CIO Audiocast
Market Update

With Chris Hyzy

Chief Investment Officer

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Bank of America

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Chris Hyzy: This is Chris Hyzy, Chief Investment Officer. Weaknesses in financial markets gathered momentum this week as macroeconomic data sharply disappointed in Germany as well as in China. In addition, geopolitical concerns increased, given the rising tensions in Hong Kong, and the lack of clarity in the Italian political situation, plus the Brexit endgame. Moreover, negative volatility increased with the U.S.-China trade battle continuing, despite the recent delay of tariffs on select consumer goods, and increasing concerns that the Federal Reserve will be too slow to cut rates aggressively enough to stave off a recession, have created an environment of risk aversion.

The 30-year treasury bond yield fell to its lowest level ever and another segment of the Treasury yield curve inverted. The 10-year yield fell below the 2-year, which is often considered a major recession indicator. Now, despite the rising probability, we still believe the US can avert a recession in the next 12 months, given the strength of the consumer, the still healthy jobs market, and the potential for the Fed to be more assertive with its monetary policy through the remainder of the year. In addition, we will need the geopolitical climate to stabilize, particularly in relation to Brexit and the Hong Kong demonstrations, and the political volatility in Italy. We'll be watching credit spreads very closely, the credit markets overall, as well as claims for any further signs of stress.

In the coming weeks, and specifically up ahead of the Fed's September 17th and 18th FOMC meeting, we will be assessing the following trends within 7 particular "c"s, three of which were by Michael Hartnett last week who is the Chief Global Strategist for BAML Research. The three, just to highlight once again are China and its growth, as well as the trade battle with the United States. Growth has been slower than consensus expectations, and there is significant headline risk around trade on a continuous basis so we'll be watching that obviously very closely. The second was claims. The health of the job market is often watched through unemployment claims. Right now it's holding in a low pattern at this point. Credit in terms of spreads and how wide they get both in investment grade and high yield so far have only been slightly wider on this recent sharp pullback.

The fourth "c" is the curve. We already mentioned that the 2-year credit spread and the Treasury yield curve between the 2 and 10 did invert briefly. We'll be watching to see if that sticks and remains in the coming weeks, as well as if that filters into the Fed funds 30 year spread, which would also potentially signal a recession.

The fifth "c" is central banks. How aggressive do central banks get given where yields are, close to (in some cases) record low levels. And also, with the fact that there's over 15 Trillion in bonds that are yielding negative rates at this point. The first up with the September 17th and 18th FOMC meeting as we mentioned and we'll be watching how aggressive the Fed gets in right-sizing the yield curve. This will be needed to calm down the recent fears and headline risk suggesting that the Fed is acting too slowly.

The other final two “c”s are confidence – both business confidence and consumer confidence. If the weakness persists and the rest of the world turns lower, then confidence could wane. That would initially hit business confidence in our view, and then potentially filter over into consumer confidence. And last but not least, contagion. We mentioned this before, but in the case of the political situation around the world, particularly the demonstrations in Hong Kong, Brexit uncertainty, election potential in Italy, as well as Venezuela and Argentina’s troubles, just to name a few.

With all of these seven c’s in addition to the latest volatility that equity markets have exhibited, we would like to highlight a fourth “c”, which is caution. It is our view that we expect volatility to remain until markets get some respite as it relates to the action in the yield curve, so for now we advise caution until there is more clarity on all of the above c’s we’ve mentioned.

It is important to allow markets to settle down, given the high emotion and machine- and computer-based trading that is occurring on a day-to-day basis, particularly in August which tends to have very low volume trading markets. Long term investors should consider having investment planning ready in order to add to equity exposure, as we believe the Fed increasingly gets more assertive, and hence, more accommodative, which should right-side the yield curve. As this materializes we expect US large caps, particularly technology, healthcare, industrials, and the financial sector to benefit and resume their longer up-trend. Overall, in the very near term, until the uncertainty subsides, we expect more defensive sectors such a utilities and consumer staples to outperform. They have risen significantly recently in terms of valuations, and it is our view that they are overvalued at this time. However, as long as risk aversion remains relatively high, and continues to be an area that’s wanted by shorter-term investors, we expect those two sectors to outperform. As we mentioned before, for longer-term investors, we advise caution at this point. Headline risk is too high, emotion is too high, and volatility should remain elevated – at least until we get more clarity out of the Federal Reserve in a few short weeks.

Thank you, and have a good day.

ARHPNLKJ