August 2019

From the front page of this weekend's WSJ:

Market's Rise Caps Dizzying Month

BY AKANE OTANI AND MICHAEL WURSTHORN

Stocks snapped a four-week losing streak Friday to end a head-spinning August just a few percentage points below their all-time high (except for small-caps, as shown below).

The month was capped by Friday's quiet session during which the S& P 500 edged up less than 0.1%. That marked a stark contrast to much of August, which was by many measures the most tumultuous period yet for markets in 2019.

Investors grappled with a lack of clarity on core issues like trade and global growth and remain wary heading into what has historically been a shaky month for stocks.

Fears about escalating U.S. China trade tensions sent the broad stock-market index down at least 2.5% on three occasions in August, the most in nearly eight years. Gold prices surged as investors sought a refuge from the selling, and the yield on the two-year U.S. Treasury note surpassed that of the 10-year for the first time since 2007—the starkest sign yet that bond investors fear a recession is on the horizon. ...

the stock market bounced back in the final week of August, with the S& P 500 managing to pare its loss for the month to 1.8%.

The index is still up 17% for the year and within just 3.3% of July's record close ....

September could be challenging, though. The S& P 500 has historically delivered its poorest return of the year in September, with an average loss of just below 1%, according to Dow Jones Market Data.

And there are plenty of potential catalysts for volatility coming up.

In the first week of the month alone, additional tariffs on both U.S. and Chinese goods are slated to go into effect and investors will get a look at data on the manufacturing sector, which has shown increasing signs of strain from the two countries' trade war. ...

Much of the market's trajectory hinges on whether the U.S. and China can come to a truce before cracks in the economy develop into a prolonged downturn—something that investors are still debating. ...

One factor on the stock market's side: bond yields have fallen to multiyear and even record lows around the world. The yield on the 30year Treasury bond fell to its lowest level ever in August, while the yield on the 10-year Treasury note ended Friday at 1.503%—down more than a percentage point from the start of the year.

Dwindling opportunities to find yield across markets have left U.S. stocks looking relatively attractive, investors say, even as corporate earnings growth has slowed markedly from the tax cuts-fueled boom of previous years.

The unemployment rate has hovered near a multi-decade low this year, while the labor market has extended its record streak of expansion to 106 months. ...

Tariffs already appear to be taking a bigger toll on Americans. A measure of U.S. household sentiment in August logged its biggest drop since 2012, according to the University of Michigan.

Nervousness around trade has also driven investors into areas of the market that have traditionally outperformed during bouts of volatility.

Gold closed August up 6.5% at $1,519.10, bringing its gain for the year to 19%.

The real estate, utilities and consumer-staples sectors also outperformed the S& P 500 throughout the month—pointing to jitters among stock investors. ...

Indexes outside of the U.S. didn't fare much better in August.

The U.K.'s FTSE 100 shed 5% for its worst monthly performance since October. Hong Kong's Hang Seng Index slid 7.4% amid intensifying protests that have hurt the local economy and prompted concerns about a recession.

From Friday's Global Investment Strategy:

"The Democrats are trying to 'will' the Economy to be bad for purposes of the 2020 Election. Very Selfish!" – @realDonaldTrump, 19 August 2019 8:26 am

"The Fake News Media is doing everything they can to crash the economy because they think that will be bad for me and my re-election" – @realDonaldTrump, 15 August 2019 9:52 am

Bad Juju

President Trump's remarks, made just a few days after the U.S. yield curve inverted, were no doubt meant to deflect attention away from the trade war, while providing cover for any economic weakness that might occur on his watch. ...

The Trade War Remains The Biggest Risk

The points discussed above will not matter much if the trade war spirals out of control. It is impossible to know what will happen for sure, but we can deduce the likely course of action based on the incentives that both sides face.

President Trump has shown a clear tendency in recent weeks to try to de-escalate trade tensions whenever the stock market drops. This is not surprising: Despite his efforts to deflect blame for any selloff on others, he knows full well that many voters will blame him for losses in their 401(k) accounts and for slower domestic growth and rising unemployment.

What about the Chinese? An increasing number of pundits have warmed up to the idea that China is more than willing to let the global economy crash if this means that Trump won't be re-elected. If this is China's true intention, the Chinese will resist making any deal, and could even try to escalate tensions as the U.S. election approaches.

It is an intriguing thesis. However, it is not particularly plausible. U.S. goods exports to China account for 0.5% of U.S. GDP, while Chinese exports to the U.S. account for 3.4% of Chinese GDP. Total manufacturing valueadded represents 29% of Chinese GDP, compared to 11% for the United States. There is no way that China could torpedo the U.S. economy without greatly hurting itself first.

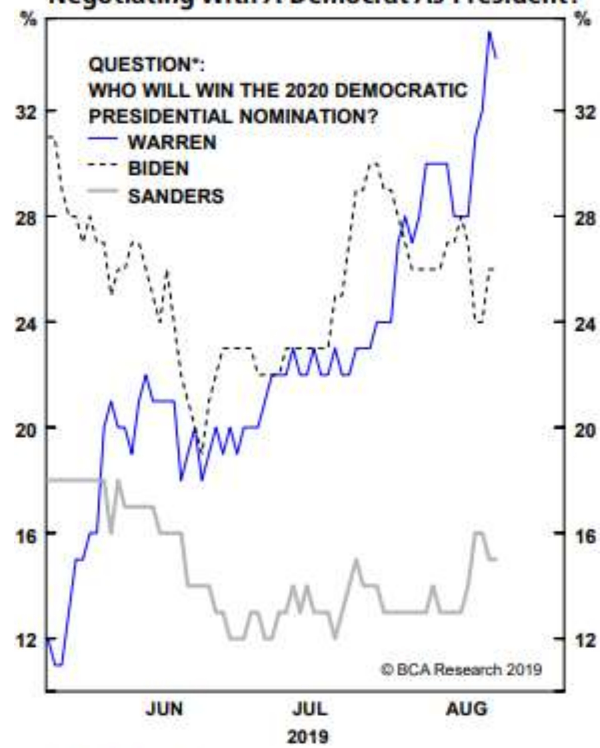
Any effort by China to undermine Trump's re-election prospects would invite extreme retaliatory actions, including the invocation of the War Powers Act, which would make it onerous for U.S. companies to continue operating in China. Even if Trump loses the election, he could still wreak a lot of havoc on China during the time he has left in office.

Moreover, as Matt Gertken, BCA's Chief Geopolitical Strategist, has stressed, if Trump were to feel that he could not run for re-election on a strong economy, he would try to position himself as a "War President," hoping that Americans rally around the flag. That would be a dangerous outcome for China.

In any case, it is not clear whether China would be better off with a Democrat as president. The popular betting site PredictIt (which we have previously shared) currently gives Elizabeth Warren a 34% chance of winning, followed by Joe Biden with 26%, and Bernie Sanders with 15% (**Chart 12**). This means that two far-left candidates (either of who's populist policies would be an economic disaster) with protectionist leanings, who would stress environmental protection and human rights in their negotiations with China, have nearly twice as much support as the former Vice President.

All this suggests that China has an incentive to de-escalate the trade war. Given that Trump also has an incentive to put the trade war on hiatus, some sort of détente between the U.S. and China, as well as between the U.S. and other players such as the EU, is more likely than not.

CHART 12
Would China Really Be Better Off Negotiating With A Democrat As President?



* SOURCE: PREDICTIT.

Investment Conclusions

Provided the trade war does not spiral out of control, it is very likely that global equities will outperform bonds over the next 12 months. Since it might take a few more months for the data on global growth to improve, equities will remain in a choppy range in the near term, before moving higher later this year. ...

From Bespoke:

Russell 2000 (IWM) Testing Support

Wed, Aug 28, 2019

Unlike large-cap major indices like the Dow or S&P 500 which managed to reach record highs earlier this year, so far in 2019, the small-cap focused Russell 2000 never managed to so much as retest the highs from around this time last year. In fact, in the past year, other than the final leg down to December lows and the subsequent rally back up to previous levels in early 2019, the Russell has been in a range between support and resistance from last fall. This support and resistance can actually be traced back even further to the highs and lows of late 2017 and early 2018. This year has seen more tests of these support levels after May declines and once again this month.

At the beginning of August, the Russell collapsed through flat 50 and 200-DMAs finding relief at the bottom of this range. Since then, the index has been bouncing between this support and the 200-day with the most recent failed test of its 200-DMA coming just last week. Over the past few sessions, while it has not closed significantly below, intraday the index has breached these critical support levels. ...

Follow-ups

From Robert J. Samuelson's August 25th NYT column titled "We're making a high-stakes gamble on the deficit":

According to CBO estimates, massive deficits stretch as far as the eye can see. Between 2020 and 2029, the projected deficits total $12.2 trillion, which is nearly [$1 trillion more] than was estimated in May. In every year after 2020, the deficit exceeds $1 trillion and is more than 4 percent of gross domestic product (GDP). By 2028, the projected deficit will be 5 percent of GDP.

The actual deficits will probably be higher, given that the CBO projections assume — unrealistically — that there will be no recession during this period and that the unemployment rate will remain near “full employment.” ...

Among Republicans and Democrats, there is little sense of embarrassment about this. The Trump White House is said to be searching for new economic stimulus policies, presumably further tax cuts, to bolster President Trump's reelection prospects. This resembles Third World countries that pump up the economy during election years, because that's what it is. Naturally, the president is also pressuring the Federal Reserve to reduce interest rates for the same purpose.

The conspicuous cynicism of a president trying to buy his own reelection with the public's money, especially when that money is borrowed, is stunning. Of course, self-serving efforts to boost the economy during an election year are hardly unique to Trump, but he has taken the practice to new lows.

Meanwhile, Democrats can't brag. Their presidential candidates have proposed a heap of costly programs. Universal health coverage. Free college. Subsidized jobs. More child-care subsidies. The list runs on. Democrats suggest implausibly that taxing the rich and corporations will cover the costs. This is dubious, but even if it weren't, it conveniently overlooks the existing trillion-dollar deficit. Who's going to pay for these programs?

Democrats have been particularly disgraceful in not acknowledging that America's aging population requires new policies. The elderly are healthier and wealthier than in the past. By and large, Democrats have fed the stereotype of all the elderly as poor and decrepit. A sensible society would have prepared for this predictable future by gradually raising eligibility ages for public programs and reducing benefits for the affluent old. Social Security and Medicare dominate the federal budget and are crowding out other important priorities. ...

The implicit hope of present policy is that the world's demand for "safe assets" — mainly U.S. Treasury securities — means that we can spend more than we tax, with the shortfall being made up by perpetual borrowing.

This is a high-stakes gamble. The possible ways in which a world sated with dollar securities could trigger a financial or economic crisis are many. The consequences of a run on the dollar — the currency most held by multinational firms, international banks, investors and traders — would clearly destabilize the world economy. A prudent society would recognize this and take preventive steps.

We are not prudent. We are just raising the risks, seemingly determined to learn how much we can test the bounds of our ignorance.

Positions

CVA - On 7/26 fell 2.7% on 3.6x normal volume on a Negative Earnings Surprise (-.1603 Actual vs. -.047 Consensus Estimate). Over the next 3 weeks 1 analyst raised and 5 lowered their 9/19 Earnings Estimates, and 1 raised and 4 lowered their 12/19 Earnings Estimates, out of the 7 of 9 analysts that updated, while 4 of them lowered their Target Price. On 8/16 we sold for all 3 clients holding @ 16.62.

RBS - On 8/2 fell 4.4% on 2.2x normal volume on lowered guidance. Two out of 16 analysts lowered their recommendations from Buy to Hold, while 1 raised and 10 lowered their Target Price. On 8/26 we sold for all 5 clients holding @ 4.4702.