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INVESTMENT & ADVISORY

Avalon Market Update
August 9, 2019

TRADE WARS REVISITED

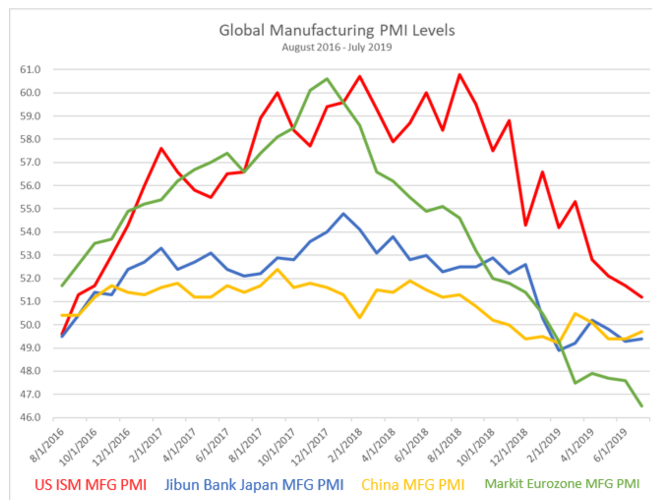
Geopolitical concerns came back with a vengeance sending global risk assets, oil and yields lower recently. On Monday, August 5, the S&P 500 closed down almost 6% from its all-time high on July 26. The proximate cause of the recent volatility was President Trump's announcement of a 10% tariff on the remaining $300bn worth of imports from China effective September 1. China responded by noting that there would be "necessary countermeasures" but declined to be specific about any actions.

WHY DO THESE TARIFFS MATTER?

Analysts estimate that the tariffs as a whole if implemented, could trim U.S. GDP growth by half a percentage point and China GDP growth by a percentage point. To put it into perspective, nearly all the U.S. fiscal stimulus in 2019 will be offset by the drag from the tariffs if this additional tariff is implemented, according to Strategas Research Partners. The tariffs look likely to stay for now with both sides needing a reason to come off their current bargaining positions.

This additional headwind is against a backdrop of a global economy which was already slowing. Manufacturing PMI provides evidence of this slowing across the major world economies (**Chart 1**).

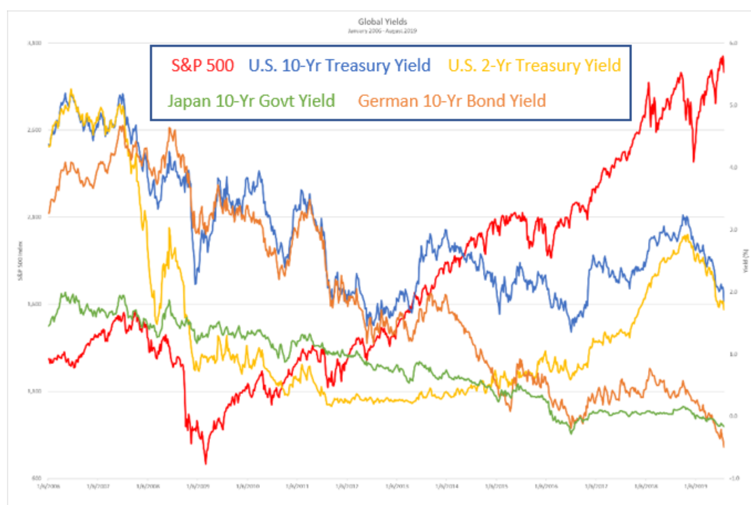
Chart 1



Source: Bloomberg, Avalon Investment & Advisory as of August 9, 2019

WHAT DO LOWER BOND YIELDS MEAN?

Chart 2



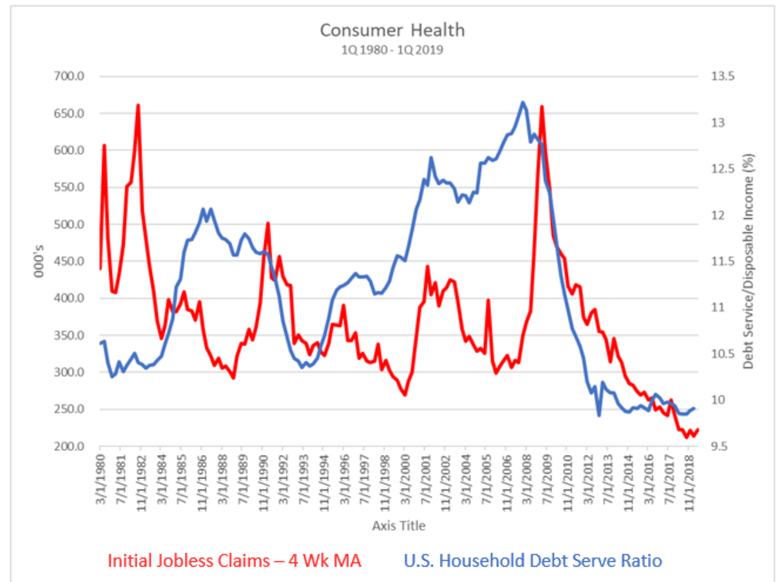
Source: Bloomberg, Avalon Investment & Advisory as of August 9, 2019

Yields have fallen globally in the wake of increased trade tensions (**Chart 2**). This decline in yields reflects the bond markets discounting slower economic growth and, in many cases, the central banks' likelihood to lower short-term policy rates in the future. In the era of asset purchases by central banks, a higher probability of increased purchases of government bonds by the central banks is also likely implied. There is also a flight-to-safety component to the decline in high-quality bond yields as well as demand for relatively-higher-yielding U.S. bonds when both German and Japanese yields are negative. The bond markets are certainly not infallible as we saw in late-2015 to early 2016 when the U.S. economy slowed and the 10-year Treasury yield fell below where it is now, but there was no recession.

IS THERE ANY REASON TO RETAIN SOME OPTIMISM?

While the U.S. economy is softening and the new tariffs will be another headwind if enacted as Avalon expects, the U.S. is still not near recession. The U.S. consumer remains strong thanks to a robust job market and wage gains. In addition, the consumer is not overleveraged and has sufficient capacity to add debt. As evidence of these views, initial jobless claims are near all-time lows from the late-1960s and the household debt service ratio remains near all-time lows as well (**Chart 3**).

Chart 3

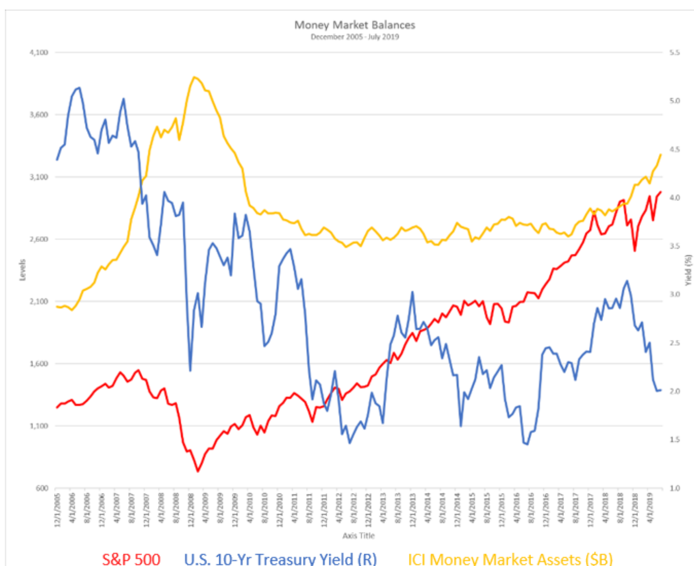


Source: Bloomberg, Avalon Investment & Advisory as of August 9, 2019

The size and composition of the U.S. economy also makes it more resilient to global economic downturns. While weakness in international economies would be a headwind to our economy, the U.S. does not necessarily need to enter recession even if other international economies do.

Despite the long bull market in stocks, investor sentiment remains muted. While it sounds contradictory, it is generally positive for future stock returns if investors are nervous. If everyone is positive about stocks, there is no one left to buy more stocks and prices likely reflect all the expected good news. Another way to consider the upside to stocks is to look at the buying power on the sidelines which could purchase more stocks. Currently, money market balances are at a level second only to amounts reached during the financial crisis and rising (**Chart 4**).

Chart 4

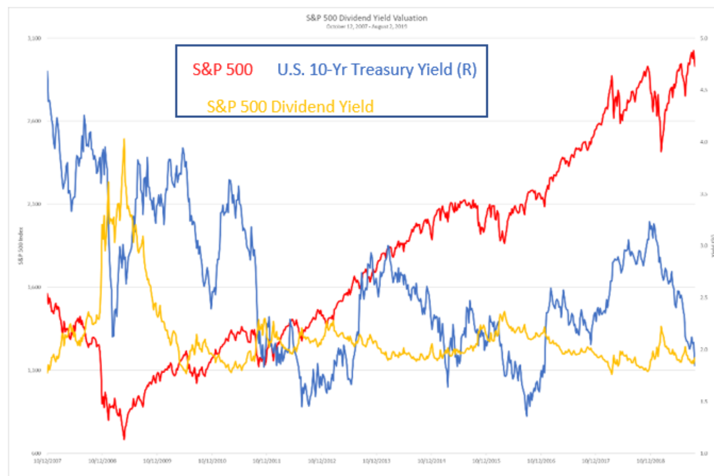


Source: Bloomberg, Avalon Investment & Advisory as of August 9, 2019

The global central banks are now in easing mode with both the U.S. and Eurozone likely to ease monetary policy further in September. The Fed could lower the policy rate again in December if the trade conflict further escalates. In reality, this easing is already reflected in the financial markets with global yields moving lower (**Chart 2**) so it can begin to have an impact before the central banks act. For example, U.S. mortgage rates have already declined almost one percentage point since 4Q 2018 which lowers the cost of owning a home and helped mortgage applications reported this week rise at a better than expected pace. China is also likely to continue to increase the stimulus as the tariffs weigh on growth.

While stocks are not cheap on an absolute basis, they look attractive relative to interest rates. The dividend yield of the S&P 500 is now above the 10-year Treasury. This was extremely rare in the modern era before the financial crisis but has acted as a good indicator of better S&P 500 performance (**Chart 5**). Certainly, the dividend advantage indicates that long-term performance of stocks should be better than 10-year U.S. Treasury bonds from this point.

Chart 5



Source: Bloomberg, Avalon Investment & Advisory as of August 9, 2019

SUMMARY & CONCLUSIONS

All other things being equal, global growth seems likely to continue to be challenged but there is a good bit of stimulus in the system. While the economy is softening, there should be no imminent U.S. recession.

Investors should be prepared for more volatility as the markets struggle with the severity of the global economic weakness exacerbated by the uncertainty around trade and other geopolitical risks.

While it is never pleasant to deal with market declines and volatility, it is (unfortunately) the price of admission for the best performing asset class through history. On average the S&P has declined 5% or more three times per year and 10% or more about one time per year, despite having very strong long-term returns (**Table 1**).

Table 1

S&P 500 Historic Volatility: Declines
1926 - Current

	5% Decline	10% Decline	15% Decline	>=20% Decline
Avg. Occurences Per Year	3.4x	1.1x	0.5x	0.3x

Source: Ned David Research, Avalon Investment & Advisory as of August 9, 2019

Avalon remains optimistic about stocks, but we still suspect that the market may experience more downside volatility before pricing in enough uncertainty. As always, investors should focus on what they can control – their asset allocation – to align goals with risk tolerance. Please contact your Avalon Client Advisor if you have any questions about your allocation. Avalon continues to monitor the situation closely and will share insights via our Macro Note, Weekly Market Guide and as needed with Avalon Market Updates informing you on relevant, timely market information.

SIGN UP FOR AVALON'S MACRO NOTE HERE AND THE WEEKLY MARKET GUIDE HERE.

Phan Phan Duong
Senior Analyst

Henry J. Lartigue, CFA
Managing Partner

Samuel E. Rines
Chief Economist

Bill Stone, CFA, CMT
Chief Investment Officer

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