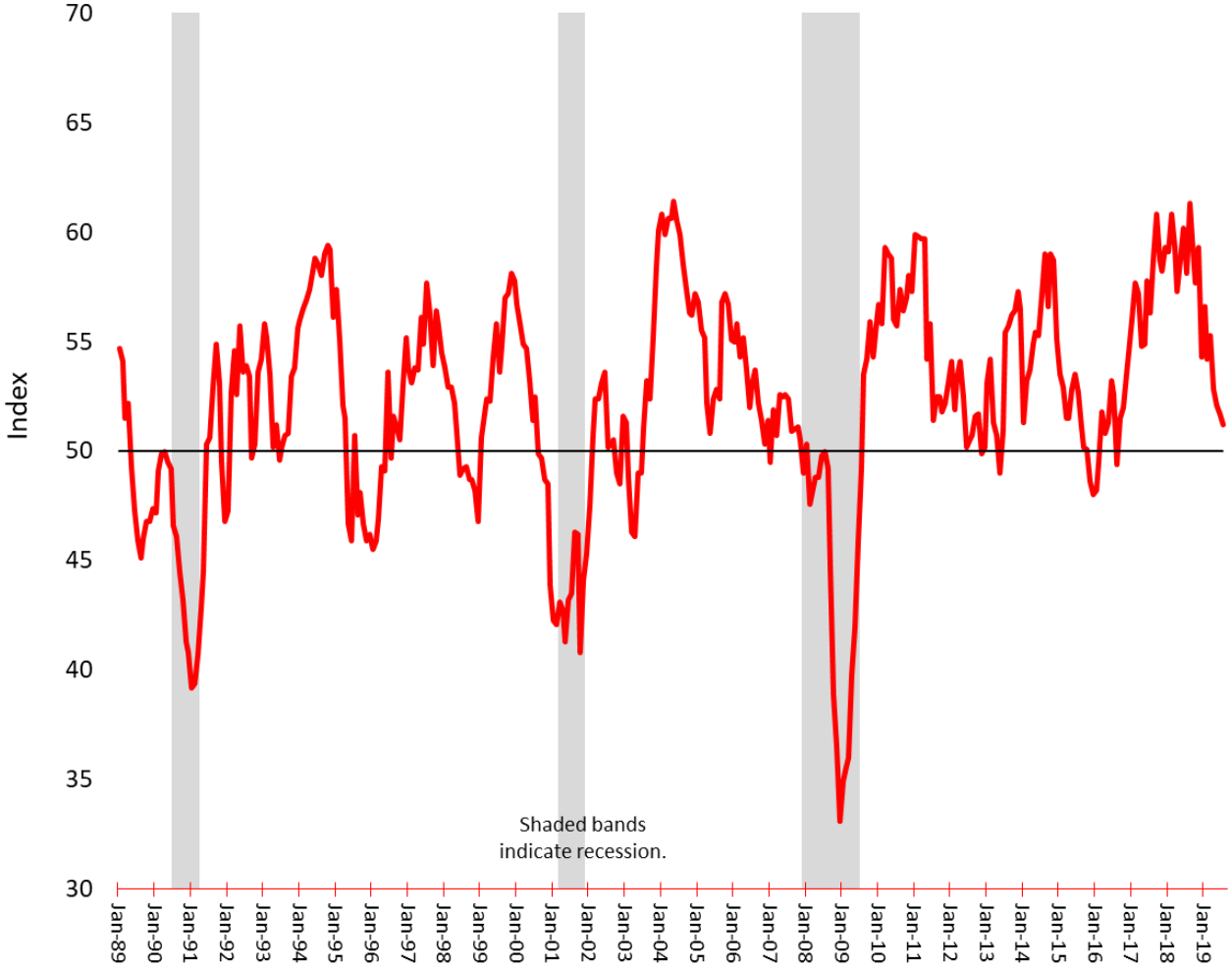

Down -0.3% in June, following no change in May and +0.1% in April.

"The US LEI fell in June, the first decline since last December, primarily driven by weaknesses in new orders for manufacturing, housing permits, and unemployment insurance claims. For the first time since late 2007, the yield spread made a small negative contribution. As the US economy enters its eleventh year of expansion, the longest in US history, the LEI suggests growth is likely to remain slow in the second half of the year."

This chart shows how the LEI has definitively rolled over well in advance of the last two recessions.

The Conference Board Leading Economic Index® (LEI) components: 1) average weekly hours worked, manufacturing; 2) average weekly initial unemployment claims; 3) manufacturers' new orders – consumer goods and materials; 4) ISM index of new orders; 5) manufacturers' new orders, nondefense capital goods; 6) building permits – new private housing units; 7) stock prices, S&P 500; 8) Leading Credit Index™; 9) interest rate spread; 10-year Treasury less fed funds; 10) index of consumer expectations.,
Source: ©The Conference Board. Data through June 2019, released July 18, 2019.

# Economic Data
# ISM manufacturing PMI – slowing growth




July ticked down to 51.2 from June's 51.7 and May's 52.1.

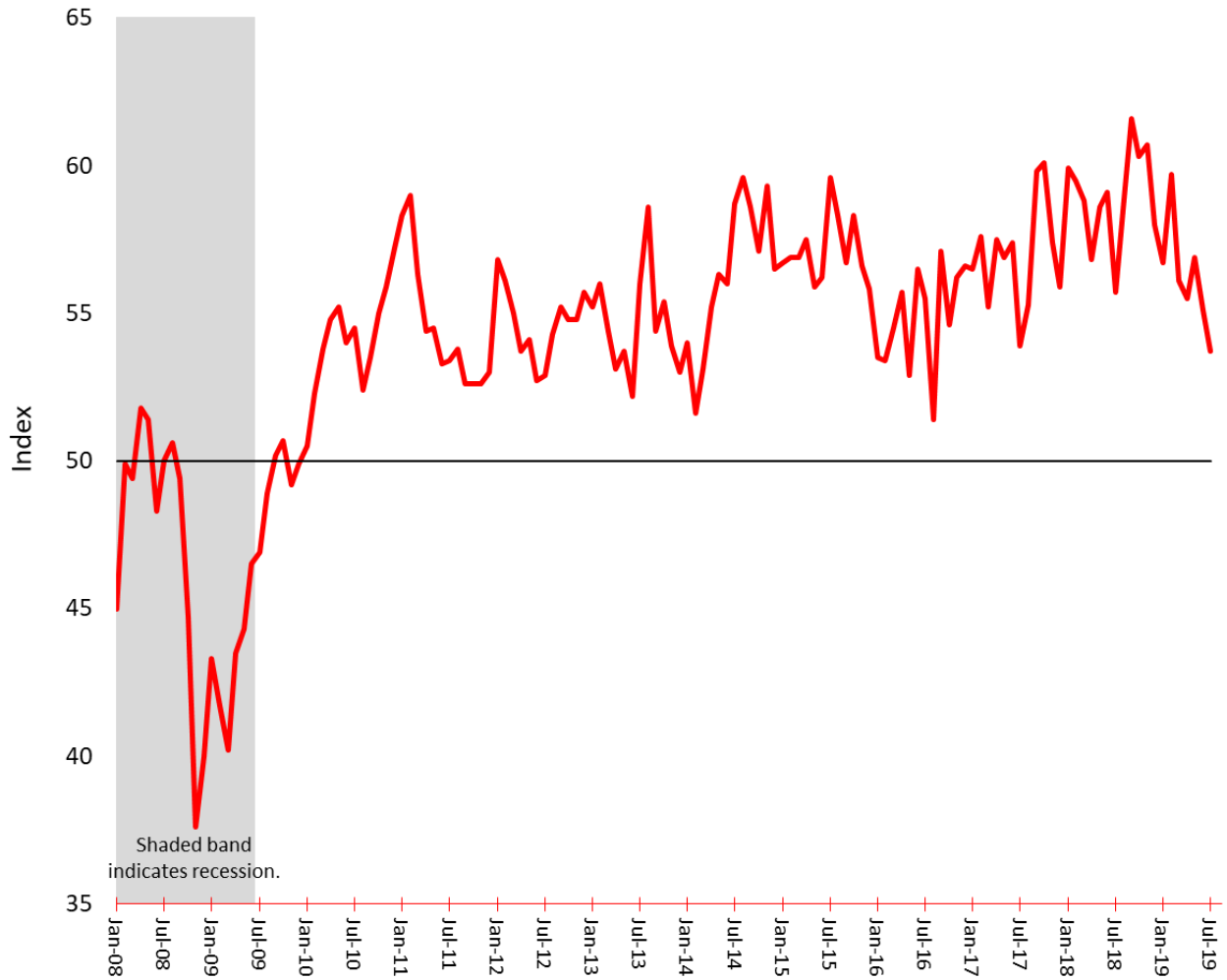
July's new orders ticked up to 50.8 from June's 50.0, which was down from May's 52.7.

Note the historic volatility in the manufacturing PMI.

Note how this indicator has slumped well below 50 even during periods of strong economic expansion, eg. 1995, 1999, 2003, 2013.

Source: Copyright 2019, Institute for Supply Management. Data through July 2019.
ISM: "A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting. A PMI in excess of 43.1 percent, over a period of time, generally indicates an expansion of the overall economy."

# Economic Data
# ISM non-manufacturing PMI – slowing growth



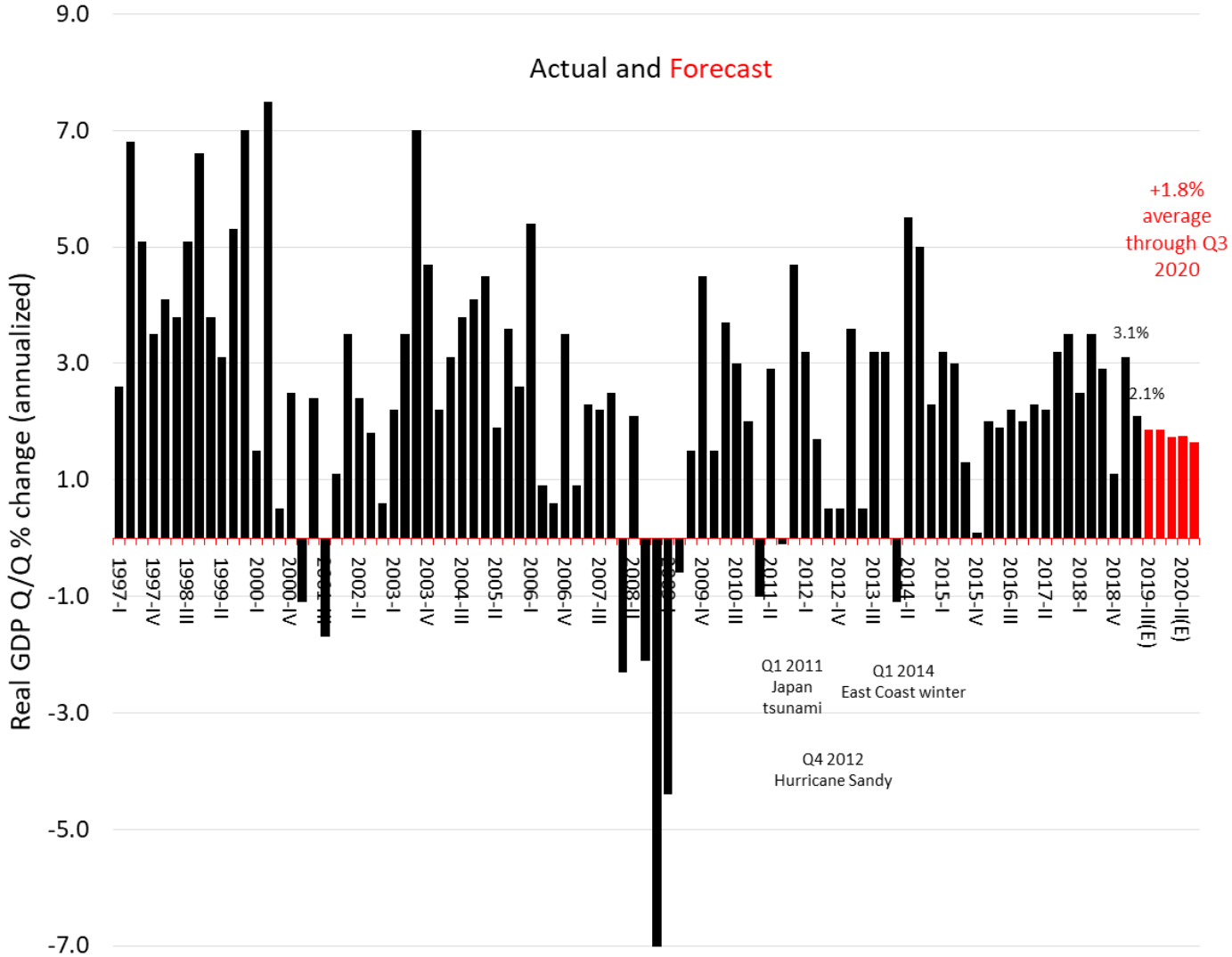

July ticked down again, to 53.7, from June's 55.1 and May's 56.9.

July's new orders ticked down again, to 54.1, from June's 55.8 and May's 58.6.

Non-manufacturing captures the vast majority of the U.S. economy.

Source: Copyright 2019, Institute for Supply Management; data through July 2019. This data series was created in 2008. ISM: "A reading above 50 percent indicates that the non-manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting."

# Consensus GDP Forecast
# No recession in the forecast




Despite the inverted yield curve and trade war …

… the 60 economists surveyed in early August see an average +1.8% rate of quarterly GDP growth over the five quarters ahead.

Sources: Bureau of Economic Analysis, actual quarterly data through June 2019. *The Wall Street Journal* survey taken August 2019.

# Jobs

- full-employment
- surprising continued strength in new jobs
- record job openings
- declining participation rate due to ageing
- Still some slack?
- strong relative U.S. job formation forecast long-term
- strong real wage and income growth
- mean and median incomes bottomed

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