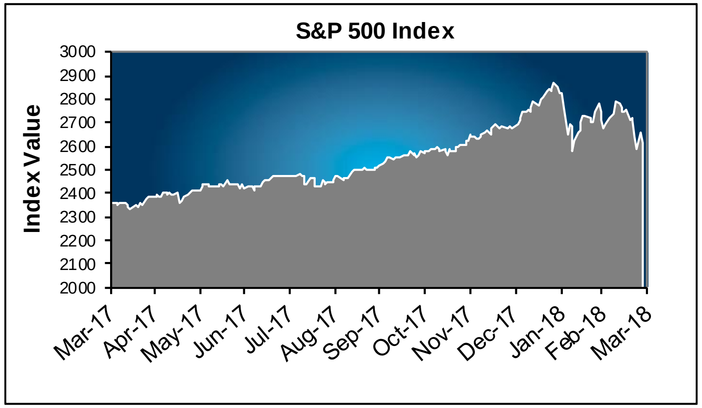
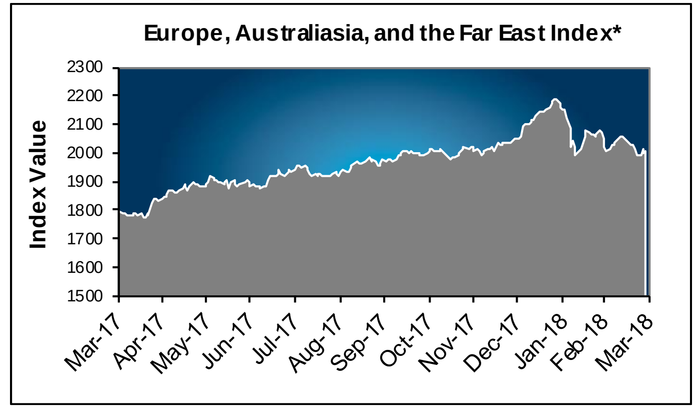
Stock Market Analysis





ANCHOR
Investment Management

Geopolitical Risks Impact Investor and Business Confidence

Uncertainty is the enemy of investors. The stock market continued the 2017 rally in January but gave back January gains in February on increasing geopolitical risk and pressure on the market leading internet stocks. The MSCI World finished the quarter with a modest loss (-1.3%). The January rally was driven by strong profits helped by accelerating economic growth and U.S. tax reform. Investor confidence evaporated in February on growing concerns that the Trump administration was stoking a global trade war. The controversial President followed through on his election promise to tackle the U.S. trade deficit but his strong-arm tactics on trade impacted investor and business confidence. The rising trade tensions could stall global economic growth but it is premature to discount the positive impact that the new technology revolution is having on productivity and global economic growth.

Trade tensions mounted after U.S. trade deficit increased to the highest level in more than nine years in January, with the shortfall with China widening sharply. Sino-American tensions have increased due to the large U.S. trade deficit and Chinese protectionist policies. The trade gap jumped 5.0% in January to $56.6 billion which was the highest level since October 2008. While the trade deficit with China had improved over the past two years it surged 16.7% to $36.0 billion. On March 1, 2018, President Trump announced he would impose a 25% tariff on steel imports and a 10% tariff on aluminum. His aggressive rhetoric has become his typical negotiating tactic but it could result in a major expansion of tariffs which would impact global growth. The U.S. Commerce Secretary, Wilbur Ross, stated that the U.S. administration was simply negotiating to reduce the significant trade deficit but retaliation rhetoric intensified when the administration warned that they would add tariffs on more than 100 goods from China citing intellectual-property violations. China originally announced a $3 billion list of U.S. goods including implementing higher duties on pork, apples, steel pipe and other goods. The value is equivalent to China's Steel and aluminum imports to the U.S. and it appeared that the Chinese were targeting exports from states where the Republicans historically have political support. On April 4th the Chinese widened the potential tariffs to match the U.S. tariffs on their goods. The threats and counter-threats have added volatility to the market but at this time they appear to be public chess moves in what will lead to trade negotiations over the next two months.

While the media focus has been on "old economy" goods, a large issue is related to technology tariff's and regulation of internet services. The U.S. dominated the development and early growth of the internet but European and Asian countries want to regulate and protect their domestic markets. The U.S. has been highly critical of China's technology policy. Chinese internet companies have benefited from the exploding demand for internet services by the Chinese consumers. Market leaders Tencent and Alibaba have experienced 40%+ annualized growth over the past decade. They have seen little competition in the domestic market since foreign companies have been hesitant to provide their services due to government regulations and U.S. companies' strict customer privacy policies. Ironically these policies have now become a major sore point for Facebook. The social media behemoth became the global punching bag for privacy advocates in March after it was discovered that client profile information was disclosed by Cambridge Analytica.

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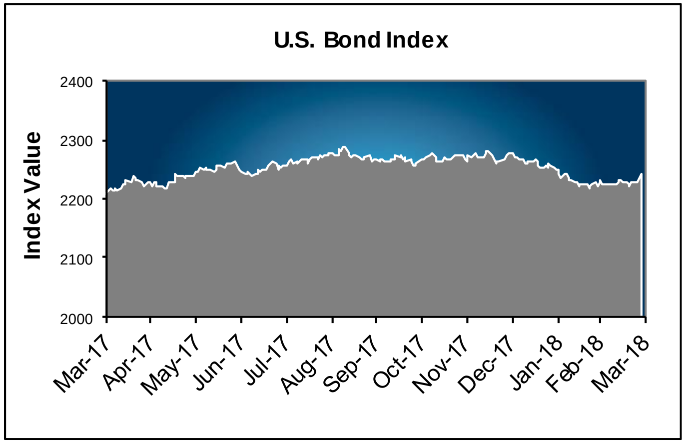
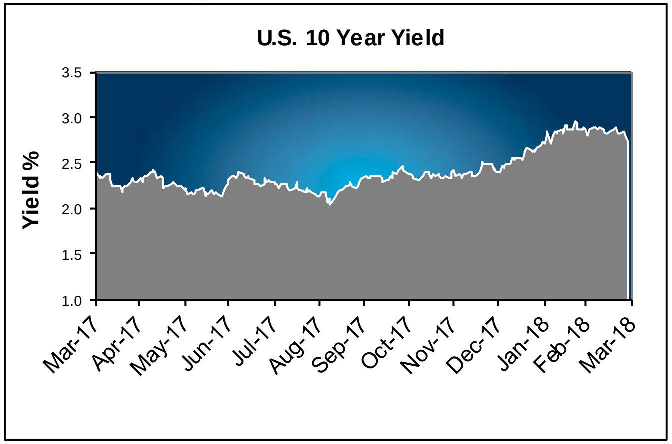
This news has changed the conversation on big tech. The power and the dominance of Google and Facebook essentially make them monopolies. In order to change their dominance, you would need to break them up. Therefore the bigger risk is that they are somehow targeted under antitrust. But antitrust regulation usually revolves around companies doing harm to consumers through price increases. Since most of the services that these companies provide are free, the question will be around their business models. Most of the large internet companies collect a vast amount of information about their customers. This data has become a powerful tool for advertisers. The legal and ethical question comes down to how personal information is used by marketers or other entities. Most consumers appear willing to give up some personal privacy and in return receive targeted marketing that meets their profile. Facebook has learned that there is a limit to this relationship. As a result, they have opened the door to regulation which is costly and may pressure margins for the entire industry if it becomes exorbitant.

There is a longer-term consequence to regulation. The larger internet players may benefit from heavy and complex regulation since the cost will likely deter competition. Other industries such as banking have seen smaller lenders suffer as the cost of doing business rose following the Financial Crisis. Technological innovation will be stifled if smaller companies need to incur huge costs to set-up, monitor and comply with new regulations. As a result, the bigger incumbents actually can gain from regulation. It increases their moat and defense against disruption because smaller competitors now become distracted and encumbered by another layer of complexity to deal with – time and money is now being spent on costs that do nothing to grow their own revenues or scale. The ultimate outcome is far from certain at this early stage of internet revolution but we remain constructive over the long term on large dominant tech firms who benefit from network effects and enormous scale.

Fixed Income Analysis





Two Sides to this Quarter…

While the first quarter of the year was undoubtedly a difficult period for the bond market, it was very much a tale of two halves. The first half (and the month of January in particular) was very much "risk-on", thanks to the continued momentum of unencumbered, synchronized global growth and low volatility as both high yield and investment grade credit spreads rallied to what would be the tightest of the quarter and near historical lows. Driven by higher inflation and growth expectations, the Treasury yield curve shifted upwards (2Y = +16 bps, 3Y = +30 bps, 5Y = 31+ bps, 7Y = +31 bps, 10Y = +30 bps). And so, we headed into February with tight credit spreads and muted volatility…

This low volatility environment ended with a bang in early February as a strong wage growth data print ignited fears that the U.S. was on the cusp of a sharp increase in inflation, which would in turn require the Fed to raise rates faster than expected. Higher rates could choke-off growth and ultimately increase the possibility of a recession. As a result, the equity market sold off, credit spreads widened (led by high yield which also saw large ETF outflows), Treasuries rallied, and the VIX index (equity volatility index) spiked. While high yield credit spreads briefly rallied to recover a portion of their losses, investment grade and high yield credit spreads trended wider for the rest of the quarter. The "risk-off" episode was an example of investor angst over stretched valuations at this point in the business cycle (9th year). Taking this and President Trump's, often blunt rhetoric regarding trade (now targeted towards China) into consideration, heightened volatility will likely be a recurring theme going forward.

Regarding the slope of the yield curve, movement in the 2Y/10Y Treasury slope very much mirrored the path outlined above. From year-end to mid-February the 2Y/10Y Treasury slope steepened +20 basis points reaching 0.77%. This steepening coincided with higher inflation expectations and an increase in the 10Y term premium (an estimate of the compensation investors require to take on interest rate risk) as estimated by the Federal Reserve Bank of New York. Real yields (as measured by the yield on Treasury Inflation Protected securities) rose as the increase in nominal Treasury rates outpaced inflation expectations (as measured by break-even inflation rates). The 10Y Treasury yield peaked in February at 2.95%. At that time, Trump's trade rhetoric was less divisive and less of a concern for the rates market and the 10Y rate looked poised to test and possibly break through 3%. However, this didn't happen. Trump's rhetoric ratchetted higher, the market took greater notice, and the 10Y was largely range bound between 2.8%-2.9% for most of March before ending the quarter at 2.73%. From mid-February to the end of March, the 2Y/10Y Treasury slope flattened to 0.41%, as the term premium and inflation expectations declined. While a flat curve is often associated with a recession, we do not believe a recession is imminent. The Federal Reserve Bank of New York's Probability of Recession in 12 months indicator while higher, is not flashing red, while corporate profitability is strong and financial conditions remain favorable in the U.S.

Fixed Income Analysis

While we expect headline risks related to a possible trade war will keep volatility elevated since global trade has been a major factor in the evolution of the U.S. economy. A trade war could impact the actions of the Federal Open Market Committee (FOMC). In particular, the pace at which they raise the risk-free (fed funds) rate to head-off inflation pressures, given its impact on the cost of credit and growth. In late March the FOMC, as was widely expected, raised the federal funds rate range +25 basis points to 1.50%-1.75%. The updated median projection for the expected fed funds rate path was unchanged (for another two rate hikes in 2018), however an additional rate hike was added for both 2019 and 2020. The Committee also raised its 2018 growth forecast to 2.7% (from 2.5%), lowered the unemployment rate forecast to 3.8% (from 3.9%), while leaving the inflation forecast unchanged at 1.9%. In Governor Powell’s press conference, he refused to be drawn in on trade war related questions, but rather stressed the FOMC’s actions would remain data dependent giving the FOMC flexibility to change course should conditions warrant. It should be noted the Fed is in a difficult position. Actual inflation and the effects of monetary stimulus are both lagging indicators. There is very little slack remaining in the labor market (unemployment rate = 4.1%), but inflation has thus far shown itself to be contained (PCE = 1.6% vs 2% target). The Fed not only has to contend with how this relationship will unfold in order to keep inflation from breaking out above target, but must do so with the knowledge of the looming impact of fiscal stimulus and trade uncertainty.

The U.S. dollar depreciated versus most of its trading partners (JYP -5.7%, EUR -2.7%, GBP -3.7%, MXN -4.7%), as shown by the DXY index’s 2.1% decline. However, it should be noted that all the decline came in January when global growth was continuing unabated. Synchronized global growth is typically bearish for the USD since the U.S. is a relatively closed economy and is not reliant on global trade to drive growth; the U.S. manufacturing and exports (commodities and finished goods) are a smaller percentage of GDP than many other countries so the U.S. benefits less from synchronized global growth. In February and March the DXY index was largely range bound as trade war fears have led to uncertainty for the path of global growth. This came at a time when there have been signs that growth outside the U.S. has been slowing (Citi European Economic Surprise Index, China’s Keqiang Index, sharp declines in Korean exports and the Baltic Dry Index). Taking this into consideration, as well as the tit-for-tat tariff actions of the U.S./China and the significant depreciation of the USD since the beginning of 2017, we remain underweight on our non-USD fixed income exposure. We would become more constructive if interest rate differentials between the G10 Sovereigns and U.S. Treasuries narrowed.