Will the Trade War End the Bull Market?

Kristina Hooper
Chief Global Market Strategist

Brian Levitt
Senior Director Investment Strategy

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With contributions from Krishna Memani, OFI CIO at Invesco

Summary of current environment & investment views

Current environment

1. Policy uncertainty has created market volatility.
2. The trade war is likely to persist and may be entering into a new frontier.
3. Economic growth has slowed.
4. Financial conditions have tightened (again).
5. The yield curve has inverted (again).
6. Markets have penalized those sectors/companies with the greatest proportion of sales coming from overseas.

We've been here before in this cycle (see European debt crisis, Brexit, Federal Reserve tightening, etc.) but the risks are rising.

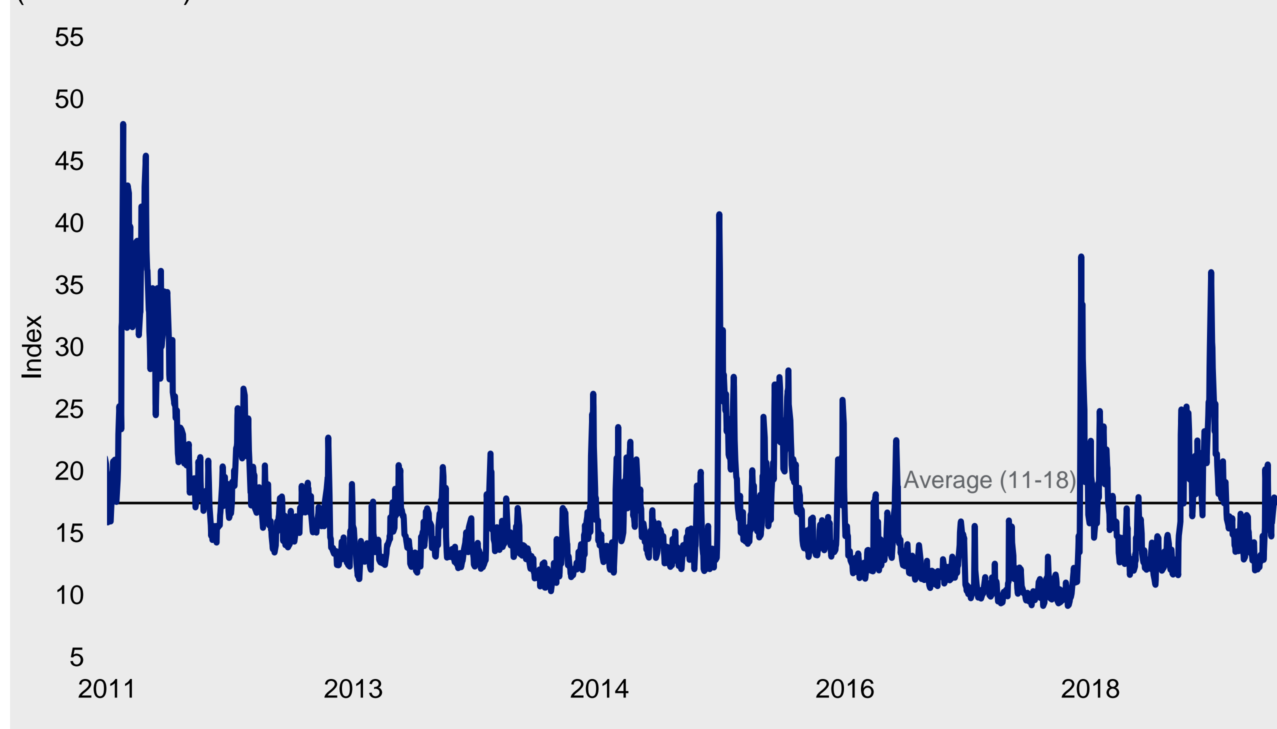
Outlook

1. A recession is unlikely:
   a) The Fed, with inflation benign, has the flexibility to respond.
   b) More China fiscal stimulus is likely to be forthcoming.
2. We expect stocks to outperform in a (still) low rate, benign inflation environment.
3. Investors may return to favoring growth in a "slow-growth world."
4. Emerging markets, given higher potential real growth and relative valuations, are poised to outperform.

There is no guarantee any referenced forecasts/outlooks will come to pass.

Current environment

1. Policy uncertainty is creating market volatility.

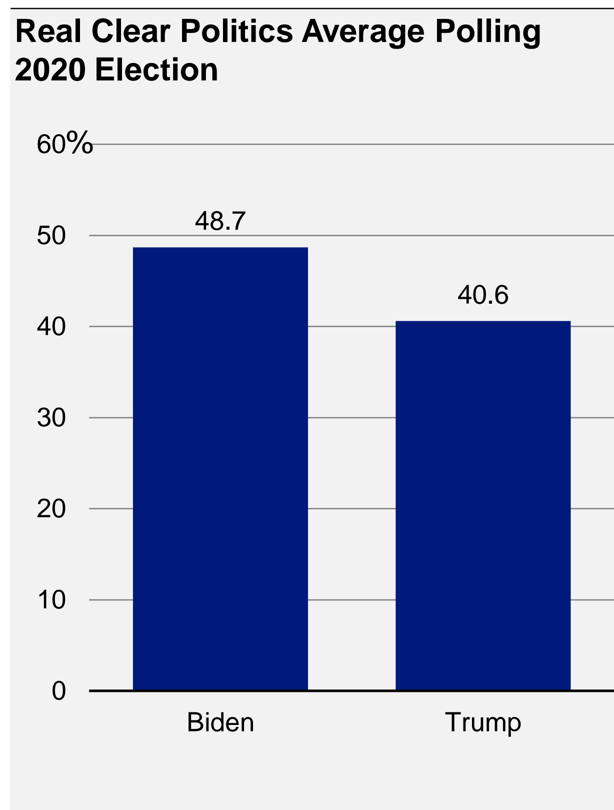


- Policy uncertainty typically results in market volatility, and the markets have responded to the deterioration in US-China trade talks as would be expected. We note that markets since the early May breakdown in talks have not been as volatile as they were in 2018 when the Fed was tightening monetary policy.
- All economic cycles ultimately end with policy mistakes, and the indirect effects of trade uncertainty, such as the tighter financial conditions, warrant watching. Ironically, the current “trade war” makes it more likely that the Fed will keep financial conditions accommodative, thus likely extending the cycle.

Source: Bloomberg, L.P., 5/30/19. The Chicago Board Options Exchange Volatility Index is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. **Past performance does not guarantee future results.**

Current environment

2. The trade war is likely to persist …

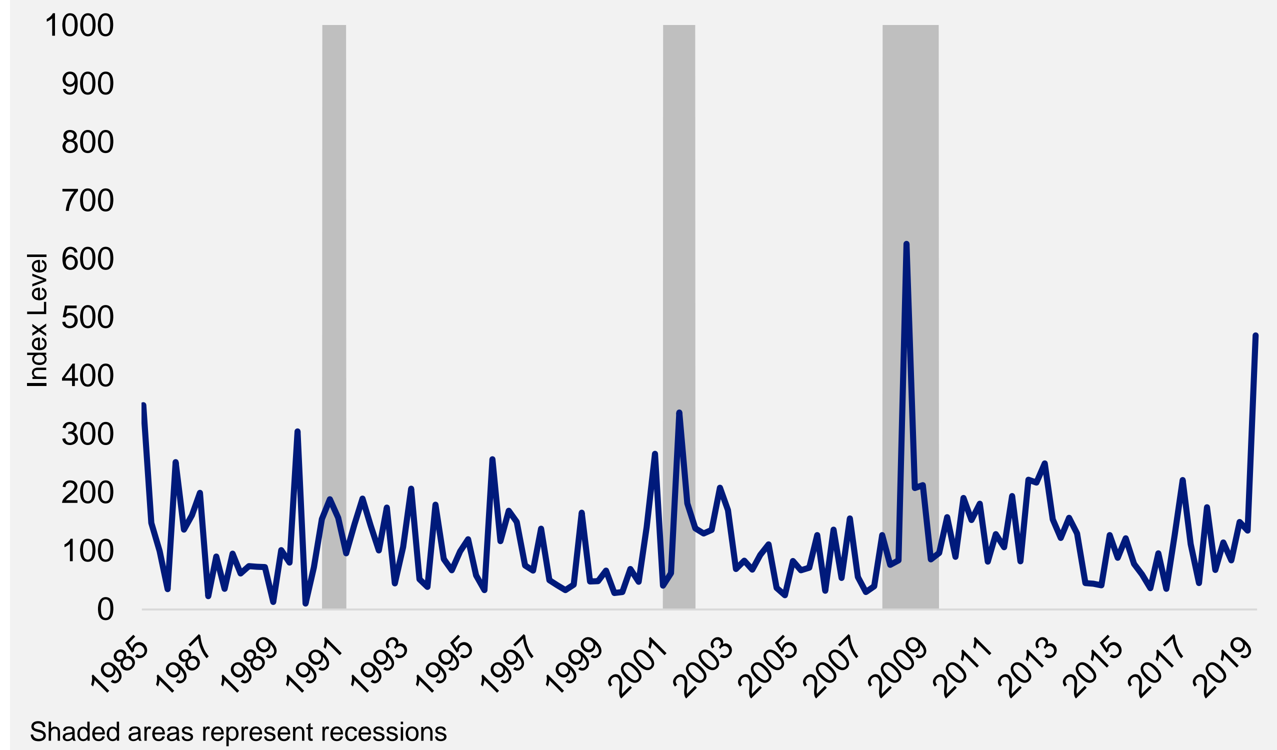


- The large majority of investors came into 2019 expecting a trade agreement between the US and China. The markets were disappointed and have responded in kind.
- Don't be surprised if the trade standoff goes on for longer than expected.
  - The Trump administration likely feels they are operating from a position of strength given that consumer confidence is high and Fed tightening is off the table.
  - China, for its part, is likely playing a long game, hoping to resist making any major concessions in the hopes that the Trump administration will capitulate and take minor concessions in advance of the 2020 election, or that a new president will be elected.

Source for left-hand chart: Conference Board, as of May 31, 2019. The Conference Board's Consumer Confidence Index® is published monthly, based on a survey of US consumers' buying attitudes and buying intentions.
Source for right-hand chart: Real Clear Politics, as of 5/31/2019

Current environment

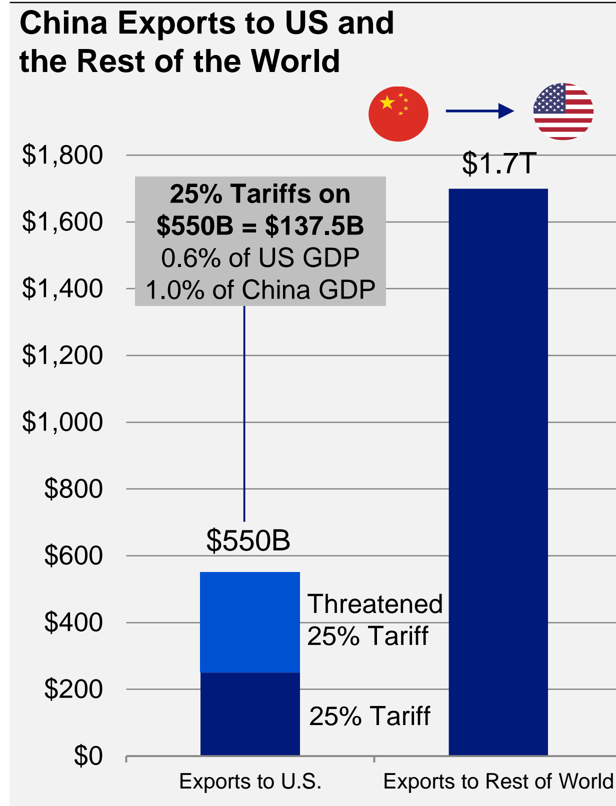
2. … and may be entering into a new frontier.



- The "trade war" may be entering a new and more dangerous frontier. President Trump recently proposed a 5% tariff — which could eventually rise to 25% — on all Mexican exports to the US unless the "immigration problem is remedied." Trump halted that plan, citing increased immigration enforcement by Mexico, but its significance remains — this was the first time the administration used the threat of tariffs for purposes beyond trade arrangements.
- This injected far more economic policy uncertainty into the environment, as this chart shows. If this tariff plan returns, we believe it would be detrimental to the Mexican economy, which is in large part driven by exports to the US. The US would not escape unscathed, in our view, as such a tariff would likely weigh on business sentiment and directly impact the US auto industry, among others.

Source: policyuncertainty.com. The Economic Policy Uncertainty Index is compiled from three underlying components that quantify newspaper coverage of policy-related economic uncertainty, reflect the number of federal tax code provisions set to expire in future years, and use disagreement among economic forecasters as a proxy for uncertainty.

Current environment
3. Global growth has slowed.



- Global growth has already slowed, a combination of the lagged effect of US monetary tightening and current trade uncertainty. Trade levels have followed and global purchasing manager indices are now at their lowest levels since early 2016.
- How big of a direct impact will the tariffs have on economic growth? It is difficult to quantify for a variety of reasons, but a back-of-the-envelope calculation reveals that the tariffs on Chinese exports to the US are equal to roughly 1% of Chinese gross domestic product (GDP), and represent a tax on US importers and/or consumers that is equal to roughly 0.6% of US GDP.
- The upshot is that annual US growth is likely reverting back toward 2% or lower, while Chinese annualized growth may also be negatively impacted, although China is likely to counter that impact with continued fiscal or monetary stimulus.

Source of left-hand chart: IMF, Bloomberg, L.P., as of 5/31/19.
Source of right-hand chart: US Census Bureau, US Bureau of Economic Analysis, Customs General Administration PRC, National Bureau of Statistics of China

Current environment

4. Financial conditions have tightened (again).

Goldman Sachs U.S. Financial Conditions Index
(1/1/08 – 5/30/19)

A weighted average* of:
- riskless interest rates
- the exchange rate
- equity valuations
- credit spreads

Index
102
101
100
99
98
97
2015
2016
2017
2018
2019

First Fed Rate Increase
Conditions Easing
Conditions Easing
Last Fed Rate Increase
Trade Deal Upended

- The larger potential issue than the direct impact to growth is the recent tightening of financial conditions, the result of a strengthened US dollar and a modest increase in credit spreads. Investors should monitor this closely.
- Markets fell into correction territory the last two times that financial conditions tightened meaningfully in this cycle (2015, 2018). Each time the Federal Reserve responded with more accommodative monetary policy. This time will likely be no different.

* Weights correspond to the direct impact of each variable on GDP.
Source: Goldman Sachs, Bloomberg, L.P., 5/30/19. The Goldman Sachs U.S. Financial Conditions Index is a weighted index of the Federal Funds Rate, the trade-weighted dollar, the S&P 500 Index and investment-grade credit spreads along with the 10-year US Treasury yield.

Current environment
5. The yield curve inverted (again).

US 10-Year Treasury Rate minus US 3-Month Treasury Rate
(1/1/79 – 5/30/19)

6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
-1.0%

Shaded areas represent recessions

1982 1984 1986 1988 1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010 2012 2014 2016 2018

- The spread between the rates of 10-year US Treasury bond and the 3-month US Treasury bill has inverted, a harbinger of a significant slowdown in economic activity.
- We remind investors that recessions tend to be preceded by the Federal Open Market Committee (FOMC) raising the Funds Rate above the 10-year Treasury rate and not the 10-year rate falling below the Fed Funds Rate after the Fed has already backed off its tightening stance.
- However, if this persists without a monetary policy response, then growth will likely deteriorate more meaningfully than we currently believe.

Source: Bloomberg, L.P., 5/30/19.

Current environment

6. Markets are penalizing those sectors/companies with the greatest proportion of sales coming from overseas.

Foreign Sales as % Total Sales by S&P Sector

Sector	Foreign Sales as % Total Sales
Utilities	0.03
Real Estate	0.14
Financials	0.22
Discretionary	0.32
Communications	0.37
Industrials	0.38
Healthcare	0.38
S&P 500	0.39
Energy	0.41
Staples	0.45
Materials	0.55
Technology	0.58

Y-axis: 0%, 10%, 20%, 30%, 40%, 50%, 60%, 70%

Top 2 performers May 2019 (Utilities, Real Estate)

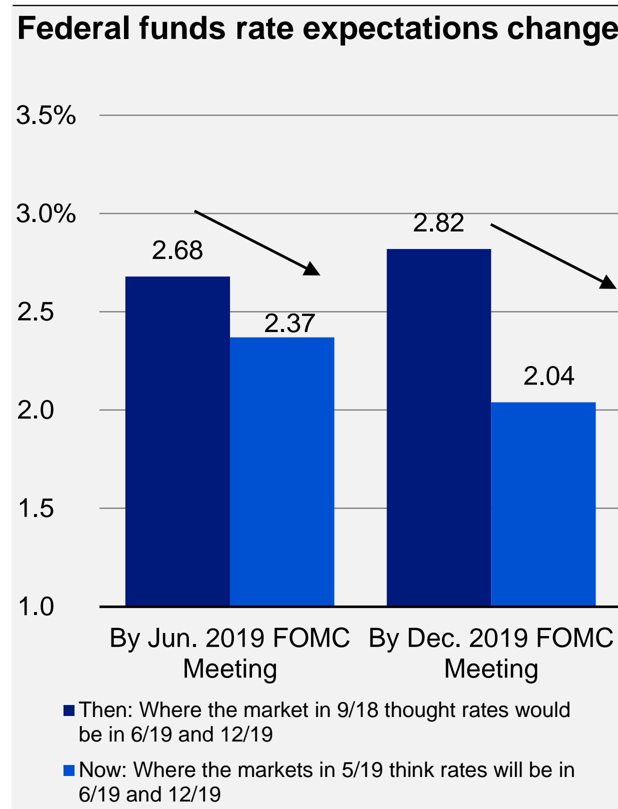
Bottom 2 performers May 2019 (Materials, Technology)

- In the short term, investors may continue to seek safety in more domestic-focused, higher yielding sectors such as utilities and real estate.
- If the cycle persists, as we expect it will, then it is unlikely that these defensive sectors will outperform over the intermediate to long term.

Source: Bloomberg, L.P.; Standard & Poor's, 5/31/19.

Outlook

1. A US recession remains unlikely at this juncture.
   The Fed, with inflation benign, has the flexibility to respond.



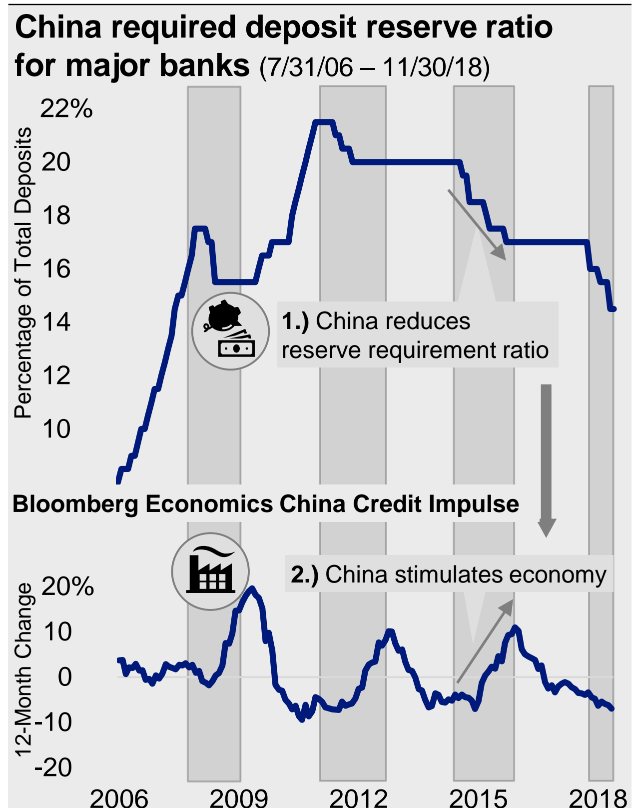
- A big underpinning of this elongated cycle has been easy central bank policy. That story has not changed. Inflation expectations, as represented by the US 5-year/5-year forward inflation breakeven, are below the Fed's perceived inflation target.
- As a result, the markets' expectations have changed. In September 2018, they priced in rate hikes for the June and December 2019 meetings. But in May 2019, they priced in two rate cuts.

Source: Bloomberg, L.P., 5/30/19.

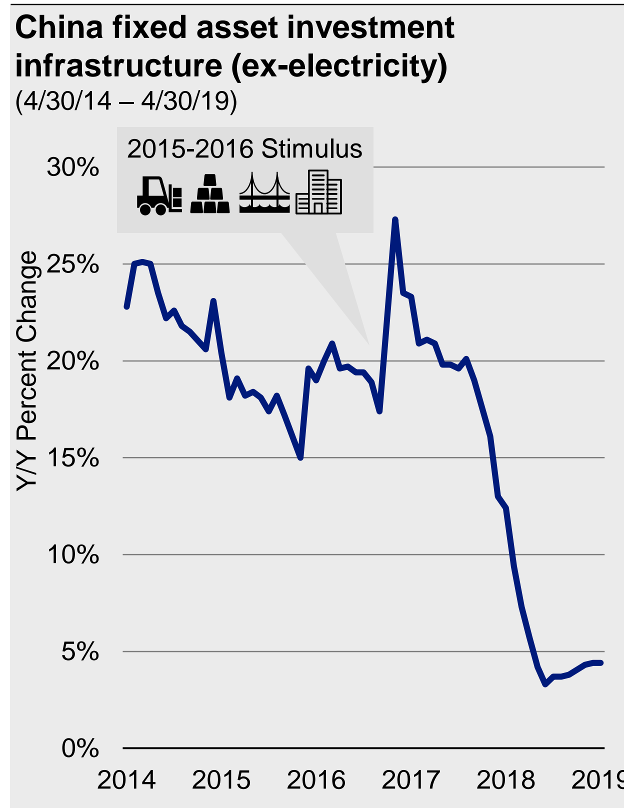
Outlook

2. Chinese growth is likely to be supported. More China fiscal stimulus is likely to be forthcoming.

Step 1: Monetary Stimulus



Step 2: Fiscal Stimulus



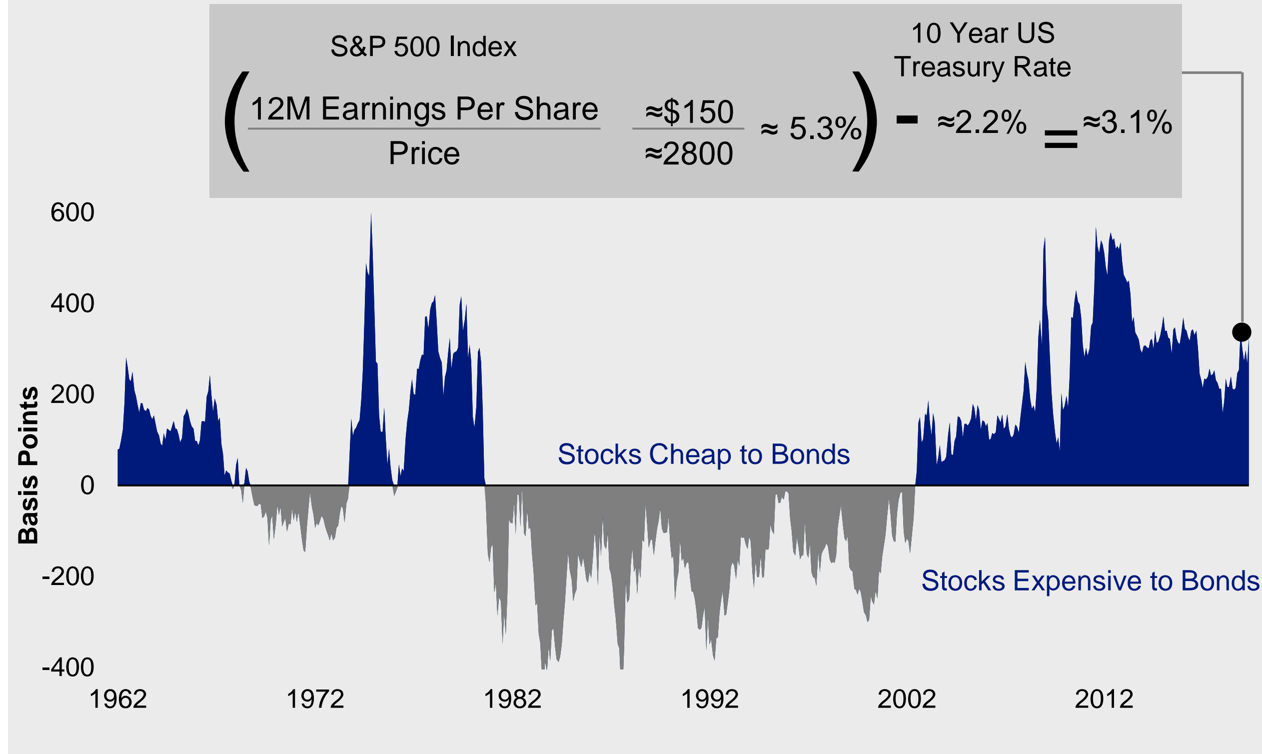
- Another large underpinning of this cycle is Chinese policymakers responding to slowdowns in Chinese economic activity with additional stimulus.
- Thus far, the response has been primarily on the monetary side with the cuts in the bank reserve requirement ratio.
- Fiscal stimulus (chart on the right) has also ramped up, likely providing a floor to Chinese slowing growth.
- China has made it clear that it will support its economy in order to ride out the ongoing trade war with the US.

Source: Goldman Sachs, Bloomberg, L.P., 5/30/19.

Outlook

3. We expect stocks to outperform bonds in a (still) low rate, benign inflation environment.

Stocks are *still* cheap compared to bonds



- As we've stated, it is unlikely that this cycle will end with the Fed providing further policy support and China stimulating their economy.
- It is even more unlikely that the cycle will end with stocks still this cheap to bonds. The recent equity selloff and bond market rally has the earnings yield on stocks over 300 basis points above US Treasuries.
- The last time that stocks were this cheap to bonds was in early 2016 as the equity market was commencing a sizeable rally.

Source: Goldman Sachs, Bloomberg, L.P., 5/30/19. Earnings per share (EPS) refers to a company's total earnings divided by the number of outstanding shares.

Outlook

3. We expect stocks to outperform bonds in a (still) low rate, benign inflation environment.

Equity price to earnings ratios tend to be supported in a low rate environment

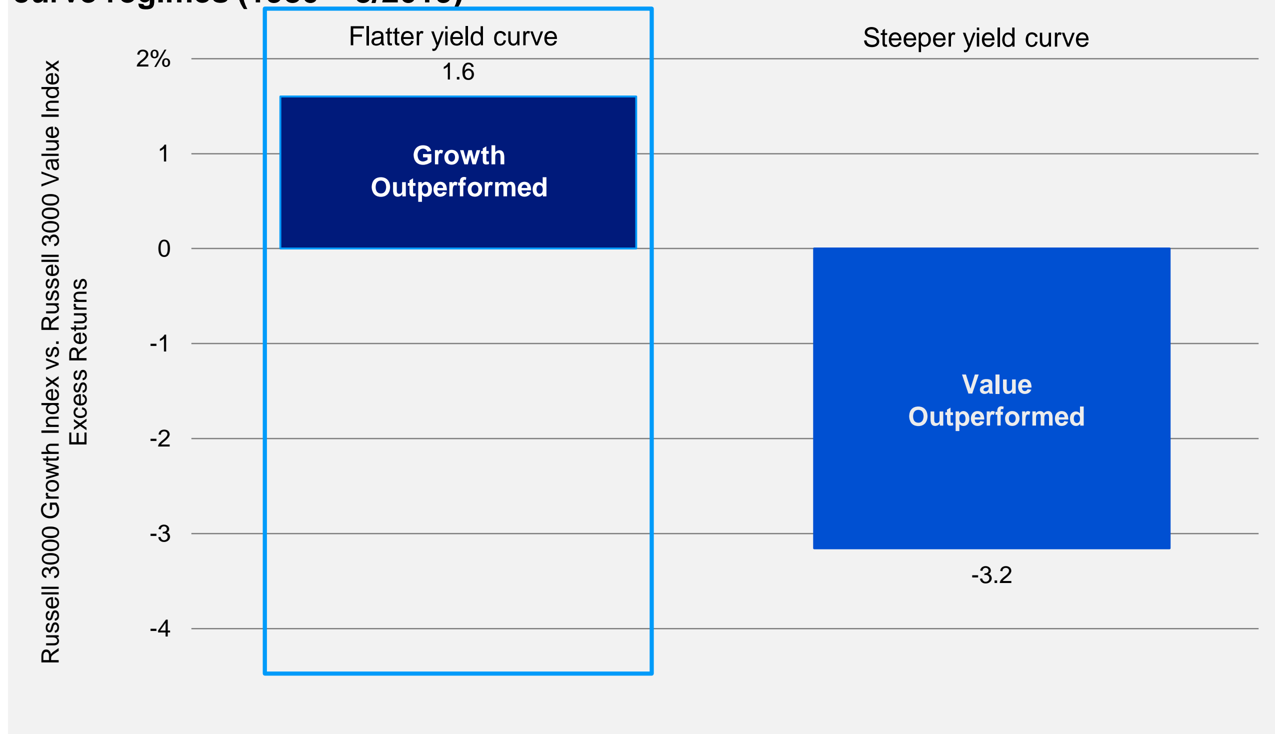
Relationship between Trailing S&P 500 P/E and 10 Year Treasury Yield (1957 - 2018)

- Admittedly, profit margins and earnings growth may be challenged in the near term as global growth slows.
- However, equity multiples have been relatively reasonable given today's low interest rate, low inflation environment. As this chart shows, rates are not near the level where equity multiples tend to contract. If anything, multiples may be on the low end, particularly if long rates remain low.

Source: Goldman Sachs, Bloomberg, L.P., 5/30/19. Trailing price-to-earnings (P/E) ratio measures a stock's valuation by dividing its current share price by earnings per share for the past 12 months.

Outlook

4. Investors may return to favoring growth in a “slow-growth world.”



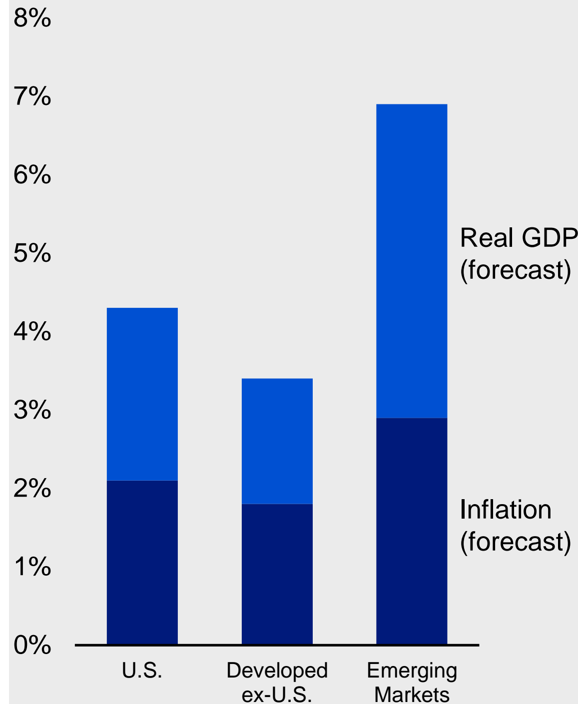
- It is rare for market leadership to change late in the cycle. We view the recent leadership of the more-defensive stocks to be a byproduct of the current trade uncertainty and tighter financial conditions. We would not expect this to continue.
- Using the shape of the yield curve as our guide, we find that true growth companies tend to outperform in an environment like today’s when global growth is slow and the yield curve is relatively flat.
- Value companies tend to outperform when the yield curve is relatively steep, which usually occurs at the depths of a recession and into the early stages of a market recovery.

Source: Goldman Sachs, Bloomberg, L.P., 5/30/19. *Performance quoted is past performance.* **Past performance is not a guarantee of future results.** *An investment cannot be made directly into an index.* A flat yield curve is one in which there is little difference in the yields for short-term and long-term bonds of the same credit quality. In a normal yield curve, longer-term bonds have a higher yield. In a steep yield curve, that difference is especially large. The Russell 3000® Value Index and Russell 3000® Growth Index are unmanaged indexes considered representative of US value and US growth stocks, respectively. The Russell 3000 Value Index and Russell 3000 Growth Index are trademarks/service marks of the Frank Russell Co. Russell® is a trademark of the Frank Russell Co.

Outlook

5. Emerging markets (EM), given higher potential real growth and relative valuations, are poised to outperform.

Emerging markets poised to be a driver of growth



EM equities are trading cheap to developed market equities

- Paradoxically, we conclude with highlighting emerging market equities in a piece about tariffs and trade wars.
- Investors seeking long-term growth may find that emerging markets are not only likely to be the drivers of world growth over the next decade, but are also trading at valuations that are cheap compared to the developed world.

Source: IMF, Bloomberg, L.P., 5/30/19. Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time. **The price-to-sales ratio** is a valuation metric calculated by dividing a company's market capitalization by its total sales over a 12-month period. The MSCI Emerging Markets Index is an unmanaged index considered representative of stocks of developing countries. The MSCI World Index is an unmanaged index considered representative of stocks of developed countries.

Important information

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The opinions referenced are those of the authors as of June 2019. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.

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