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The Latest – Tariff Tantrum

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It was approximately five years ago that the word "tantrum" was first used to describe the fits and starts in the markets. Specifically, "taper tantrum" was used in reference to the bond market, due mainly to concerns regarding the tapering of bond purchases by the Federal Reserve (Fed), as bond yields quickly rose from low levels. This year, at the beginning of February, we woke up to a new tantrum, this one driven by inflation worries, which sparked a significant increase in volatility across asset classes. In just a few days we experienced more than a 10% correction on the major U.S. equity indices, which wiped out all of January's gains. The inflation spark led to a consistent grind higher in 10 Year yields in the U.S. and in Europe, with Treasury yields nearly reaching 3%, and 2 Year yields breaching 2.2%. Rising yields, along with concerns of higher inflation expectations and a sharp hiccup in volatility, kick-started the first wave of portfolio re-balancing.

Portfolio re-balancing developed further as a re-pricing of risk and a "regime shift"—related to higher growth, inflation, yields, and perhaps a quicker pace of Fed hikes than originally estimated—took place, with some changes occurring for the first time in several years. Large pools of capital that were positioned for a low (yields and inflation) and slow (economic growth and Fed hikes) environment had to re-tool their foundation and begin to adjust for the new regime. Portfolio re-balancing wave part one briefly stabilized over the course of a couple weeks as the S&P 500 bounced off its 200 day moving average, at around 2550, and settled closer to the 50 day moving average of 2735. This sharp bounce back occurred as more fundamental investors with higher than normal cash allocations increased equity exposure at lower, more attractive valuations than at the end of January, and focus switched from inflation concerns to what we believe is a still attractive global synchronized expansion and solid profit cycle story.

Volatility, as measured through the VIX Index (Chicago Board Options Exchange estimate of future volatility), settled closer to 15, down from 30, which was around a three-year high, and equity asset prices began the "normal" process of a bottoming phase. This process tends to take weeks if not months, as portfolios adjust to the new regime and shorter term traders use technical levels to add/remove risk. This tends to create a saw-tooth market pattern, which helps strengthen the final short term bottom. This is important to understand because, in our view, although the fundamentals on a medium term basis are healthy and still gathering momentum, the short term technical factors can outweigh the attractive global growth story on a day-to-day basis. This is normal in regime shifts and has the potential to shake investor sentiment.

The fragile sentiment reappeared in the last few days, removing more than 1100 points, or over 4%, from the Dow Industrials index, and pushing many market indices into the red for the year. Most of the pressure came in Thursday's trading, which is when the Tariff Tantrum began. The announcement that the U.S. would impose tariffs of 25% on imported steel and 10% on aluminum for a "long period of time" kick-started more than a 700 point reversal, with the Dow ultimately closing down over 400 points and the VIX rising 13% to back over 20. Instead of rising yields and worries over inflation expectations and a more hawkish Fed, investor concerns centered around trade protectionism and possible retaliation by our larger trade partners (this was one of the risks we highlighted in the Year Ahead report). U.S. large capitalization multinationals (most notably Industrials) and market leaders—namely in Technology and Financials—experienced the largest declines.

The Inflation Tantrum and Tariff Tantrum are examples of a fragile investment community trying to come to grips with a regime shift (a repricing of risk as we transition further into a late cycle economic phase). The shift can take longer than just a few weeks to filter through (as we discussed); but ultimately we expect the Tantrums to be buying opportunities, especially given our view on growth, profits, still low real rates, a stable dollar, and little recession risk for the foreseeable future. We also believe that central bankers are more than likely to continue to be patient with their rate normalization process. Moreover, Fed Chair Powell on Thursday said that he does not "see evidence the U.S. economy is overheating" and inflation indicators are still below target. Ten Year Treasury yields fell to 2.8%, after nearly touching 3%.

Do we see a quick reversal in the fundamentals or is the recent market action in both the equity and bond markets signaling something deeper is around the corner? We don't think so. Credit markets have been agitated but not signaling deterioration. Investment flows have been buying the dips recently but sentiment is still fragile and not euphoric. S&P 500 price to earnings valuations are more reasonable at more than one point lower than the peak in January. Is this second wave of rotation part of a normal adjustment process while expectations are reset? We think so. Right now, however, a short term trading approach is in the driver's seat. That said, we expect the bull cycle to resume when first quarter earnings announcements begin in early April. We believe that the profit cycle is alive and well and still gathering momentum. This could help support the final foundation for equities in this almost decade long period. We will be watching the BofAML Research Global Wave very closely for any signs of a reversal of the economic uptrend and internal market dynamics. When there is meaningful evidence that the global profit cycle and financial conditions are deteriorating then we will adjust our view and asset allocation accordingly.

What do we believe will occur in the next few months?

- Investor sentiment will remain fragile as uncertainty stays elevated
- Headline risk remains (trade wars, tariff retaliation, geopolitical worries, central bank action and communication, etc.)
- Volatility settles down to more normal numbers but remains above last year's record low levels
- Portfolio rotation and a re-pricing of risk by various investor types continues but at a more gradual pace
- Bond yields should settle into a new range around current levels but not too much higher (2.8-3.2% range)
- Inflation expectations grind higher but still remain in check
- Fed stays on target for three hikes this year but the possibility for four remains
- Expect equities to outperform fixed income in a multi-asset portfolio, but returns are choppier and closer to historical percentages versus 2017
- Continue to emphasize both large cap U.S., non-U.S. developed and Emerging Market equities
- Higher quality assets in equities and fixed income are preferred versus lower quality overall
- Despite the higher yields, S&P 500 equilibrium target of 3000 remains and is still achievable, given a healthy and Growing denominator (earnings of $153 or better for the S&P 500)
- Global earnings revisions continue to exhibit healthy signs
- The initial move up in yields is due to see above trend growth which allows for real rates to stay low
- The U.S. Dollar remains stable
- Bond proxies (higher yielding equities) remain vulnerable
- Profit momentum becomes more visible with each successive quarter
- Rising diversification remains a major portfolio theme
- Sector and stock specific divergences increase throughout the year
- Saw-tooth market action in equities into March, then an improved uptrend in April/May

Tantrums are likely to come and go until investors come to grips with the actions and communications of a newly led Fed and uncertainty around trade dissipates. We are not yet at the point in the cycle where earnings are slowing down and then about to roll over while interest rates are rising, which raises recession risks.

Unless the recent trade grappling turns into something more widespread we view this second spike in volatility as part of the original bottoming process which began in early February. We will be watching the trade and geopolitical scene closely (NAFTA renegotiation efforts, China trade battles) for any signs that the broader global economy is being impacted by further trade and tariff implications.

Take advantage of weaker market periods where appropriate while the fundamentals remain intact and stay the course regarding long term goals.

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