Market Commentary

May 2019

Everyone's a Skeptic

Investors should gain some measure of comfort that despite the outsized year-to-date gains in global stock markets, it is difficult to detect an overwhelming sense of market euphoria. Rallies are met with skepticism. Analysts fret over trade deals, China, leveraged loans, asset valuations, too restrictive Federal Reserve (Fed) policies, too loose Fed polices or whatever happens to be the flavor of the moment. Not that we are above worrying. Hardly. Our investment team spends a great amount of time seeking contrary opinions to our current outlook (we are generally positive on continued growth and investment grade credit conditions) or identifying potential downside risks poised to negatively impact our strategies and clients.

Well, the flavor of the moment is China. China is a tough risk to get your hands around and I am loathe to handicap politics and political deal making. For investors, most China-linked concerns are trade related and rightly so. President Trump's threat to raise tariffs to 25% in retaliation for perceived backtracking by Chinese negotiators on previously agreed to concessions shook global equity markets, reminding investors how headlines and rumors on the progress – or lack thereof – on U.S. / China trade talks still move markets. Investors crave certainty and companies are just hoping to get the new rulebook and get on with business. China's influence on markets does extend beyond just trade. As one of the few reliable sources of global growth, a lot of attention is paid to China's decelerating growth rate and attempts by its central government to stimulate activity. But the reality remains that the U.S. and Europe are more impactful to China's growth than vice-versa, which gives us confidence a reasonable trade agreement will be worked out – eventually. In the near term, trade complications and tariffs may temporarily spook markets and hurt individual companies, but it seems unlikely to meaningfully move the U.S. GDP needle or force the Fed to take out an insurance rate cut.

To be sure, the Fed is not going to mess up by prematurely lifting rates and derailing the expansion. No chance. With his calm performance at the May 1st post-meeting press conference, Chairman Jay Powell wiped the slate clean from last year's overly-hawkish verbal gaffes and laid out a clear rationale for patience. Mr. Powell went further by saying he and FOMC committee members don't see a strong case for a rate move either way. We agree. The bar to lift policy rates is much higher now, probably requiring continued 3%+ growth, a much steeper yield curve and a sustained period of core inflation above 2%. All of which could eventually happen, but it just doesn't seem like 2019's business. One could argue Fed patience is its own form of tightening and a threat to the economy, especially as investors are betting on a 2019 rate cut. After all, ten-year yields rose 10 basis points and the S&P 500 fell about 1.0% in the 24 hours following the Fed's May statement and the Chairman throwing a proverbial wet blanket on potential rate cuts. Perhaps such market moves tighten financial conditions on the margin, but investors were getting ahead of themselves discounting rate cuts and a resetting of expectations was both needed and helpful.

Probably the worst kept secret on the risk spectrum is increasing corporate leverage – specifically in the high-yield debt and leveraged loan space. This week in its semi-annual Financial Stability Report, the Fed noted debt levels are increasing for the riskiest firms and an economic slowdown could result in a jump in defaults. Further, the Fed believes lending standards have weakened with leveraged loans now standing at $1.15 trillion – higher than before the Financial Crisis. Unlike the pre-Financial Crisis era, I think those investing in high-yield markets more fully understand and accept the risks they are assuming with these securities and are better capable of absorbing any losses – all of which should help

Jim Palmer, CFA
Chief Investment Officer

usbancorp Asset Management, Inc.

ward off a negative debt cascade. In a downturn, some highly-levered companies will default, their employees will unfortunately be laid-off and GDP will suffer for it. But a downturn on the scale of 2008 just does not seem to be in the cards. For our investment purposes, we strive to avoid the most at-risk companies and sectors by focusing on stronger investment-grade corporate issuers, well-capitalized and liquid banks and asset-backed securities supported by prime borrowers.

If I had to pick one risk which really keeps me on edge, it is the global growth of sovereign and corporate debt over the past several years. Leverage makes economies more vulnerable to downturns and limits policy responses. Continued diligence on the part of central banks and investors should help limit asset and sector bubbles and keep U.S. growth on its modest but durable path.

Sources:

Bloomberg

Federal Reserve, Transcript of Chair Powell's Press Conference, May 1, 2019

Federal Reserve, Financial Stability Report, May 2019

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5/2019 0028-19