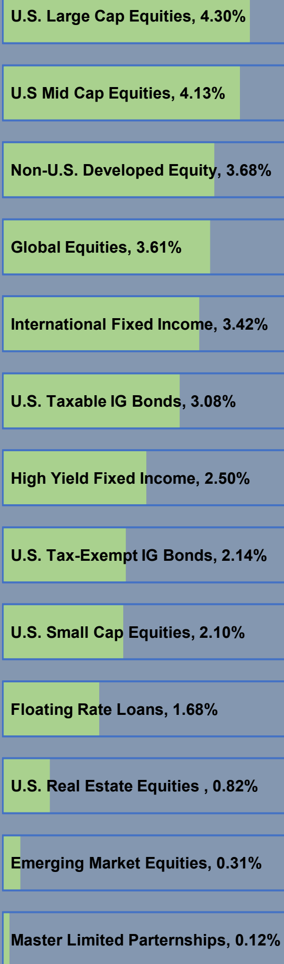
Independence | Asset Advisors

MarketMatters

INDEPENDENCE ASSET ADVISORS' QUARTERLY GLOBAL MARKET JOURNAL

June 30, 2019

Second Quarter Results*



In this issue…

P.1 Market Overview & Themes

P.2 Trade & Global Economic Growth

P.3 Market Review (Q2 2019)

P.4 Market Outlook (Second Half 2019)

*Source: eVestment Analytics

> "Crosscurrents have reemerged, with apparent progress on trade turning to greater uncertainty. With incoming data raising renewed concerns about the strength of the global economy, many FOMC participants judge that the case for somewhat more accommodative policy has strengthened."
>
> \- Federal Reserve Chairman Jerome Powell

Second Quarter Market Overview & Key Themes

➢ **Trade & Tone**

Trade negotiations between the U.S. and China escalated during the second quarter, which stoked concerns about the deceleration of global economic growth. As a result, both the Federal Reserve and European Central Bank repostured, shifting their tones more clearly toward monetary accommodation.

➢ **Better-than-Expected, but Volatile**

Global equity markets rose at a more measured pace in the second quarter, supported by a backdrop of reasonable fundamentals, better-than-expected corporate earnings, and relatively benign geopolitical risk. However, equity markets exhibited late-cycle volatility, falling sharply in May before recovering to end the quarter positive.

➢ **Synchronization**

Investors enjoyed broad-based gains across both perceived "safe-haven" investments, such as government bonds, and riskier investments, such as equities and below investment grade bonds and loans. Unlike the fourth quarter of 2008, when stocks sold off amid declining bond yields, thus far in 2019 we have seen equities rise alongside U.S. Treasuries.

➢ **Emerging Markets & China**

Emerging markets equities lagged most major global asset classes in the second quarter. This was predominately attributable to the concerns about China's economic growth trajectory, sagging manufacturing results, and trade effects. China's monetary policy stimulus efforts appear to have stabilized the economy, however high debt levels are likely to inhibit a growth re-acceleration.

➢ **Yield Inversions**

The 10-Year Treasury yield ended the second quarter 0.12% below the 3-month Treasury yield. This specific yield curve inversion has preceded the past seven recessions. However, the time between inversions has varied, and there have been two instances where the economy expanded for two years before contracting.

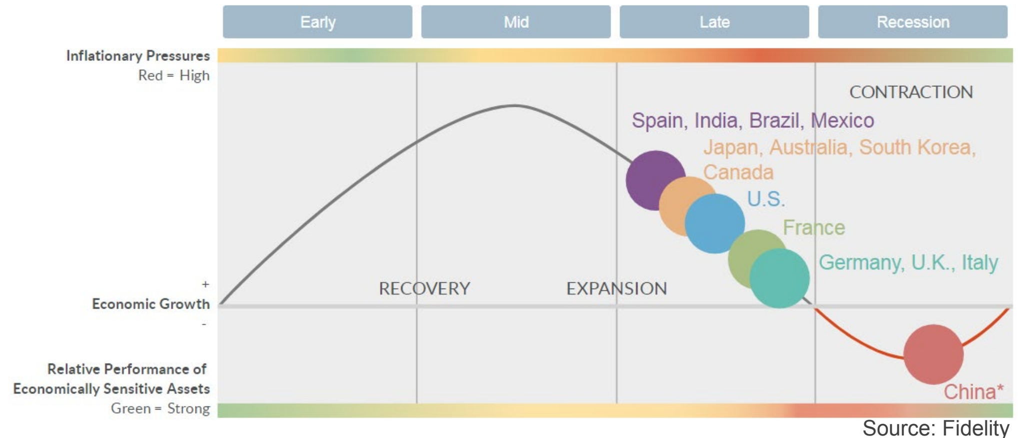
➢ **Fallen Angels**

There is a growing concern about the size of the BBB-rated corporate bond market. The risk is that much of the segment, the largest of the investment grade corporate market (>50%), may be downgraded to high yield. Passive investors would be negatively affected, while active investors could benefit.

Trade & Global Economic Growth

- The U.S. is firmly in the "late" stage of the business cycle, but there appear to be no catalysts or "bubbles" that would result in a near-term "hard landing" recession, despite a yield curve inversion and trade-policy friction.

- China, which is shown as being in the trough, or "recession" phase of the business cycle, appears to have stabilized its economic growth trajectory with assistance from its government stimulus. However, high debt levels and trade may offset stimulus measures.



Source: Fidelity

The chart above is intended to demonstrate that the global economy is slowing. There is a multitude of factors that may be contributing to the current state of economic growth, including Brexit, faltering manufacturing and the disappearance of fiscal stimulus from U.S. tax cuts. However it appears certain that the synchronized deceleration in global industrial production and trade-policy friction between the U.S. and China are weighing on global growth. In this section we briefly focus on trade, and the specific impact of tariffs.

Beginning in March 2018, the U.S. imposed a series of tariffs on steel and aluminum imports (all countries except Australia). In July 2018, the U.S. extended the first in a series of tariffs on imports from China. The specific targeting of China was in retaliation for China's refusal to change intellectual property rights-related acts, policies and practices that the Office of the U.S. Trade Representative (USTR) had determined were adversely affecting U.S. companies. The U.S. has recently established a truce with China, which stabilizes tariffs but does not reduce them, and maintains that additional tariffs will be imposed if China continues to fail to implement a long list of changes to its intellectual property rights policies and practices, and to narrow its trade surplus with the U.S.

The escalation of tariffs by the U.S. (both actual and threatened), as well as the retaliatory tariffs imposed by its trading partners, seems to have had an impact on global producers, consumers, workers and the markets. While it is too soon to quantify the direct GDP impact, the trade war is clearly reshaping global trade. Recently released data show that China's economic growth has slumped to its lowest level in 30 years, as the country has reported a fall in both exports and imports. China's global exports fell 1.3% year-on-year for the first half, while imports declined 7.3%, and exports and imports to and from the U.S. declined 8.1% and 30%, respectively. The trade war is also impacting the global automotive industry and information technology companies. For example, Apple (AAPL) sales in China dropped 21.5% year-over-year in the second quarter as a result of tariffs, not as a result of diminished product demand.

The U.S. Administration argues that its implementation of tariffs and quotas have nothing to do with the slowdown in the global economy, yet institutions such as the International Monetary Fund suggest that "the escalating trade tensions are the largest risk out there." Tom Orlik, Chief Economist at Bloomberg Economics, argues that "The U.S. economy is already suffering as China's tariffs hit sales of agricultural products. Inability – in the short term – to fill the gap left by Chinese products means a second blow as U.S. manufacturing firms miss crucial inputs into the production process. As the economic iron curtain falls, it's not just those on the Chinese side that are suffering."

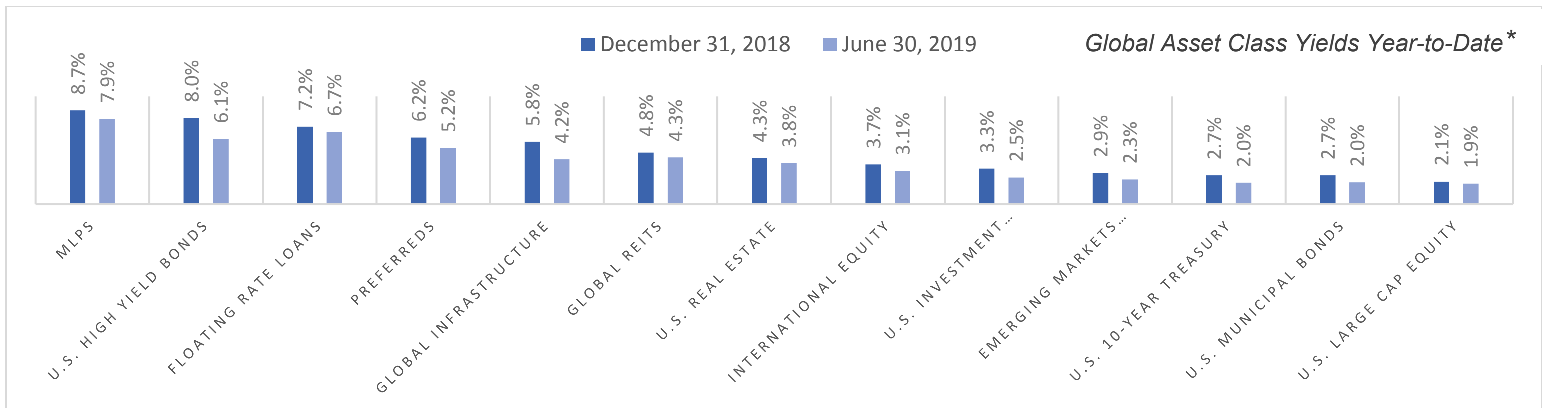
It may be too early to tell if trade wars are to blame for the positioning of the countries shown above on the economic growth chart, but there is no doubt they are affecting global trade flows.

What are tariffs anyway?

A tariff, by definition, is a tax to be paid on a particular class of imports. Money collected under a tariff is called a duty, or customs duty. Tariffs are used as a tool by governments to generate revenue or to protect domestic industries from competition. At their most basic level, tariffs make foreign goods more expensive to domestic consumers, causing a decline in imports, a decline in the supply of the good, and a resulting increase in the price of the good. The price increase usually motivates domestic producers to increase output of the product. A contrarian view of tariffs is that they interfere with free market ideals by diverting resources to domestic industries that are less efficient than foreign producers.

*Source: eVestment Analytics, JP Morgan, federalreserve.gov, Bloomberg, Fidelity, taxfoundation.org, WorldTradeOrganization (WTO)

2019 Global Yield & Asset Class Review



- **U.S. Equities**

The S&P 500 Index gained 4.3% in the second quarter, improving its year-to-date return to 18.5%. This is the best first half return for the index since 1997, and an unexpected result considering the headwinds pressuring U.S. stocks. In our opinion, the stock market rally is a result of a combination of factors, including lower global interest rates, an adjustment of U.S. monetary policy from tightening to accommodative, modestly increasing earnings growth, and a stronger than expected recovery from the fourth quarter correction.

- **Midstream MLPs**

Energy infrastructure investments managed to remain positive in the second quarter despite a crude oil sell-off that saw oil prices plummet from $66 to $51. We are encouraged by the resiliency of midstream energy companies during this period, as the correlation to oil has noticeably increased over the years. We believe the neutral result during a challenging period, and the 17.0% gain year-to-date, is the result of record earnings, strong fundamentals, growing distributions, and record high debt coverage ratios (partnership "cushion" to pay distributions).

- **U.S. REITs**

Returns for U.S. REIT common equity were muted but positive during the second quarter, an adequate result during a choppy market. Easing interest rates were a notable factor underlying second quarter returns for REIT senior securities, including both unsecured bonds and perpetual preferred equity. For common equity investors, there were distinctive performance differences by property type, with underlying themes and influences reflecting company specific factors.

- **Foreign Equities**

Developed non-U.S. equities and emerging markets equity indexes diverged in the second quarter, with the MSCI EAFE Index and MSCI EM Index gaining 3.7% and 0.6%, respectively. International developed markets rallied as both the U.S. Federal Reserve and European Central Bank signaled they would take measures to combat slowing economic growth. The prospect of more accommodative monetary policy, partnered with an acknowledgement that risks associated with trade tensions would be addressed, supported developed markets. Emerging Markets were suppressed by Chinese growth trajectory concerns, weak manufacturing and trade fears, and high debt levels.

- **U.S. Investment Grade Bonds**

The Barclays U.S. Aggregate Bond Index gained 3.1% in the second quarter. The index finished the period yielding 2.5%, which is down from 3.3% at year-end, and 0.3% lower quarter-over-quarter. In terms of attribution, investment grade corporate bonds performed best, gaining 4.5%, followed by commercial mortgage backed securities and Treasuries, at 3.3% and 3.0%, respectively. While all segments were positive, asset backed securities lagged, returning only 1.7%. In terms of spreads, the Barclays aggregate has tightened 8 basis points year-to-date, and the Index is trading at $104.7.

- **U.S. Municipal Bonds**

U.S. tax-exempt bonds have performed well, gaining 2.1% in the second quarter and 5.1% year-to-date. Municipals are very expensive, trading at a $110 premium to par, but offer an attractive tax-equivalent yield of 3.4% (on a 2.0% yield). In terms of attribution, BBB-rated municipals provided the best return during the quarter, up 2.9%, and the 5-year and 10-year indexes returned 1.7% and 2.2%, respectively.

- **U.S. High Yield Bonds**

High yield bonds have participated in the equity rally, gaining 2.5% during the second quarter and 10.0% year-to-date. BB-rated bonds are trading at a $103 premium, while CC-rated bonds are considerably less expensive at $83. Yields for these issues were 4.5% and 11.8%, respectively, at quarter end. Default rates remain near historical lows, but lower quality high yield is susceptible to equity market volatility.

- **U.S. Leveraged Loans**

Despite heightened liquidity concerns, bank loans performed well in the second quarter, gaining 1.7%, which improves the year-to-date total return to 5.7%. Loan prices inched higher during the quarter, and the CLO market set a record for new-issue volume. Loan prices have trended higher since the financial crisis, with the average bid of the S&P/LSTA Index ending June at $99 overall. This asset class is no longer "cheap," and with a 100% probability of a rate reduction, bank loans are likely to offer a lower rate of income to current and prospective investors.

*Sources: JP Morgan Guide to the Markets, Eaton Vance Monthly Market Monitor, Dow Jones Indices, FactSet.

2019 Global Market Outlook

Takeaways

- It feels like a good time to be cautious.
- Trade negotiations will remain front page news.
- Monetary accommodation should provide enough support to keep stocks positive.
- We expect the Fed will cut rates by 0.25% in July and up to 0.50% by year-end.
- We have downgraded our global growth outlook for the second half with a flat trajectory for equities amid a tepid earnings forecast.
- Our outlook for Emerging Markets is negative.
- We see good value in energy infrastructure and REIT investments, but higher late-cycle volatility.
- We are cautious of corporate credit and a BBB-rated bond selloff, but acknowledge there are some value opportunities in this segment.
- We are aware of loan liquidity risk and will not add to this segment with a rate cut forecast.
- We see better opportunity in securitized consumer credit.

BBB-Rated Bonds

We introduced BBB credit downgrade, but thought it was important to give an active manager's opinion on the issue. The following has been provided by one of our specialized debt managers, Aristotle Credit.

"While it is a fairly shocking statistic that BBBs now comprise over half of the IG corporate market, it is also something the market has focused on and dissected for a while. Absent a recession here in the U.S., something we are not currently expecting, we do not expect a spike in volatility due to rapid downgrading in BBB credits. There will be a handful of names that move down due to very specific situations, but the vast majority of BBB credits have plenty of levers they can pull to manage their balance sheet enough to satisfy the agencies and remain IG. Those credits that are charting a clear path of deteriorating metrics, and thus likely downgrade to HY, are mostly trading with this expectation priced into current spreads. We have found some relative value opportunities in the BBB market this year, especially given the exceptionally strong performance of BBs in HY market year-to-date. Current technicals allow you to selectively find bonds in much larger, more liquid and higher rated credits at similar or sometimes better spreads. For a good fundamental credit shop like ours, this does present some compelling opportunities."

Leveraged Loans

Regarding the loan market, we have seen our active discretionary fixed income managers reduce their exposures in the first half. This is attributable to the reversal in Fed rates policies and the preference to own more liquid traded bonds in a market where they want to be more defensively positioned.

The market is concerned about liquidity in the loan market, and our managers concur, but CLO origination has largely diminished this risk.

In terms of downgrade risk in loans, there are questionable one-off loan issuers out there, but that is always the case and our managers are not involved with these deals.

Our managers maintain small allocations to loans because they provide an attractive yield carry relative to some of the very tight short maturity bonds offered in the HY bond market – this in spite of the fact that they will likely float modestly lower in the coming months.

BBB Downgrade Risk

Concerns are growing that the BBB-rated corporate bond market has grown too large, and there is a very real possibility that a meaningful portion of this segment could be downgraded to high yield.

Years of record low interest rates have generated enormous growth in the U.S. corporate bond market. Over the past decade, the broad corporate bond market has tripled in size, from $2.3 trillion to $6.6 trillion. The share of U.S. BBB-rated debt has increased to a record 50%, compared to 33% in 2008. Default rates for BBB-rated bonds are incredibly low, at 0.2% annually, but the risk we are addressing here is not default risk but downgrade risk.

When markets experience a downturn, which is becoming more likely at this stage in the economic cycle, corporate fundamentals will soften and U.S. corporate earnings will decline. This will negatively affect the cushion available to cover interest payments and leverage will rise. As a result, ratings agencies will downgrade credit from investment grade to high yield. BBB-rated bonds are distinctly affected by this action, as they sit just north of the of the high yield boundary (BB).

All passive investors would be immediately exposed to this shift, being forced by mandate to sell the "fallen angel" bonds at the next rebalancing to maintain an investment grade rating quality. Given the massive size of the BBB market, this segmentation would result in a massive sell-off, and the impact on portfolio returns would be negative. Around 28% of all U.S. bond assets under management are now owned by passive index funds, up from 9% in 2008.

Active investors, or those with mandates stimulating a methodology of "hold to maturity," would not be forced to sell, and may actually benefit from the downgrade.

Disclaimer:
The views and opinions in this newsletter are solely those of Independence Asset Advisors (IAA).
IAA has made every attempt to ensure the accuracy and reliability of the information provided, but it cannot be guaranteed.
Past performance is no guarantee of future returns.