—New Albany—
Investment Management

August 12, 2019

Trade, Tariffs, & Currency Tantrums

After briefly making new highs in July, the equity markets have made a sharp reversal this month on concerns of deteriorating trade negotiations, tariffs, and currency fluctuations. Last week we saw a significant increase in trade tensions between the US and China. President Trump announced additional 10% tariffs on Chinese goods to commence in September due to lack of progress on trade talks. In turn, China 'allowed' their currency, the Yuan, to depreciate significantly against the dollar. The net result is investor confidence has been zapped once again, and for the moment, there is limited visibility of the path ahead.

Since the headlines are dominated with Trade, perhaps a quick refresher on trade basics is appropriate.
Trade Basics:

- Global trade accounts for about 58% of the global economy. Some countries rely almost entirely on trade. (World Bank)
- Exports account for 12% of the US economy. (World Bank)
- It is estimated US consumers' purchasing power is about $10,000 higher due to access to cheaper priced imports. (U.S. Chamber of Commerce: data from the Peterson Institute for International Economics.)
- Foreign currency devaluation lowers the cost of imports. In the case of China-US relations, as the value of the Chinese Yuan declines, Chinese goods are now cheaper for the US consumer. And a weaker Yuan, also makes the US dollar strong, reducing competitiveness of domestic producers both here and globally.
- Tariffs increase the cost of foreign goods which can shield domestic producers from competition. At the same time, tariffs can make imported raw materials more expensive which can hurt sales and operating margins.
- Interest Rates affect the valuation of currency and vice versa. Central Banks can use interest rates to adjust the relative value of their currency.

So, after reading the above, I am sure you have a much better idea of how this trade dispute is going to affect the stock and bond markets. If you don't, you are in good company. The fact is, no one knows how long this trade dispute is going to last; how deep both sides are willing to 'dig in' before any compromise; or how much it will eventually impact corporate profits, the consumer, and the economy. It is indeed a very messy situation with the outcome ranging from small to quite large.

Opaque Market Environment: Though difficult, the current market situation is not hopeless, it is just opaque for the moment. Just like a pilot in the clouds, when visibility is low, its best to look at the instrument readings to navigate. There are many, many market indicators, but for this discussion, I have narrowed it down to five measures to 'watch' for direction of the path forward.

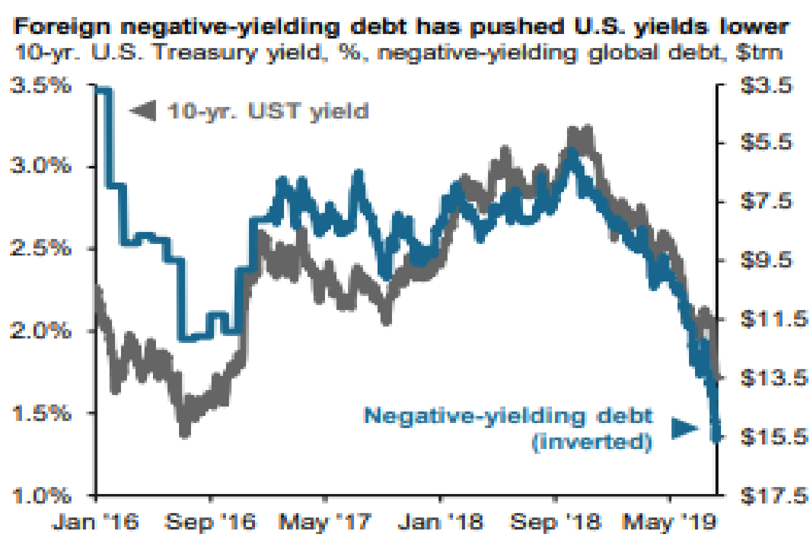
The Watch List:

1) **The YUAN:** The Chinese Yuan saw a significant devaluation last week when it broke through a key level that had previously been defended by the PBOC (Peoples Bank of China). The chart below shows the Yuan popping up through the 6.90Yuan/US level and now sits around 7.02 Yuan per US Dollar. A weaker Yuan helps

offset the negative impact of tariffs. If the Yuan continues to weaken further, it would indicate the Chinese are not particularly interested in resolving the trade issues any time soon, but in fact are in it for the long haul. Some pundits have surmised the Chinese will wait until after the US presidential election next year before they come back to the negotiation table. If this happens, business investment will likely decline further, potentially triggering layoffs and impacting economic growth. So, **watching the level and direction of the Yuan relative to the US dollar will help provide direction to the markets and the economy.**

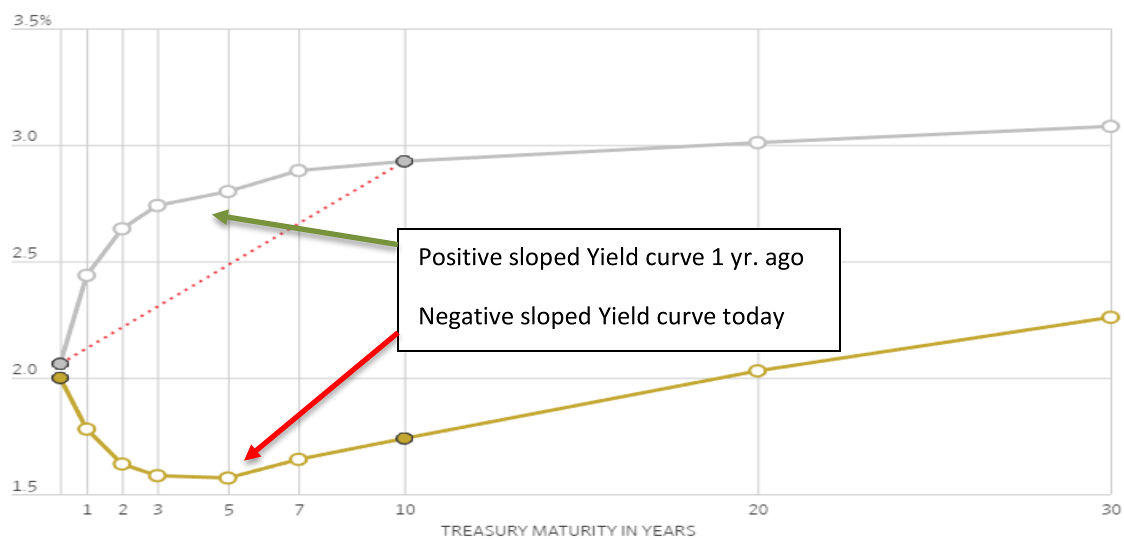
2) Interest Rates: Since peaking in November 2018, 10-year U.S. Treasury yields have fallen 150 bps, from 3.2% to now just 1.7%. That is a whopper of a move! Slowing global growth, lower inflation expectations, a dovish Fed, and the end of the Fed reducing its balance sheet had been the main drivers. But now with escalating U.S.-China trade tensions, fears of further slowing economic growth and weakening foreign currencies have pushed rates down even further to levels not seen since the world economy was in a deep recession. (2007-09). In many countries, yields are back into negative territory such that globally, there is now over $15 trillion in negative yielding bonds! As rates have fallen, investors are on the hunt for yield and have been scooping up US Treasuries, causing bond prices to rise here in the US, and long-term rates to fall. **Watching the level of rates will tell us investors sentiment about future growth.**

The chart below shows US Treasure Yields falling (blue line, left scale) over laid with the amount of negative yielding global debt rising (black line, right scale).



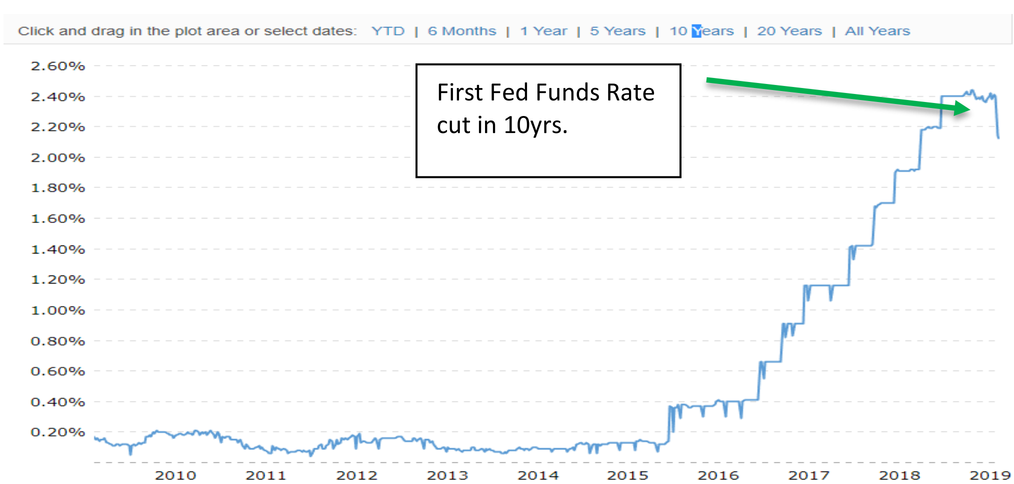
3) Shape of the Yield Curve: While the Fed controls the level of short-term bank borrowing rates, the natural forces of supply and demand determine the level of long-term rates. And, the difference between short term and long-term yields, depicted in the slope of the yield curve, has almost always been a good leading indicator of future growth. The slope of the curve started to go negative (long term rates lower than short term) in the Spring and signaled correctly that growth is slowing. Recently the yield curve has become even more inverted, with the US Treasury 10yr note now at 1.7% and short-term rates around 2%. Historically, an inverted yield curve has signaled a recession is nearing. So, **watching the actual level of rates and the shape of the yield curve will give us a good indication of the expectation of future growth.**

The chart below shows the slope of the yield curve a year ago (Gray line) - a positive sloping curve, and the current slope (yellow line)- a negative sloping curve.



Source: Treasury Department

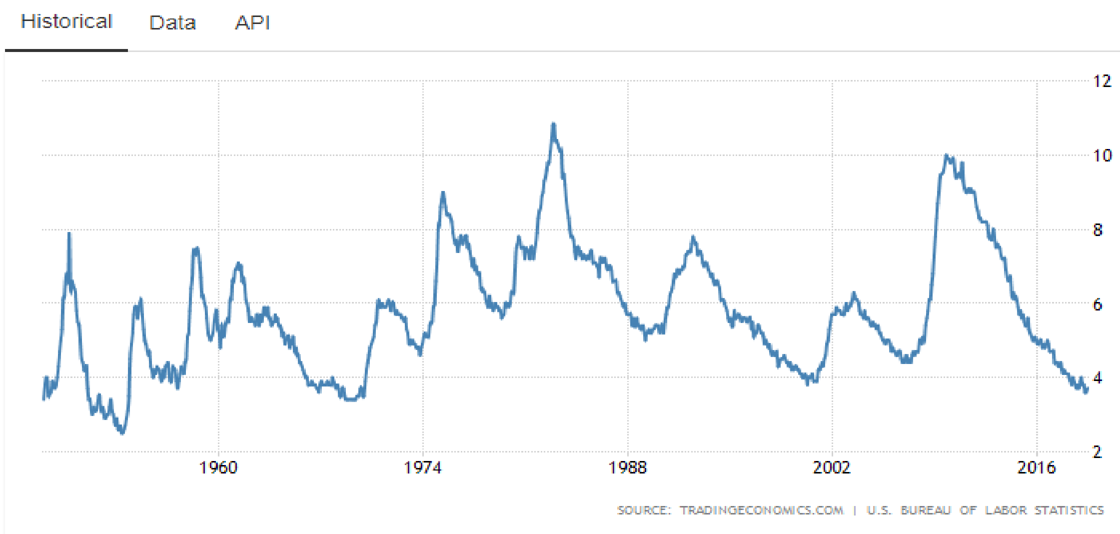
4) The Fed Funds Futures: In July the Fed cut short term interest rates for the first time in a decade (see chart below), citing low inflation as the reason. With the trade disputes ratcheting up, concerns of further weakening growth will likely prompt the Fed to continue to cut short term rates in the months ahead. In fact, the futures market is now pricing in at least two more cuts before the end of the year. **Watching the futures market will tell us the market expectations about the Fed and the health of the economy.**



Source: Macro Trends

5) Unemployment Rate: There is some good news! The US unemployment rate remains at recent historic lows. A low employment rate means the consumption will not fade away anytime soon and nor will the economy. Remember, consumption is the largest driver of the US economy, at 69%, and so even if corporate spending is slowing, the consumer still carries the big stick when it comes to growth. **If the unemployment rate starts to tick materially higher, that would be a strong warning sign the economy is near entering a recession**. But so far, the rate is holding steadfastly low. A good sign.

Chart of the US Unemployment Rate since 1945



In sum, many of the technical indicators are flashing weakness; but with the US consumer on very strong footing, the US economy is still growing and will offer support to the market. The trade dispute is a very important factor and will continue to dominate the headlines. This means the markets are subject to sudden and sharp gyrations, and volatility will remain elevated. Offsetting this is a dovish Fed and very low interest rates, both of which are supportive to the market. The indicators outlined above will help provide visibility for the near-term direction of the markets, but longer term, it may well be a bumpy road until we are past the elections next year (15 months!). So, as an investor, keep your seat belt fastened.

Investment Strategy: A more volatile market warrants a neutral, balanced, and broadly diversified strategy which is the strategy we implemented last December. Thus, no changes. **The portfolio strategy is working very well in current volatile market environment**. Both stock and bond exposure remain in the neutral zone. Please contact me with questions or concerns.

These are my thoughts. Your feedback is always appreciated.

Best Regards,
Barbara

Barbara HS Huff, CEO
New Albany Investment Management
614-216-6139
bhuff@newalbanyinvestment.com