Kastel Capital Advisors

Third Quarter 2019 Investment Outlook

Avoiding A Wit Beating

"Trade war! Trade war! Not afraid of outrageous challenge! Not afraid of outrageous challenge! A trade war is happening over the Pacific Ocean! If the perpetrator wants to fight, we will beat him out of his wits." – Zhao Liangtian, from his trade war theme song that went viral in China

"…the use of iPhones, driving in American automobiles, eating at American fast food restaurants, using American household products, and traveling to the U.S. is forbidden by a new company policy; any employee who violates the new rules will be fired." – Jinggang Motor Vehicles Inspection Station

"Tariffs will make our Country MUCH STRONGER, not weaker. Just sit back and watch! In the meantime, China should not renegotiate deals with the U.S. at the last minute." – Donald J. Trump on Twitter

The escalating U.S.-China trade war and its current and future impact on global economic growth dominated headlines during the second quarter. Through April 30th, the U.S. stock market benefited tremendously from the abrupt pivot in early January by the Federal Reserve towards a more accommodative policy stance as well as optimism that a U.S.-China trade deal was imminent. However, in early May, the optimism faded fast as trade negotiations fell apart and President Trump announced increases to existing tariffs on $200 billion of Chinese imports and threatened to add 25% tariffs to another $300+ billion of Chinese imports. The Chinese responded in kind with increased tariffs on $60 billon of U.S. goods and planned for further actions to respond to U.S. tariffs. At the recent G20 meeting in Osaka, Japan, a détente was declared, and trade negotiations are expected to resume shortly. It appears Trump backed off on more tariffs and was at least partly influenced by lobbying from the U.S. business community.

Even as the U.S. stock market traded to new all-time highs post the G20 Summit, it is still highly uncertain how this trade war saga will end. The fact is that Trump is under re-election time constraints while Xi does not have to worry about his position as the China's National People's Congress in 2018 eliminated the two-term limit for China's President. Consequently, Xi appears to have the upper hand in negotiations: he has all the time he needs to get a deal acceptable to China even as China's economic growth is showing clear signs of faltering. Besides attempting to beat us out of our wits, the Chinese are employing other non-tariff pressures like encouraging the boycott of U.S. consumer products, not purchasing U.S. agricultural

products, and trying to get our allies to pressure the U.S. to back down on its demands. China is also encouraging students not to attend U.S. universities, which would be a major problem for the massively overpriced U.S. higher education system where Chinese students typically pay full retail and subsidize U.S. student costs. Finally, since the start of the trade war with the U.S., China has actively reduced trading tariffs with most other countries.

Despite these counter punches by the Chinese, the damage done by the Trump Administration to China's status as a global manufacturing hub may be permanent. Many U.S. companies, caught in the trade war maelstrom, realized they are too exposed and are making plans to move some production out of China even if a trade deal happens. U.S. companies have historically relied on China for low-cost production. Tariff increases have not only made Chinese imports more expensive but also highlighted a new business risk and they must act accordingly. Companies like HP and Dell have already announced plans to move some production to other countries. Not only is this happening with U.S companies but their foreign suppliers are also looking to pull production out of China too. Foxconn, which assembles Apple iPhones, is moving some production out of China and Japanese companies like Sony and Nintendo are considering their options. Retailers like Walmart, which imports a significant amount of products from China, are also shifting production to avoid U.S. tariffs. What is bad for China could end up being a new source of economic growth for other regional countries like Taiwan, Thailand, Malaysia, Vietnam, and India.

It is not an understatement to say that tariff trade negotiations will weigh heavily on the direction of the global economy over the next 12 months. Although negotiations will restart shortly, it remains to be seen if the two parties can bridge the divide that led to the breakdown in talks in early May. Can Trump hold out for the level-the-playing-field trade deal he wanted from the start or will he take a lesser deal so the U.S. economy has time to recover in 2020 in time for presidential election? Will Xi purposely stretch out negotiations and maintain his hardline position to undermine Trump and increase the odds he gets voted out so China can eventually deal with a presumably less confrontational U.S. Administration? These are large unknowns at present, but the stakes are quite high for the global economy including the potential wit beating hanging over our heads if the trade war escalates.

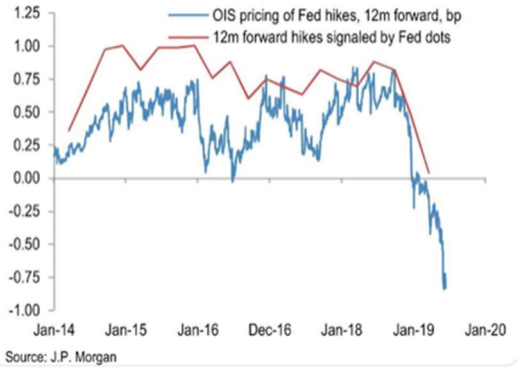
Recession or Soft Patch?

Even as the trade war hangs like a wet blanket over the global economy, the U.S. stock market has been acting as if everything is "hunky-dory." U.S. stocks posted the biggest June rally since 1955 and the first half of the year recorded the strongest returns since the first half of 1997. The U.S. stock market was propelled higher by the Federal Reserve stating at its June meeting that interest rate cuts were coming sooner rather than later. Where financial markets go in the second half of 2019 will depend heavily on whether we are headed into an actual recession or just going through an economic soft patch as has happened most recently in 2015/16.

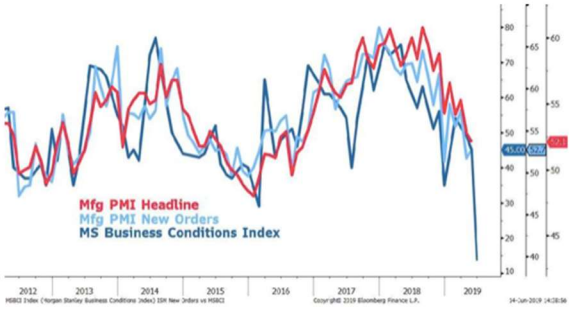
The stock market seems to be ignoring the increasing evidence that the U.S. economy is now experiencing more negative effects from the trade war. Cyclical data points like train car loadings, auto and home appliance sales, and semiconductor bookings, are giving off recessionary signals. With more pronounced evidence the U.S. economy is slowing, the stock market has embraced a view that the Fed will aggressively cut interest rates. The market view is reflected in the next chart, where the blue line is the yield on the 10-year U.S. Treasury bond and the red line is the market's 5-year forward inflation expectation. Both lines indicate a significant decline in forward economic growth and inflation expectations for the U.S. economy and are strongly suggesting a recession. The 10-year U.S. Treasury yield recently touched 1.95%, down

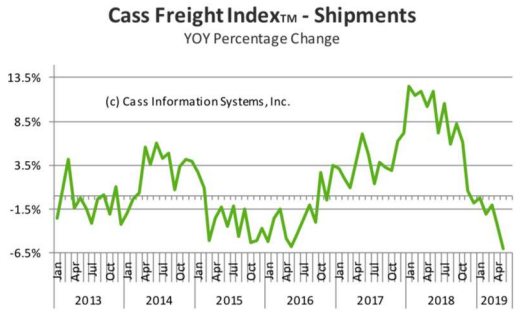
from 2.69% at the start of the year. In stark contrast, the S&P 500 Index as represented by the green line remains near a record high (up 20% year to date) as stock investors expect the Fed to come to the rescue with interest rates cuts. The wide expectations gap between stocks and bond yields indicates the stock market is expecting a soft patch while bonds are predicting a recession.

The next chart shows the market expectation is for the Fed to cut the Fed Funds rate by 0.75% over the next 12 months. Currently, the market is pricing in a 0.25% rate cut at the July 31st meeting and then another 0.50% thereafter. Note that it wasn't too long ago that the market was expecting the Fed to raise rates 0.5%.

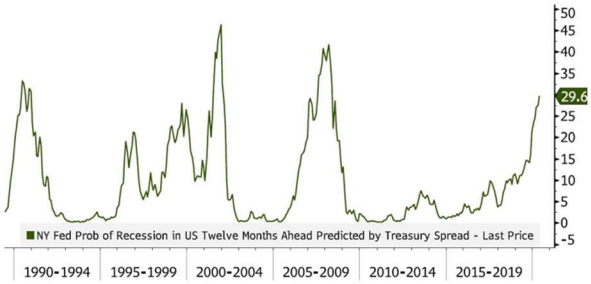


The market has moved aggressively towards the view that the Fed needs to cut rates because of the deterioration in U.S. economic data, as reflected in the next chart on the left showing the Morgan Stanley Business Conditions Index (MSBCI) and PMI data. The deceleration in U.S. economic activity is quite pronounced since the early 2018 peak. May was the biggest one-month drop in the MSBCI going back to 2002. The Purchasing Managers Index of manufacturing activity closely tracks the MSBCI and is also showing signs of significant deceleration. The right chart shows the Cass Freight Index of airfreight/trucking/railroad volumes, which also confirms a decelerating U.S. economy since peaking in early 2018.





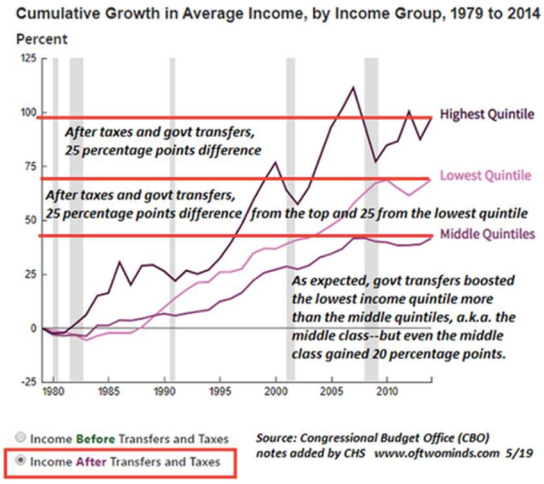
The NY Fed's recession model shows a recent large uptick and 30% probability of a recession. While 30% may seem low, note the model hit the 35%-40% probability level in the last three recessions.

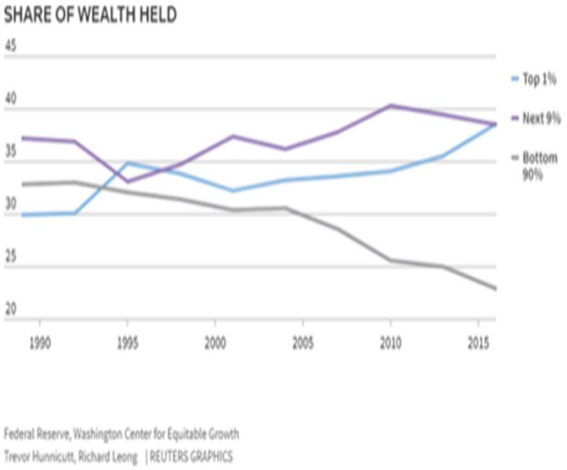


Source: Bloomberg, Evergreen Gavekal (data as of 5/31/2019)

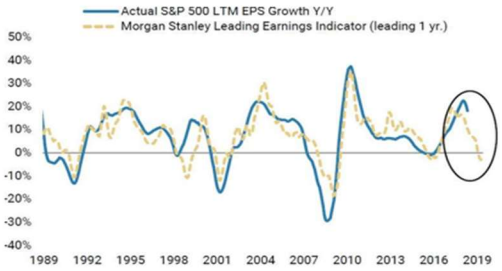
Despite all of this, a recession is not guaranteed. The U.S. economy set a new record this month for the longest economic expansion on record, surpassing the prior one that ran from 1991-2001. In addition, the unemployment rate is sitting near all-time lows and the job market remains solid, as evidenced by the June Non-Farm payrolls report of a surprisingly strong 224,000 of job gains. Consumer spending trends remain favorable and consumer confidence is holding up so far. The big caveat to this current expansion is that it has been one of the weakest on record and too many Americans have been left behind over the past decade. The last ten years have been very rewarding for owners of financial assets and the Top 10%, but significantly less so for everyone else.

The next two charts show in glaring fashion the failure of Fed policies and the U.S. economy to lift all boats. Average incomes and the wealth of the Top 10% of Americans have recovered strongly from the Global Financial Crisis lows but the bottom 90% have experienced limited wage growth and have not benefited from the rising financial assets world brought on by extreme central bank policies.

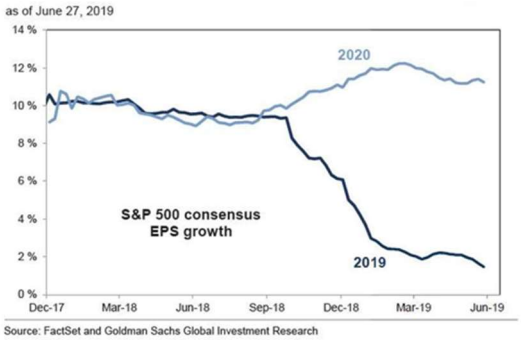




Even if a recession is not a given, the corporate earnings outlook has weakened considerably. The left chart below shows the Morgan Stanley's Cycle Indicator has officially moved into Downturn mode in its latest iteration. This typically portends bad news on the corporate earnings front because when the leading indicators have rolled over in the past, corporate earnings have eventually followed, as shown in the right chart below.



The next chart shows how 2019 earnings estimates for the S&P 500 Index have already fallen significantly since the beginning of the year. However, earnings estimates for 2020, while starting to decline, still reflect a rather optimistic earnings growth outlook of over 10% for next year. In light of an uncertain trade war outcome and slowing global economic activity, 2020 earnings estimates have a high probability of seeing more cuts in the second half of 2019. The big question is whether the U.S. stock market can remain elevated, supported by expectations of aggressive Fed interest rate cuts, even as the forward earnings outlook appears at risk of more negative revisions.



What Finally Gives?

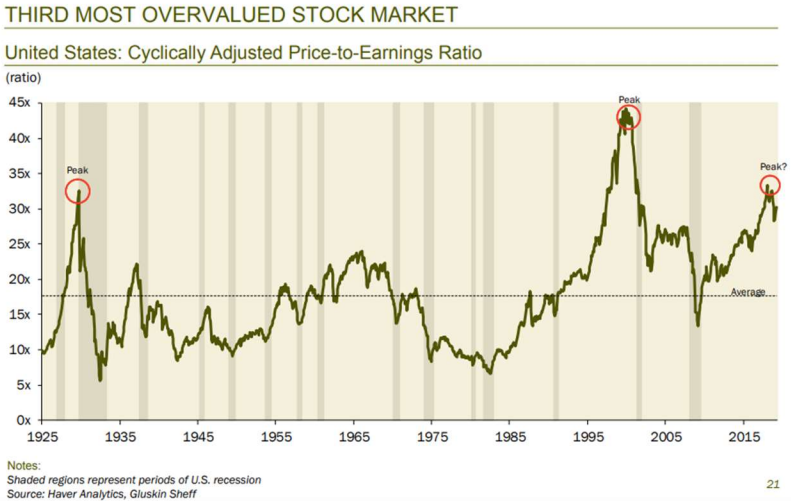
To understand why stocks keep rallying in the face of a deteriorating global economic outlook, an investor needs to understand what is going on in global bond markets first because bond yields are having a large influence on stock prices. The next two graphs depict the global bond market. The chart on the left shows the amount of global debt with negative yields recently surpassed $11.5 Trillion (that is a "T," not a "B"). The chart on the right shows several major foreign countries and how much of the sovereign debt of each is trading with negative yields. For example, 85% of its German government debt is trading with negative yields. A negative yield means the lender is willing to pay the borrower for holding its debt, a complete flip on its head of the normal relationship where a borrower pays the lender a yield to borrow money from them. Why is this happening? Because major holders of sovereign debt value liquidity above all else, including earning a positive return. It's a potentially ominous sign that so much global debt has such a distorted yield profile.

The U.S. bond market does not trade in a vacuum. U.S. bond yields are impacted by global bond market developments. Thus, U.S. yields fell dramatically in the second quarter as more bond yields outside the U.S. moved into negative yield territory. As bond yields collapse, investors are forced into higher risk assets like stocks in order to improve their prospects for earning positive returns. The stellar first half returns of U.S. stocks have been helped not only by the market's view that the Fed will aggressively cut interest rates, but also because of the collapse of bond yields across the globe.

Navigating The Mine Field

All of this geopolitical and global economic uncertainty has made navigating financial markets quite challenging in both stocks and bonds. The next chart shows U.S. stock valuations going back to 1925 using the Cyclically Adjusted Price/Earnings ratio or CAPE ratio. At the tech bubble peak in late 1999 / early 2000, when sock puppet commercials were on the 2000 Super Bowl and companies like Pets.com could go public with just a concept and little revenues (it went belly-up within 12 months), U.S. stocks traded at valuations that are unlikely to be reached again in our lifetime. In the 10 years post the tech bubble peak (2000-2009), annualized returns from stocks were slightly negative. By contrast, when the Global Financial Crisis hit hard in the fall of 2008 and stocks hit their lows in March 2009, there wasn't a bullish investor to be found anywhere. Any buyers of stock at a time when it felt like the world was coming to an end earned mid-teens annualized returns from stocks over the ensuing decade.

There are only two other times when stock valuations got close to the excessive valuation levels during the tech bubble. The first, on the far left, was in 1929 and right before the stock market crash that set off the Great Depression. The second period is today. The greatest buying opportunity over the past 100 years was at the end of the 1980-1982 recession. Investors old enough to remember the economic situation back then remember a time when the U.S. economy was in a severe recession and nobody wanted to buy stocks. U.S. Treasury yields exceeded 15% so who needed stocks to make a great return? The stock market traded at an absurdly low 6x earnings multiple using the CAPE ratio. The CAPE recently hit 32x, near where U.S. stocks traded before the 1929 stock market plunge.



With U.S. stocks currently trading at above average valuations, the economy showing clear signs of deceleration, and corporate earnings rolling over, the setup for future U.S. stock returns is not very compelling. We are in one of the most extreme environments for financial assets in history and it is a delicate time for investors and portfolio positioning. All financial assets have moved higher over the past six months but both stock and bonds look extended. The major support for U.S. stocks today is the widespread belief that the Fed will come to the rescue (the so-called Fed put) and is about to aggressively cut interest rates.

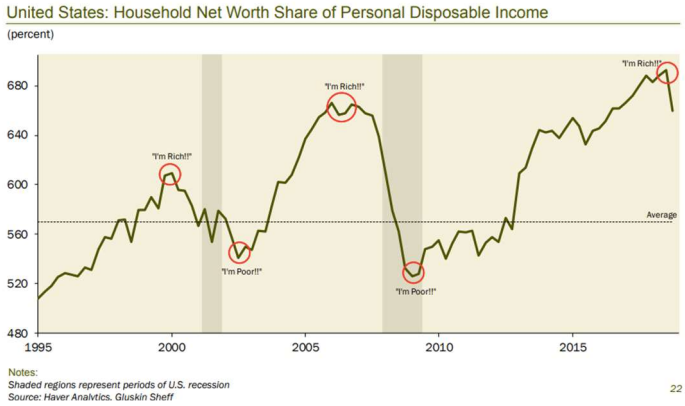
After a decade of aggressive central bank intervention post the Global Financial Crisis, and with U.S. stocks having generated just over 15% annualized returns for the past decade, investors must begin to consider the idea that forward returns are going to be notably lower. Since we have just come through a 10-year period of mid-teens annualized returns, it is not out of the realm of possibility to expect U.S. stock returns for the next 10 years to generate annualized returns in the low- to mid-single digits.

The following graphic from Vanguard provides a perspective on their forward return expectations for U.S. and non-U.S. stocks compared to the past 30-year experience. There are many other thought leaders in the area of forecasting asset class returns that agree with Vanguard and expect future U.S. stock returns will be lower in the next decade compared to the prior 30 years. The prospects for international stock returns are higher given lower valuations and higher dividend yields compared to U.S. stocks.

Lower future returns are not just a stock market thing. With the 10-year U.S. Treasury yield recently going below 2.00% and investment grade bond yields below 3%, bonds are unlikely to offer investors a source of higher returns. According to Bloomberg, 40% of global bonds are now yielding less than 1%.

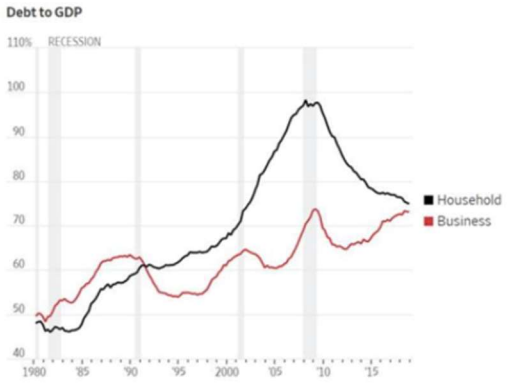
The next chart shows the nearly 40-year history of the 10-year U.S. Treasury yield. From a peak of near 16% in the early 1980s, bond yields have been on a downward trajectory for nearly 40 years. It is difficult to see how bond yields will reach levels that existed pre 2007 unless inflation or economic growth somehow return in force, causing bond yields to gap higher in the future.

Also concerning is the degree to which the net worth of many Americans is tied to the prospects of rising financial assets valuations, whether stocks, bonds, or real estate. The next chart shows U.S. household net worth share of personal disposable income. Even the tech bubble of 1999/2000 was no comparison to the real estate bubble of 2006/2007 that eventually collapsed and lead to the Global Financial Crisis. The use of extremely low interest rates and Quantitative Easing by central banks and the significant positive impact those polices have had on financial asset values means Americans are now the most exposed to the vagaries of financial markets than at any other time. It should be noted that last peak on the far right of the chart was right before global stock markets experienced a significant decline during the fourth quarter of 2018. In the first half of 2019, stocks have since recovered that entire decline and bonds have also rallied, meaning this chart would now be at a new record high.



The Tipping Point?

Whenever there is an economic slowdown, debt rises to the top of the worry list because slowing economic growth makes companies with higher debt levels more susceptible to defaulting on their obligations. The next chart shows how personal debt ballooned higher in the years before the 2007/2008 Global Financial Crisis. Since then, personal debt has come down quite a bit. However, taking the baton now is corporate debt, which has continued to rise since the GFC occurred over a decade ago.



In a recession scenario, the amount of debt rated BBB, which is the lowest rung of the investment grade ladder, could become a market flash point. As shown in the next chart, a rapidly growing amount of debt over the past decade has been rated BBB while the amount of junk bond debt, labeled speculative grade, has flat lined. The concern here is that credit terms have been stretched to enable more corporate borrowers to qualify for investment grade status, which benefits the issuer in terms of getting lower rates on the debt. However, in the event a recession occurs, a larger amount of BBB debt is subject to downgrades to junk bond status, or bonds rated BB or below. If the U.S. officially enters a recession, the high yield bond market has the potential to get hit with a tsunami of debt entering the junk bond category from its former BBB investment grade category and would end up causing major liquidity problems for credit markets, which undoubtedly would negatively impact the U.S. stock market as well.

A new debt crisis, whether from sovereign or corporate debt, may be the Achilles Heel of global financial markets. For now, investors have confidence that the central bankers worldwide will do whatever it takes to support the global economy, and the stock market trading near all-time highs is a reflection of this view. However, the massive amount of global debt outstanding, currently estimated at $244 trillion (again, that is a "T," not a "B"), is a potentially serious area of concern in a global recession scenario.

Summary

With U.S. stocks near all-time highs and bond yields low-to-negative, coupled with decelerating global economy and corporate earnings under pressure, we are witnessing the most unusual investment circumstances in recent history.

Based on the last decade of experience, most investors appear confident that the Fed and other central banks will once again do whatever it takes and not allow the bottom to fall out on economic growth or from financial markets. As yields plummet, investors are being forced into higher risk assets like stocks further depressing their forward return outlook.

If the Fed cuts interest rates and manages to achieve a soft landing for the U.S. economy and the current economic slowdown is a temporary soft patch rather than a recession, then investors will avoid the worst-case scenario outcome.

However, if the U.S.-China trade war carries on into 2020 with no resolution and the global economy slides into a recession, investors who have been chasing yields in stocks and junk bonds will find themselves in the proverbial hot seat and in danger of having their wits beaten out of them.

Mark J. Majka, CFA

July 11, 2019