WealthHealth
Personal Wealth Management

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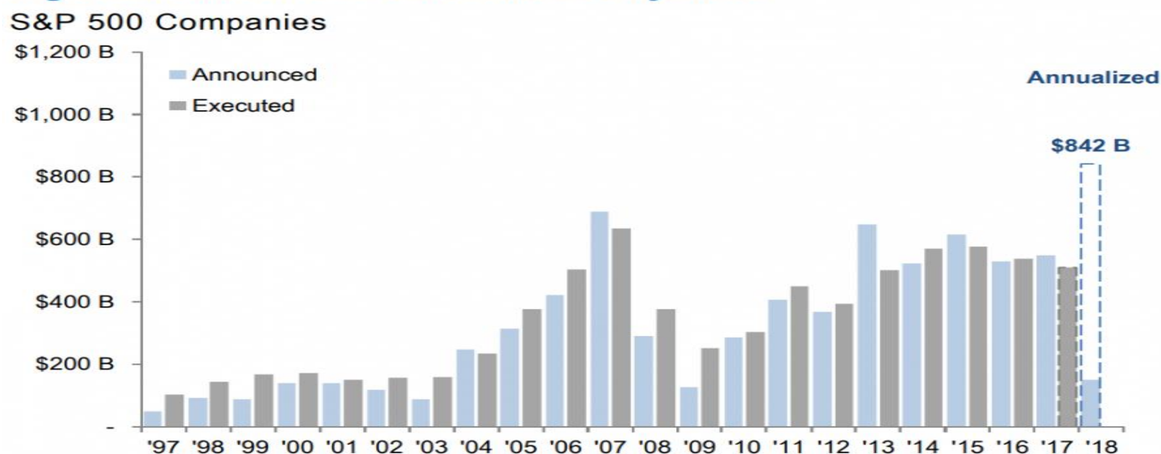
Market Review

As expected, following a dramatic resurgence in volatility during the first quarter of 2018, risk has since subsided, with equities recovering most of their losses. However, emerging markets and international equities continue to lag significantly behind their US counterparts as US growth and US small caps outperform. Corporate tax cuts from the Trump administration, and the ensuing cash repatriations flowed mostly to stock buybacks, fueling a strong rally in tech stocks with the Nasdaq continually making new highs along the way.

Stock buybacks were so strong in fact that this year is currently on pace to be a record year for companies buying back their own shares, implying continued equity market performance. While that should translate into continued wealth accumulation, it is worth noting that there is a growing concentration of risk of tech firms in the S&P 500. Currently, 5 companies make up roughly 16% of the index. Apple (AAPL), Facebook (FB), Amazon (AMZN), Alphabet (GOOG) and Microsoft (MSFT). If for some reason tech companies do start to falter, there could be an outsized negative drag on the S&P500 index.



On the fixed income side, floating rate securities outperformed all other sectors while emerging market bonds lagged, following a strong two-year run. Increasing trade disputes weighed heavily on emerging bonds (and stocks) as China, the largest emerging market economy, was threatened by higher tariffs. Overall, fixed income is having a tough time this year as rates continue to climb with the 10-year touching 3.1% in mid-May (it's moved down slightly since to 2.9%). Concurrently, the Barclay's US Aggregate Bond index is down -1.6% as of 6/30/2018. As a reminder, while higher interest rates do translate into higher coupon income from your fixed income holdings, the *transitional* period where rates reset higher can be a temporary drag on your overall portfolio as bond prices move lower. However, the effects tend to be muted as fixed income is traditionally considered to be much less risky than equities.

The remainder of 2018 will likely see floating rate securities continue to perform well as interest rates continue to climb and the economy continues to improve. And while higher interest rates are a sign of positive economic health, there is also the possibility of an eventual 'inverted' yield-curve. That is, the prospect of short-term government debt yielding the same amount as longer-term government debt. Typically, an 'inverted' yield-curve signals peak economic growth with the prospect of contracting GDP going forward.

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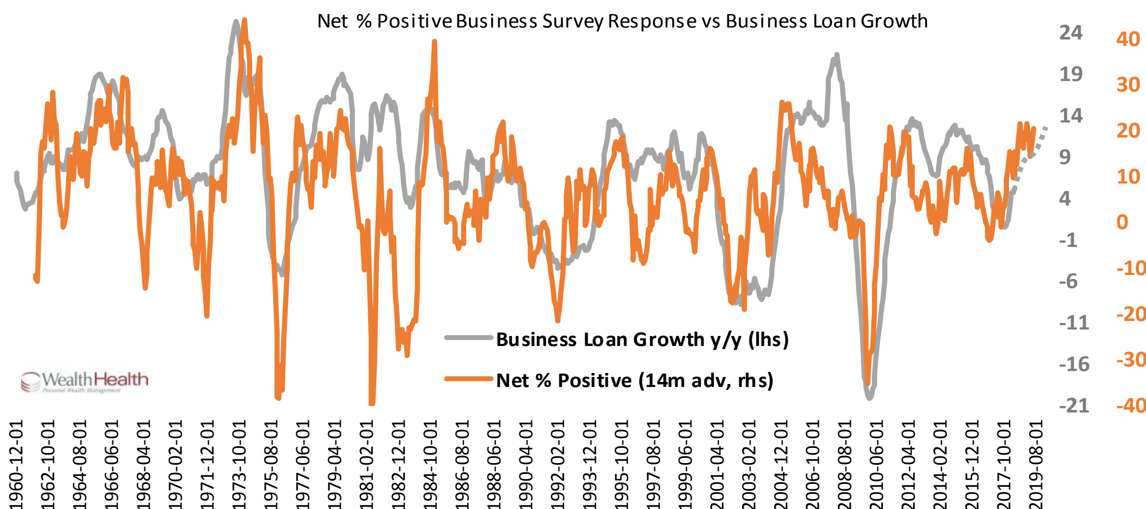
Broad Look

Overall, the first half of 2018 continued to post positive economic data although some data points did in fact point to weakness. Survey indicators, while still positive, are showing waning sentiment about future economic prospects. While most survey indicators tend to be coincident indicators, some (such as the one below) tend to be leading and somewhat contrarian. Notice how prior to the last recession, in 2007, a clear majority of respondents expected a flat-to-weaker economy going forward with very few respondents replying in the positive.

Exhibit 18: How do you think the global real economy will develop over the next 12 months?

Source: BofA Merrill Lynch Global Fund Manager Survey

While fund manager sentiment is waning, small business and other economic fundamental surveys are instead showing higher levels of enthusiasm. For example, business sentiment is one data point that typically translates into actual economic activity. Typically, increases in business sentiment survey data leads spending and investment activity data by about 14 months. Simply put, when businesses feel confident about their prospects, measurable increases in business activity tends to follow within 14 months or so. This translates into an increase in hiring, capital goods expenditures and investments. This relationship can be displayed graphically when advancing the business survey data by 14 months, and in so doing, we can forecast an increase in business loan growth into August 2019. Something of note is the dramatic disconnect between the data sets in 2005-2008. Currently we see no such disconnect and the overall trend is positive.



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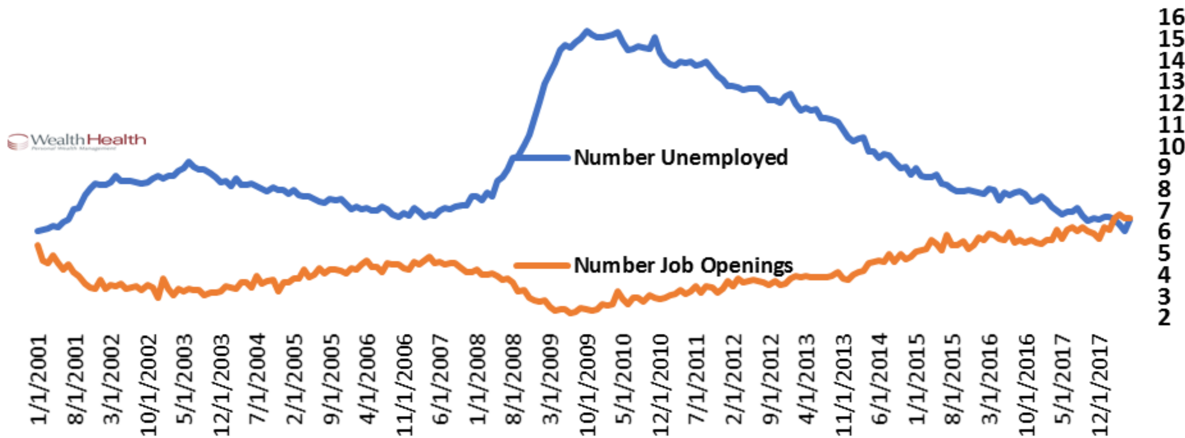
Other factors in addition to sentiment data show similarly positive prospects for future economic growth. Looking at the labor picture, there are currently over 6.6mm job openings while at the same time, approximately 6mm people are unemployed. The likely outcome of more job openings than unemployment claims is a continued increase in wages and the overall economy.



While things continue to look positive on balance, there are growing risks and excesses as extreme complacency is setting in once again. Specifically, covenant-lite loans are an aberration that could only have been made possible through the central banks' low interest rate, easy-money policy.

Source: Wall Street Journal; Institute of Int'l Finance

Covenant-lite loans are a type of financing that is granted with limited restrictions. Traditional loans generally have protective covenants built into the contract to protect the lender, including financial maintenance tests that measure the debt-service capabilities of the borrower. The issuance of covenant-lite loans means that debt is being issued to borrowers with fewer restrictions on collateral, payment terms and level of income. Covenant-lite loans are also referred to as "cov-lite loans." - investopedia.com

In addition, typically bond covenants restrict the company to certain solvency metrics (such as low debt, high cash, etc) throughout the life of the debt (bond). In contrast, cov-lite credits have what are called *incurrence covenants*, that is, an issuer must meet certain financial metrics *only if* it wants to partake in various activities (such as paying a dividend). This means that these risky credits are typically free to take on a growing amount of debt and are left virtually unchecked throughout their lives. These credits now make up more than 50% of the entire leverage loan market for the US and EU. In the US, cov-lite loans are approximately 8% of the entire corporate bond market.

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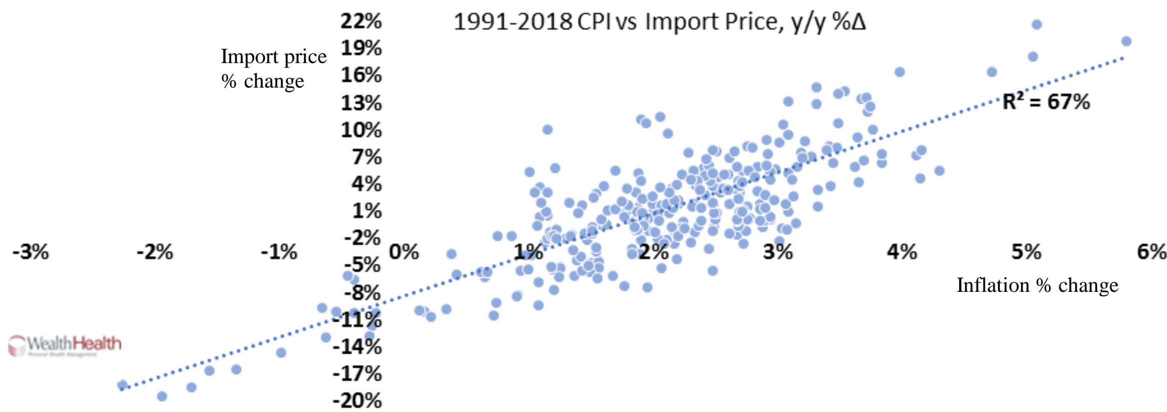
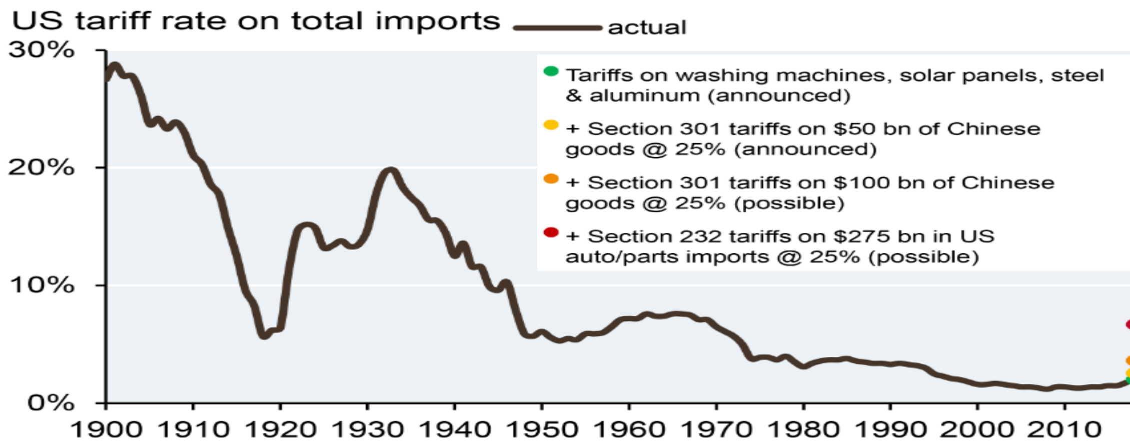
Looking Ahead

Overall, the US economy continues to do well as lower corporate tax rates and fiscal stimulus will likely translate into continued upside in equity's. However, risks remain scattered across the capital markets. One common risk being discussed frequently as of late is the prospect of a "trade-war". The Trump administration has been extremely vocal about equalizing the disparity between tariff rates, with the targeted goal of reducing the US trade deficit and boosting US manufacturing. Trump's main target, China, has twice the US average tariff rate at 3.6%, giving credence to an argument for raising US tariffs on China. However, the risk with doing so raises the prospect of higher inflation and may result in unexpectedly higher interest rates. Historically, import price changes are highly correlated to inflation price changes. Assuming all tariffs are implemented exactly as proposed, inflation data could prove to be much higher than expected, leading to a reflexive response from the bond market and a corresponding move higher in interest rates, possibly slowing the current growth trend.





In Summary

Lately, media sources have been eager to overemphasize the prospect of a "trade-war" as a foregone, inevitable conclusion. However, recent developments whereby President Trump and the EU agreed to a de-escalation strategy, challenged that notion. Moreover, an agreement with the EU gives the US more leverage when it comes to negotiating with China. As such, continued economic growth remains on a strong footing and will likely continue over into next year. While cautious, we continue to have a positive outlook.