Stegent Equity Advisors Investment Letter

Stegent Equity Advisors, Inc. July 2018

In the second quarter volatility waned and performance decoupled as divergent backdrops created variances in returns for assets classes and markets across the globe. The winning trades for the second quarter were in the U.S. energy sector, U.S. small companies, and a select group of technology and consumer discretionary stocks. Energy thrived on a rising oil price, small companies on avoiding international earnings exposure, and technology/discretionary on the back of their perceived growth and safety prospects. While U.S. stocks rebounded throughout the quarter, international markets declined, and emerging market stocks were severely punished on the back of a soggier global growth backdrop combined with higher U.S. rates and a stronger dollar. Commodities were a mixed bag, with the energy complex posting big positive returns resulting from favorable supply fundamentals, while the metals and agriculture sectors appeared to succumb to a stronger dollar and other micro fundamental concerns. In fixed income, bonds were volatile but range bound, and very short-term maturities saw moderate returns on the back of continued tightening by the Federal Reserve.

Looking forward investors are challenged with deciding whether these divergent trends will persist, or whether markets are set to recouple as policy burdens build across the globe.

U.S. Tug of War & Rising Global Pressures

Currently major U.S. stock indexes appear to be trapped in a trading range defined by the January 26th high and the February 8th low, while international indexes have recently slipped to new lows on the year. The U.S. has been a relative source of market strength this year and continues to enjoy the residual fruits of the prior tax cuts that are flowing through the economy. But outside the U.S., the overall message of the markets seems to be that a variety of forces are percolating that may act to keep a ceiling on equity valuations for the time being. The combination of cooling global growth, monetary tightening, an increasing risk of a trade policy error, and a challenging seasonal backdrop all appear to be conspiring to prevent stocks from making new highs in the short-term. This has created an environment akin to a tug of war in the U.S., but risks seem to be building and may keep world markets under pressure over the next quarter or so.

2018 Surprise: Less Synchronized Growth

One of the surprises of 2018 has been the downshift in the synchronized global growth story. The simultaneous expansion in global economic growth and earnings was a major driver that helped propel global stock prices higher in 2017. Coming into 2018, that story looked promising to continue, but instead the global economy has run into a soft patch. The U.S. economy got off to a sluggish start in the first quarter, but most signs pointed to a strong acceleration in the second quarter. However, most global economies have experienced recent setbacks, and there doesn't appear to be any catalysts on the horizon to give them a fresh boost in the near term.

China is the second largest economy in the world and has been slowing, but policymakers there have been taking it in stride, so it's probably too early to expect a 2015/2016 style fiscal intervention that would pump up growth again. European and Japanese growth rates have also been weaker, with recent headwinds caused by their leverage to overall global growth rates, escalating trade tensions, and the upcoming tapering of bond purchases by European monetary authorities.

While the developed world seems soggy, it's the emerging economies that are coming under considerable pressure. The combination of rising U.S. interest rates and an unexpected rebound in the U.S. dollar has led to a tightening of financial conditions and exposed underlying weakness in some of the more fragile developing economies. Stock prices have come under fire, and the currency markets are experiencing some notable volatility, which may be a warning signal that some of the weak links in developing markets are starting to crack. The bottom line is that global growth looks weaker than it did coming into the year, and despite the U.S. doing its best to pull the rest of the world along, it may not be able to do so without some sort of positive catalyst coming to the fore.

U.S. Fundamentals Currently Strong

In a world where global growth has softened, the U.S. continues to look fundamentally solid, and we agree with consensus expectations for a material second quarter bounce back in GDP growth after a somewhat tepid first quarter performance. Presently, both consumer and business confidence is high, the labor markets are robust, leading indicators are still pointing up, and fiscal stimulus is still exerting upward pressure on the U.S. economy. Overall, the odds of a recession still seem very low over coming quarters in the absence of a major shock from something like a spike in oil prices or a full-blown trade war. Earnings have also been rising in tandem with the economy, and small business confidence has remained elevated, providing a solid back drop that should give businesses the wherewithal to invest more and help keep the expansion going. Though the U.S. is likely in the late phase of the expansion, so far the economy has reaped the fruits of a healthy labor market and higher incomes, along with inflationary pressures that have been developing at a slow enough pace to keep the positives outweighing the negatives.

Risks to U.S. Rising

When it comes to the economy, stocks are currently caught in a bit of a pickle. One risk is that the U.S. is beginning to overheat as late cycle tax cuts collide with a tight labor market where demand appears to be outstripping supply. The risk is that eventually the tightness in the labor market will stoke a material rise in wages. Higher wages are good for consumers' wallets, but if they accelerate too fast they become an inflationary input that crimps corporate earnings and puts pressure on interest rates. From this perspective, good economic news can actually be bad news for financial assets like stocks and bonds. So far wages have been rising very slowly, which has allowed the Federal Reserve to move methodically in raising rates, but if this dynamic changes it would likely be a game changer that lures the Fed into a more aggressive approach that eventually chokes off growth.

Another more deflationary risk is that the U.S. may be headed towards an economic disappointment in coming quarters due to several factors that appear to be materializing at the same time. The Fed is tightening monetary policy at the same time the world appears to be slowing, and financial conditions are starting to tighten in the U.S. due to the mix of higher rates, a stronger dollar, and increasing oil prices. The tax cuts should continue to give the economy upward inertia for a few more quarters, but the boost will gradually fade, leaving the economy to deal with several headwinds that may start to dampen the recent forward momentum. The risks outlined above are also being compounded by the all-important wildcard coming out of Washington in the form of trade policy.

Elephant in the Room: Trade Policy Risk

Last quarter we wrote that the most significant risk to equities was a potential trade-related policy misstep coming out of Washington. We've been monitoring this risk closely for the last quarter and have not been encouraged by the tone coming out of the White House. The optimists on trade frictions still believe that President Trump is either posturing for the best possible revised agreement, or that he will only push things so far if financial markets begin to riot, since he hasn't been shy about using stock market gains as a barometer for success. We are not so sure if either choice will have a positive impact. The idea that the U.S. has been disadvantaged in our trade relationships seems to be a core belief of this administration, and as a result, they appear determined to pursue significant changes to long-standing trade agreements.

There are a multitude of reasons to believe the risk of a trade war is growing. First and foremost is the fact that the president and his team believe that making material changes to trade is the right thing to do, and that a trade war will be easy to win because we have such a significant trade deficit. This may be a miscalculation in the eyes of many economists, but the administration seems to staunchly believe in the premise, which is important when trying to discount future decision making. The president has assembled a team around him that will be tough on trade, and this is one area of policy that he has unilateral authority to change without the approval of Congress. To make matters thornier, the president's approval ratings have been rising recently, so he will likely believe his recent actions on trade to be winning support going into the mid-term elections this fall. Why change strategy when things appear to be working?

The current math on trade frictions may seem harmless at first blush, but a closer look at the numbers shows that this protectionist behavior could be a material headwind to the global economy. While some estimates of the first $250 billion in tariffs on China may only cost the U.S. less than half of a percentage point in GDP growth, the real trouble will likely be felt in the secondary effects of tariffs on supply chains across the globe. This is because many goods exported through China are made in other Asian countries and sold to China before making their way to the U.S. The result is that a material reduction in Chinese exports turns into a problem for not only China, but also those countries that start the chain of production. One eye popping stat from research firm Cornerstone Macro shows that China plus other key Asian supply chain countries make up approximately 20% of global growth. The administration seems very focused on changing the trade relationship with China, and if they keep pushing then a large chunk of global GDP could be at risk.

Outside of China, the White House seems ready to pick a fight with any country, including some of our allies like Canada and the European Union. Recently, auto tariffs seem to be under serious consideration, and there is a non-trivial risk to pulling the plug on the North American Free Trade Agreement and possibly even our membership in the World Trade Organization. The bottom line is that trade risks are escalating and will likely weigh on markets globally until there is enough political or market pressure to get the U.S., China, and other countries to pull back from these ill-advised policies. This may eventually happen, but right now it seems like it may take some pain before policymakers reverse course, particularly from the U.S. side.

Building Some Defense

We are beginning to lower portfolio volatility profiles due to what appears to be a poor risk/reward scenario that may be developing over the next quarter or so. We will be de-risking in an incremental fashion and looking to use upside volatility as an opportunity to get more defensive on the rise. From a high level, portfolios will generally own less in equities, with less international and cyclical exposure than in recent quarters. In U.S. and international sectors, we plan to rotate into more defensive sectors of the equity market that should be less volatile than the overall market, should volatility begin to rise. In fixed income we are also building back into high-quality treasury bonds as a defense against the faltering of global growth and the risk of a trade war causing a deflationary shock. We continue to hold some gold as a hedge as well but prefer to own a variety of hedges in case the dollar keeps rising and continues to weigh on the precious metal. We'll also continue to own more cash-like securities than the benchmark. In an environment where short-term rates are rising and there are seemingly risks to any asset class, cash just might be king for a little while.

Conclusion

As we start the third quarter, we believe there are a variety of risks building in markets that have tilted the risk/reward balance into a place where global equity volatility may be poised to increase in coming quarters. We don't currently see the signs of an increased risk of a recession in the U.S., which should limit potential downside (though the trade frictions in progress could potentially turn into a game changer if policymakers continue to turn up the heat and trade frictions turn into a full-blown trade war).

While we are pulling back towards neutral volatility levels on a tactical basis, we are also keeping an open mind for what develops from here. If volatility forces policymakers into a better place while the evidence stays firm, it may provide an opportunity to increase exposure at better prices. On the other hand, if evidence deteriorates or policy keeps getting worse, it might compel us to start defending more aggressively against the possibility of a cyclical bear market. The last few years have been great for growing investor wealth, but we may be drawing closer to a time where we need to focus on preserving principal. This is a time to be more cautious, but also to remain flexible to react to what unfolds over coming quarters.

As always, we are grateful for the opportunity to continue to serve as your trusted advisor. Please reach out with any questions or concerns.

Loyd J. Stegent, President
Stegent Equity Advisors, Inc.