From the desk of the CIO
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August Market Action

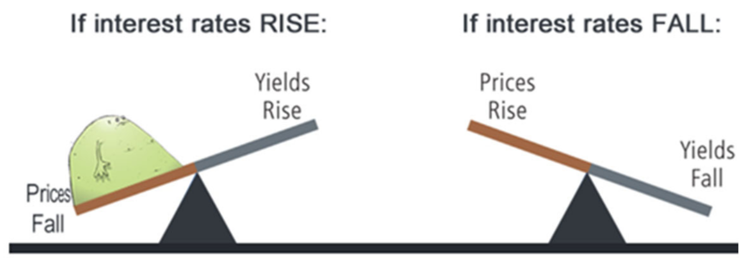
Recently, announcements and currency swings related to the ongoing “trade war”, primarily between the U.S. and China, caused volatility to return to the stock and bond markets. These trade tensions exist in the setting of a slowing economic growth rate around the globe. This slowing of growth is probably caused in part by the trade tariffs that are the centerpieces of the aforementioned trade war.

Without a trade deal going into the start of 2019, an inverted yield curve, and declining earnings estimates by many analysts we adopted a cautious, “risk neutral” posture in our portfolio planning. By risk neutral, we mean protect first and participate second. Our job is to seek higher probability outcomes for clients, achieving specific client objectives with the least possible amount of risk. Recent trading has shown the fragility of the global stock market and its propensity to tumble far and fast on any perceived negative news.

Yields on foreign government debt have become negative in many countries outside the U.S., and here at home government bond yields have dropped to multi-year lows, although not in negative territory. A negative yield means an investor would pay money for a government treasury to hold the investor’s money. The negative yield on higher risk European government securities drove fixed income investors to the more attractive, lower risk U.S. treasury securities, and this buying stampede caused the 10 Year U.S. Treasury bond yield to fall to below 1.7%. A secondary effect of this flight to U.S. treasuries was to increase the value of the dollar due to the higher demand for dollars in exchange for foreign currency to buy U.S. treasury securities.

These dynamics are on display in the two charts to the right.

The Relationship Between Interest Rates, Bond Prices and Yields



Dynamics Between U.S. Dollar Value and Treasury Yields

The takeaway from this rather technical discussion is that the inverted yield curve, often cited as an indicator of recession in the next 12 - 18 months, does not match other indications that show the U.S. economy is still chugging along, albeit at a slower pace in recent quarters.

However, risks are certainly elevated when compared to say 2017. Could an ongoing trade war with China push the U.S. economy into recession? That’s entirely possible. The longer both countries go without a deal, even a less than optimal deal, the greater the risk. The decline in economic transactions outside the U.S. may eventually spill over into our economy to a certain extent.

Many U.S. publicly traded companies stock prices are based on investors expectations of projected sales of products and services globally. Remove some of that growth resulting from trade tensions and now you have contagion into the U.S. Add to that, an increasing U.S. dollar value and our exports become even less competitive.

We're keeping an eye on corporate sales and profits. At the end of the day, the direction of stock prices follows growing or shrinking cash flows. The former is good and the latter less so, when investors grow worried. If they can continue to do this, it will certainly cause volatility as we experienced in recent weeks.

One of the most important dynamics we continue to follow, as a gauge of future growth potential, is the level of corporate expenditures and investments for future growth. The consumer has been carrying the day, keeping GDP at an acceptable level, but corporate investment and spending has been a drag on economic growth. Since tariffs were first imposed in 2018, we've noticed a pull-back in corporate expenditures. This was due to a lack of confidence in the future business climate for companies. A trade deal and a more settled political environment would certainly go a long way to instill confidence in company executives to spend for future growth.

We'll continue to monitor the situation as it evolves and stay in touch with you as necessary. As always, don't hesitate to contact us with questions.