CIO Viewpoint Audiocast
Digging In: A Rise in Uncertainty Prompts Lower Non-U.S. Allocation

With Chris Hyzy

Chief Investment Officer

Please see important information at the end of this program. Recorded 6/4/2019

Bank of America

Chris Hyzy: Hello, this is Chris Hyzy, Chief Investment Officer with our monthly viewpoint update. Yields are falling as inflation expectations at home and abroad continue to drop. The market is pricing in four cuts by June in the federal fund's rate of 2020 with three expected by January of 2020. To put this in perspective, literally a couple of weeks ago the market was pricing in only two total cuts in that same timeframe and only one by the end of 2019. So as yields have hit close to record lows around the world and, in the United States, have hit multiyear loads, the fed cuts that are priced into the market have changed considerably. Real US GDP is still decent as the consumer continues to spend, but nominal growth is now fading. Nominal GDP filters into incomes and wages, corporate profits, cash flows, revenues, and provides a boost overall to confidence. This is why nominal growth is much more important as a level than real growth. The Federal Reserve, in our opinion, is likely to switch from on hold to patiently cutting as they are now assessing inflation expectation more closely than they did last year. The longer the fed waits to act to confront dropping inflation, the more they will likely have to cut later in our view so the fed is considerably unwatched from our perspective at this point. The yield curve is telling us the story that the fed's holding pattern is for a few years. Previously, as early as this year, the fed's holding pattern was expected for only a few short months as discussion around transitory inflation was the talk of the town at that point but now the 10 year yield has fallen as inflation expectations have declined while the front end of the curve is driven by federal reserve action. So if the fed's cuts rates soon the front end should follow and thereby adjusting the curve overall albeit slightly in specific areas. We will watch for these signs in fed's speeches and the midyear testimony by Fed Chair Powell in July.

So here's the bottom line, the bond market and the yield curve are providing the ammunition for fed cut and a switch further into easing mode from a holding mode. This is due to inflation dropping considerably below their current target. A protracted trade war with China and escalating trade tensions now with Mexico, potentially Turkey and India, and obviously Europe, this all risks slower global growth and global down side earnings revisions. US real growth is good again, but nominal growth is now fading.

Let’s discuss the market landscape. The fed hikes of 2018 and the trade war plus new tariff threats with Mexico have hurt the non-US economies more than the US in our opinion. This should accelerate with further trade war escalations even in the face of a potential fed cut therefore US equity should widen the gap further versus the rest of the world. The equity markets in the US however are not immune to a correction given the increase in uncertainty surrounding the overall level of growth in the coming months. A larger issue on the table is that longer term, a tech war that is cemented by national security interest could create two big trading blocks: One dominated by the US surrounded by free trade partners and one dominated by China which could include a China alliance nation that are less friendly with the US. This could widen the gap further and force the other nations to choose between the US and China, creating more global uncertainty. We expect the fed to ultimately act as we’ve previously discussed but with patient cuts while the trade war remains in confrontation mode. Fed cuts are more needed based on inflation and not based on supporting the equity market. With our view that debt is deflationary in nature as capital is used to pay interest in debt versus used for investment or for transaction oriented purposes and also our view that hyper-competition mixed with automation leads to price displacement where any short term price hikes do not stick. Particularly as demographics continue to pressure wage driven inflation, we expect yields to remain low for a very long period of time. This should create an environment that keeps economic growth in the US at trend or better -consider that at about 2% - 2.5% real GDP growth or better - with an upside and a downside scenario. So let’s examine those scenarios quickly. The upside scenario is one that is driven more by productivity which we have not had for several years. Productivity would be induced through automation, robotics, machine learning, artificial intelligence, etc. and that could lead to higher growth than overall trend growth that we have recently experienced. The fed, in this scenario, goes back to a hold mode from cutting and investors remove some level of their risk off mode that you've recently seen as equities have dropped some 7% from their peaks of early May. In a downside scenario, this includes a fed that waits too long to combat downward sloping inflation expectation and at the same time the trade war saves business confidence. This would likely lead to lower than trend GDP growth - consider that growth below 1.75%. In this scenario, business investment in automation would slow which affects productivity and growth would ultimately fade in our view. The fed would then have to act with more force to avert a major growth slump or recession down the line.

So in summary, we expect a soft landing with slightly increased risk at this juncture as more dovish signals come from the fed in the months ahead and improved trade negotiations with China but no assertive closure to the trade war in our opinion. The markets want a trade deal between the US and China but something as mundane as a trade truce or at least a de-escalation of tensions at this point would be supportive of equities. At the same time, bond yields, in our view, have likely bottomed around current levels. So tactically, we still believe equities are more attractive relative to bonds at current valuation and prospects for the foreseeable future, but given the momentum that has gathered recently regarding global trade uncertainty, coupled with our view that the US is further breaking away from the rest of the world in terms of tis growth level, monetary policy flexibility, and potential future economic catalysts, we are downgrading our positioning in non-US developed market equity and emerging market equity from their current stance. We've lowered each exposure by around 2% which further underweights non-US developed markets and moves emerging markets to a slight underweight from a slight overweight across our CIO strategies. So although both regional equity classes are in valuation levels that rival historic lows, at least in the short term we are not confident in the earnings in growth base in the foreseeable future. We do believe however that emerging markets have solid long term growth prospects driven mainly by the help and the growing nature of their consumers. In addition to limited growth catalyst outside the states, we now expect the US dollar to maintain its re-strengthening until greater clarity materializes in the trade front. This could further limit gains outside the states. Lastly, given our view that the fed has more policy flexibility relative to non-US central banks, we expect presumptive action against a further retracement in inflation expectations to take place first in the US. This would likely reverse some of the recent risk off pullback in US equities. Hence, we are therefore allocating half the downward adjustment, so 2% of the overall 4% removal from the non-US markets to US large cap equities and the remaining 2% moves to cash. We maintain our overweight stance overall in equities by further emphasizing the US relative to the rest of the world and at the same time de-risking the portfolio slightly in terms of portfolio positioning by adding some to the cash allocation. In the long run, our bull market thesis, which sent us around a powerful spending wave of the Millennials and Generation Z mixed with business investment in automation and machine learning activities, healthcare, life sciences revolution, and a new housing cycle remains in full gear. In the coming months we ultimately expect some sort of core trade agreement but the timing is very difficult and the substantive nature of it is likely to remain vague. We also expect the fed to move further into easing mode and help engineer a soft landing scenario. We will be analyzing the impact on growth, corporate profits, and any changes to business confidence, the yield curve, inflation expectations, and fed commentary closely for signs of a turn in investor sentiment in the weeks ahead. The two key dates to keep in mind for more insight include the G20 on June 28th and 29th and Fed Chair Powell's midyear testimony in mid-July.

Once again, we remain favorable on equities overall as we still believe in our long term bull market thesis but would be patient in the coming weeks and let the market settle down before adding considerably to your overall equity exposure. Thanks and have a great day.

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