Global Economic Review

Eagle Eye

MARKET & ECONOMIC OUTLOOK

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ON THE RADAR SCREEN

1. Fourth Quarter 2019 earnings are anticipated to be near flat on a year-over-year basis. A significant deviation in either direction could set the tempo for the market moving through the new year.
2. A skinny deal with China, agreement on USMCA, and the emasculation of the WTO mark significant wins for the Trump administration toward their policy goals. It remains to be seen if this results in a lull in the trade wars that were a hallmark of 2018 and 2019.
3. Global manufacturing has suffered a prolonged, if relatively shallow, contraction. There are some indications it may have bottomed. Watch PMIs, particularly in Germany.
4. Perhaps connected to elevated levels of policy uncertainty, business capital expenditures have been disappointing in the wake of the tax cut. With several trade objectives now met and the Fed on hold, a rebound is possible.
5. Headline unemployment numbers and job loss reports hold near record lows. Can, and will, businesses continue to add to their workforces as the year progresses, growing aggregate income?

BARILOTTI WEALTH STRATEGIES, LLC IS PLEASED TO PRESENT ECONOMIC AND MARKET INSIGHTS FROM THE MULTI-ASSET SOLUTIONS' PORTFOLIO MANAGERS.

"A victory of hope over experience" – Guarav Saroliya, Oxford Economics

Conscious uncoupling. So, have we made nice? U.S. and Chinese trade negotiators have announced the completion of a "phase 1" agreement, although the actual text is not yet available as of this writing. Import/export volumes are expected to rise, some vague promises around the protection of intellectual property have been made, markets will open a little more widely to foreign investment, and planned tariffs will be eliminated while some existing tariffs are to be partially rolled back. Progress, right? A little, maybe.

At the very least, it is a welcome shift in the tone of negotiations. That frictions are no longer escalating is itself a relief to capital markets. But it strikes us as a hefty exaggeration to paint this as a consequential win. For the most part, the commercial relationship between the U.S. and China will remain weaker than was the case before the first shot was fired almost two years ago. The relationship also seems likely to deteriorate further in the years ahead. Today's headlines sound promising, but actual corporate activity is less so. The use of "unreliable entity" lists, component bans, and the ever-present risk of new tariff impositions leaves firms on both sides of the Pacific increasingly reluctant to deeply engage with one another. Supply chains are being reengineered and markets are becoming more regionalized with the divorce of the world's two economic giants.

Adding insult to injury, the World Trade Organization was effectively emasculated on almost the same day that Trump gave approval to the skinny deal with China. The U.S. has blocked new appointees to an appeals board. With the latest retirement, there is no longer a quorum of judges available to rule on trade disputes. An institution that has been central to global trade for decades has been idled. The experience of the past two years reveals that the tide has turned on globalization, a force that has been nothing but benign for capital markets investors (although for middle-class workers in the developed world, the story has been quite different). Whereas globalization has been a tailwind, we fear that deglobalization/nationalization will be a headwind of similar intensity for financial markets in the years ahead. Expect structurally lower returns.

Insights from Multi-Asset Solutions' Portfolio Managers

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"An era of artificially low interest rates is the greenhouse that greatly aids the growth in financial shenanigans and fraud." – Jason DeSena Trennert, Strategas Research. Late in an economic cycle, it's not uncommon for corporate accountants to become somewhat creative when presenting results. We may be getting a whiff of that now. The National Income and Product Accounts, data provided by the Bureau of Economic Analysis, indicates that private sector profits have roughly flatlined over the past five-plus years whereas earnings releases amongst publicly traded entities point to significant growth. There are many factors contributing to that divergence, but we suspect that massaging (dare we say manipulating?) of the data is a significant culprit. We have come across several anecdotal reports to that effect. In the loan market, the use of EBITDA "add-backs" that flatten profitability and lower estimates of leverage is said to have grown considerably. New Constructs, a financial research boutique, estimates that roughly 22 cents of every dollar in reported profit is the result of subjective adjustments (i.e. distorted numbers). Similarly, reported earnings growth has outpaced free cash flow growth in recent quarters, implying possible accounting sleight of hand. All this is to say that earnings quality is becoming increasingly suspect in our eyes. Another caution flag is out.

The market is the most efficient mechanism anywhere in the world for transferring wealth from impatient people to patient people." Warren Buffett. An old Wall Street adage we'd rather forget reminds us that being early is no different than being wrong. Well, mea culpa (or 'my bad'). We've been early. After having been persistent bulls for a decade, we became skeptics (if not quite bears) late last spring. Thus far we've been offsides on that call as U.S. equities have achieved new all-time highs and credit spreads remain generally tight. But we play the long game. By our lights, this long economic expansion and accompanying rally in equities is largely exhausted. It could continue for another year or two, but remaining upside is limited. It's equally possible that the show ends abruptly sooner than most pundits anticipate, leaving investors exposed to painful losses. That's not an attractive risk to take given elevated valuations – there's space for prices to fall quite some distance. With this in mind, we remain moderately risk-off, refusing to get caught up in the recent swell of optimism that has lifted markets in recent weeks. We'll sit out the last gasps of an aged bull market, protecting principle and looking to re-enter at much more attractive pricing down the road.

About Risk

All investments are subject to market risk, including possible loss of principal. Stocks and bonds can decline due to adverse issuer, market, regulatory, or economic developments. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline. A bond's prices are inversely affected by interest rates. The price will go up when interest rates fall and go down as interest rates rise.

MLPs and other natural resources sector companies are subject to certain risks, including, but not limited to fluctuations in the prices of commodities; the highly cyclical nature of the natural resources sector may adversely affect the earnings or operating cash flows of the issuers in which the Fund will invest; a significant decrease in the production of energy commodities would reduce the revenue, operating income, and operating cash flows of MLPs and other natural resources sector companies and, therefore, their ability to make distributions or pay dividends.

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