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INVESTMENT MANAGEMENT

U.S.-China Talks at G20 Go Slightly Better than Expected

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Presidents Trump and Xi managed to beat expectations, slightly, at the recent G20 meeting in Osaka, Japan. They met consensus in that the current trade polices between the nations remain unchanged. Positive surprises included the willingness for concessions from the U.S., with respect to Huawei, and from China, with respect to agriculture. Additionally, Trump did not insist on a deadline for the new round of trade talks as he did at the Buenos Aires meeting in December 2018, which ultimately postponed tariffs for 3 months. Furthermore, Trump's rhetoric changed with respect to China in that the U.S. should become its "strategic partner," and not a "strategic competitor." This marks an overture to de-escalate tensions emanating from the U.S., where the door is open for additional talks, but without tangible details or urgency to make a trade deal. Downside risks remain a dominant theme.

Global central banks to remain easy as data outlook has not improved

The "soft data" remains very weak, where consumer sentiment and global inflation, as measured by PMIs, continue their march toward weaker outcomes. The sharp fall in the "soft data," coupled with the depth of the decline, is indicative of a recession within twelve months.

More measurable "hard data," such as production output, is falling, but not to the degree of the sentiment-driven "soft data." Inflation pressures remain low, and slowing corporate capital expenditure may feed upon itself and result in consumption and labor weakness. This is the risk.

The bottom line? The U.S. Federal Reserve (Fed), European Central Bank (ECB) and other global central banks will likely keep policy "easy" moving forward.

Market positioning remains defensive

- Investors are underweight to neutral on risk.
  - The U.S. Dollar is weakening, as the Fed is expected to cut rates, not hike.
  - Global equities are in net outflow year to date.
  - Conversely, high-quality bonds have experienced net inflows.
  - Moderate to low risk exposure to emerging market and high yield is in evidence.
  - As are high levels of cash.

- The key takeaway is that the market is better positioned to absorb volatility, and less likely to force a liquidation of assets.

What is the bond market telling us?It depends which bond market you are talking about. The U.S. Treasuries (UST) market is pricing a recession in 12-months. Credit/high yield is pricing an extension of the economic expansion (low recession risk/low default risk). The overall bond market indicates that lower UST rates are increasing the valuations of riskier assets.

What is the right level for UST yields?

If we take at face value the market expectation for rate cuts close to 100 basis points, then we believe the UST 2-year yield could fall to within a range of 1.50% - 1.75%. The yield curve should have some slope if these cuts serve as “insurance” against rising recession risks, 2s10s 25-50 basis points. This leaves the UST 10-year yield in a range of 1.75% - 2.25%.

We believe these levels are fair and reasonable based on what we know right now. Lower yield expectations require a more negative economic outlook than is currently priced, and vice versa for higher yields.

Our investment strategy

Most of the investment returns attributed to long duration in our portfolios have already been recognized for this year. We believe ‘insurance’ rate cuts from the Fed are mostly priced in, and returns attribution in fixed income may be generated by carry and spread narrowing for the remainder of the year. Our focus remains on the real economy and the strength of the consumer in both investment grade and high yield credit. Financials, building materials, gaming and delevering themes in communications remain key sectors for us. Our largest exposure remains in non-agency mortgages and asset-backed securities due to strong credit fundamentals in select areas within this asset class.

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