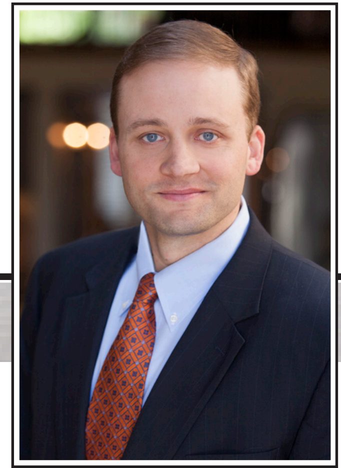
Scott & Stringfellow

THE MARKET MATTERS



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No In-Between

Years from now, this period in U.S. history could be remembered for any number of people, events or movements. There is no shortage of candidates. But one characteristic seemingly pervades all facets of American life in the late-2010's. It may be the one that eventually defines this era. The trait: division. We expend very little energy in search of our most valuable real estate: common ground. Instead, an immeasurable amount of time and energy is dedicated to the polarization of today's most critical discussions. Open dialogue, nuance and tolerance are sacrificed in service of manufacturing click-bait, "hot takes" and shouting matches. It makes informed analysis and decision making extremely difficult. This is true in the fields of science, politics, social policy, even economics. Below we discuss the fissured state of our current investment landscape through the lens of three major questions – and see if we can't create a space for level-headed discussion.

U.S. Monetary Policy There are two starkly different trains of thought about the Federal Reserve's policy outlook and what the rest of 2019 has in store. On the one hand, the Fed has practically shouted since its March meeting that it intends to leave rates on hold and sees no compelling reason to either raise or cut its benchmark rate. It will end its balance sheet reductions roughly three months from now and says it is fully committed to caution. On the other hand, market participants are independently forming a case that the Fed will have to cut its Fed funds rate at least once, if not twice, before the end of the year. The basis for this massive divergence of opinion: the recent deterioration in the U.S.-China trade dispute will persist indefinitely and likely worsen. The market consensus asserts the Fed may have gone too far last year with its rate hikes, and went way too far if a global trade war takes root. Therefore, as the market watches U.S.-China negotiations ice over, a growing number of participants are preparing for significantly easier monetary policy in the near future.

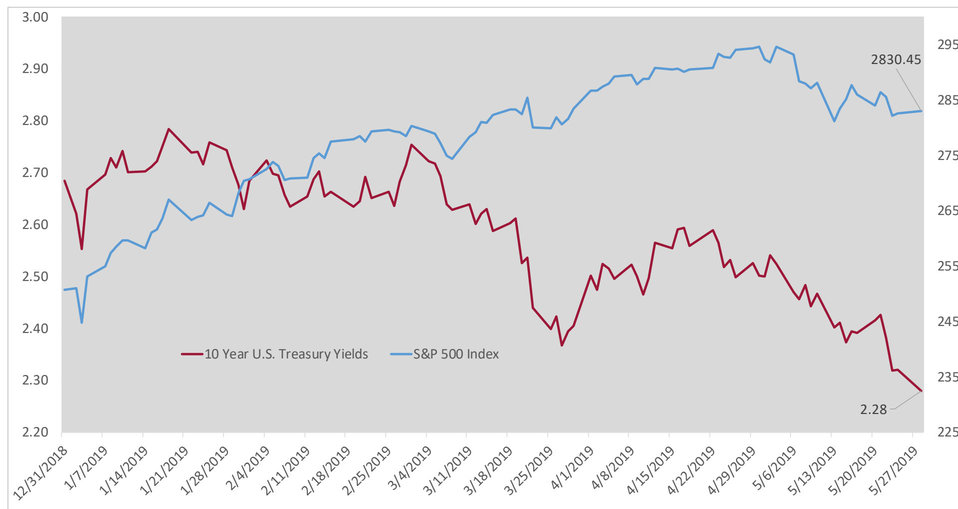

Chart 1. S&P 500 Index levels and UST 10 yields (YTD) Source: Bloomberg

We believe the Fed has a high hurdle in place before it would consider one rate cut – or more. The Fed desperately wants to avoid the type of asset bubbles that ultra-easy policy can create. It also sees little breathing room between current rate levels and the zero-bound. It is an invaluable cushion the Fed will be reticent to surrender. The central bank wants to protect its credibility by delivering on its "patient" policy guidance. And the Fed sees some reason for optimism, namely stable domestic growth and a strong labor market. However, it is hard to ignore the market's solid track record of positioning for future Fed moves well before the Fed itself. But recent recalibrations to ready for multiple rate cuts in the next six months appear overdone. While we agree with those

who would say the Fed got ahead of itself last year, we agree with the Fed's proclivity for patience over panic. The central bank's "wait-and-see" approach deserves a more positive reception than it is currently receiving. The Fed may need to revisit its current stance at some point this year, but we expect it would require a rapid deterioration in U.S. economic data or a full-blown collapse in U.S.-China discussions – neither of which have emerged.

U.S.-China Trade War Deal or no deal? This one is more binary in nature than interpreting the Fed. Either the U.S. and China can come to terms and prevent the rise of isolationism or the two sides use the trade battleground to fortify their long-term economic interests in pursuit of the pole position. President Trump's negotiating tactics and China's recent reluctance make it hard to measure where we stand. The primary question: is the U.S. simply ramping up pressure near the finish line to earn a few last-minute concessions or are the differences of opinion starting to galvanize? If it's the former playing out, May's U.S. equity losses could be quickly recovered and the powerful U.S. Treasury rally could ease. However, the second scenario (which some see as the precursor to a new Cold War), would cause far more havoc for investors. The impact of a protracted stalemate would be felt far beyond China's and the U.S.'s interior. Monetary policy would likely require easing on a global level to adapt to the lower growth potential. The global economy cannot function properly without cooperation from its two largest economies. It's the equivalent of two cylinders failing to fire in a four-cylinder engine.

We continue to expect the U.S. and China to ink a trade deal in 2019. We do not subscribe to the belief that this is the beginning of the end for U.S.-China trade relations. There is an opportunity to signal progress at this month's G-20 summit where President Trump and President Xi are scheduled to meet. One (undesirable) catalyst for a quicker agreement is an abrupt deceleration in U.S. or China growth that would force one (or both) side's hand. We have not experienced sufficient pain yet for this greater sense of urgency to arise. Therefore, we continue to point to the political pressure each leader will increasingly feel as the most powerful facilitator to a trade deal. In the interim, we expect trade's progress to suffer through the one-step-forward-one-step-back cadence that will be met with increased stock volatility and weaker risk-taking sentiment.

Equities vs. Fixed Income Even U.S. markets themselves are forcing us to pick a side. Although U.S. equities endured their worst monthly performance of 2019, they still sit within 4% of the all-time highs set in April (Bloomberg). On several occasions in May, U.S. equities fell significantly intraday only to stage late-day comebacks that suggested traders were not willing to fully buy into trade pessimism and souring growth expectations. U.S. equities were also stabilized by the notion of an on-hold or easing Fed, which would keep U.S. rates low for the foreseeable future. However, fixed income markets signaled more concern. More than $11 trillion worth of global sovereign debt now carry negative yields (Bloomberg). The U.S. yield curve has re-inverted between 3-month and 10-year maturities, historically a concerning economic warning signal. Falling inflation expectations, led by crude oil price's recent decline, have played a factor in lowering U.S. yields but it doesn't fully explain the divergence of opinions between equities and fixed income. The month of May saw U.S. yields routinely fall even as major equity indices rallied – the opposite of their traditional relationship. Equities' logic: the Fed will cut rates to prop up the economy, therefore stocks should rally based on expectations of easier monetary conditions. We believe this logic is problematic. By pushing equities higher on the basis of an easier Fed, it ignores the fact that the Fed would be doing so because the economy is deteriorating. As we discussed in the previous section, we think the Fed will require consistently poor U.S. data before easing policy. Increasing equity exposure on the basis of potential rate cuts overemphasizes the stimulative effect of looser Fed policy while ignoring the negative reasons underneath it. A U.S.-China trade agreement would provide a sturdier foundation for a bullish equity case and higher U.S. yields – but for that we will have to wait. Until then, our outlook tends to better align with U.S. fixed income's concerns.

Our expectations for Fed policy, trade, and market performance lie between the extremes. We expect a patient Fed that will resist cutting rates. We expect a trade deal, but not without periods of pain. We believe there are reasons for longer-term economic concern, but believe a trade resolution could fuel a risk rally in the coming months. It's unproductive to plan based on the splashy, extreme opinions.

The truth almost always exists in the middle.

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