August 5, 2019

Time to Reexamine the Investment Landscape

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Key takeaways

- *The Federal Reserve's (Fed) recent decision and the ongoing U.S.-China trade dispute likely mark some rockier ground for investors.*
- *If the international economic slowdown continues and more tariffs aggravate that weakness, then the Fed may cut rates more aggressively, but investors may see correspondingly more volatility and may need to consider the investment landscape more carefully than in the first half of the year.*

What it may mean for investors

- *In this environment, we favor opportunistically trimming strong first-half profits where allocations have become extended and are shifting back to strategic targets; tactically bending portfolio exposure to areas where we remain favorable and valuations prove reasonable; and understanding that slightly higher levels of cash can prove prudent and provide optionality.*

Anyone who enjoys outdoor activities knows that the landscape can turn a little rough at points. At those moments, it's wise to think about the path ahead and maybe change one's pace. For investors, the first half of the year delivered the strongest and broadest gains across assets in a decade, but the path since May has featured more hills—more ups and downs—that could stretch into the next 12 months.

Since the beginning of the year, the three most important drivers of markets arguably have been slow but still positive economic and earnings growth (no recession), the prospect of Fed interest rate cuts, and the U.S.-China trade dispute. The earnings slowdown is playing out as we have expected, and neither an earnings recession nor an economic recession is likely in the next 12 months, in our view. We believe that's the easy terrain for equity investors.

More difficult terrain awaits

The Fed's recent decision and the ongoing U.S.-China trade dispute likely mark some rockier ground for investors. At its July 31 meeting, the Fed cut interest rates by a quarter-point, as expected, but indicated that the cut is an adjustment to prolong the economic expansion and another could follow.

Yet, policy makers do not anticipate a long series of cuts. The decision confirms our outlook since June for only two quarter-point rate cuts, but this has disappointed markets that have been expecting as many as four quarter-point cuts over the next 12 months. Market volatility after the meeting could extend into the near term (i.e., the coming days or weeks) to reflect, in part, a tempering of market expectations for Fed policy easing.

A day later, the 12th round of U.S.-China trade talks closed with little progress, and President Trump threatened new tariffs on a wide range of consumer goods—tariffs that could be activated by September 1, 2019. China retaliated on August 4 by instructing its state-owned firms to stop buying U.S. agricultural products and allowing its currency to weaken sharply against the U.S. dollar. The moves triggered sharply lower oil prices and equity prices as well as multi-year lows in bond yields, evidence that the global economic picture is not robust and that new tariffs could aggravate the economic weakness.

The latest tariff escalations (including one in May), should fuel additional market volatility for two main reasons. First, no one likes to be pushed around publicly, and countries are no different. By weakening its currency to its lowest exchange level of 2019, China is sending a clear message that it may let the currency depreciate as a retaliatory and offsetting mechanism to the latest round of tariff announcements. The two sides have hardened their stances for the September round of talks.[1]

Second, investors should evaluate any signs of progress judiciously. Just a few days before the latest U.S. tariff threat, the White House announced that China would buy more U.S. agricultural products. The U.S. has made this announcement multiple times this year, each time raising hope for a deal, and it would be a comparatively straightforward step for China to buy more U.S. food products. Yet, China now says it will buy less. We take Beijing's latest decision as a clear signal of a policy change, and a sign that China is not seeking a near-term deal. From Beijing's perspective, it seems clear that any compromise, even on apparently simple issues, depends on U.S. concessions on one or more of the more difficult issues. In short, all the issues, whether easy or difficult, appear to depend on one another.

The rest of the year is likely to bring increased market volatility. If a trade deal doesn't arrive until mid-2020, many companies will have been dealing with high and rising tariffs for two years. What's more, the complexity of the issues involved suggest that any deal is likely to be partial and retain some tariffs. An agreement that is long delayed and limited in scope likely will disappoint investors who have been hoping that U.S. firms can avoid reconstituting their supply chains originating in China.

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[1] For a more detailed view of the red-line issues and potential retaliatory moves by China and the U.S., please see our May 28, 2019 report, "He Said, Xi Said: Can There Be a U.S.-China Trade Deal?"

Summary and what investors can do now

Economic and earnings growth should support further U.S. and emerging equity market gains. However, the S&P 500 Index is trading close to historically fair value, and we see considerable risks for additional volatility over the next 12 months:

- For the near term, market adjustment to fewer rate cuts should create some downward pressure on equity prices.
- More volatility is also likely to accompany any new public jousting between Washington and Beijing over the terms of the trade negotiations.
- If the international economic slowdown continues, and if more tariffs aggravate that weakness, then the U.S. may slow enough for the Fed to cut rates more aggressively than we currently expect.

In this environment, our advice to reappraise the economic and market landscape is not a signal to exit current or existing portfolio positions, or to turn materially defensive. Rather, we believe investors should look opportunistically to trim strong first-half profits and shift back to strategic assets where allocations have become extended; tactically bend portfolio exposure to areas where we remain favorable and valuations prove reasonable (as outlined in our asset allocation guidance); and understand that slightly higher levels of cash can prove prudent and provide optionality if the second-half speed bumps become more frequent.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets.

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