Weekly Markets Commentary

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What Does Trade and the Latest Fed News Mean for Investors?

The U.S. and China agreed to a cease fire in their ongoing trade war. Following a meeting of the two sides on Saturday evening at the G 20 meeting in Buenos Aires, the U.S. agreed not to impose any new tariffs for ninety days, while the two sides continue to negotiate. Unless substantive progress is made, the agreement will expire on March 1 of next year. The agreement not only delays the expansion of tariffs to all Chinese exports to the U.S., but also somewhat unexpectedly includes a delay in the scheduled increase on January 1 to 25 percent from the 10 percent tariff already in place on $200 billion of Chinese exports. Ninety days is unlikely sufficient time to fully resolve the differences between the two sides, but the agreement is a constructive step that can be extended beyond the March 1 expiration if sufficient progress is made and should be viewed as positive by markets.

Last week, U.S. equities soared 4.8 percent after comments from Fed Chairman Powell were interpreted as implying a less aggressive tightening cycle. It was the best weekly gain in the S&P 500 index in seven years. Powell said that the overnight rate was just below the broad range of what is considered to be neutral. Although there was some debate about exactly what that meant, equity markets interpreted the comments as unambiguously dovish and rallied sharply. The ten-year Treasury note finished the week below 3.00 percent. The Fed's presumed more dovish posture will be tested with this week's full economic calendar, headlined by the November jobs report on Friday.

The Fed Makes News with its Financial Stability Report

The Federal Reserve also made news last week by publishing its first semi-annual financial stability report, in which it identified certain vulnerabilities in the financial system, resulting in some rather worrying headlines.

The intent of the financial stability report is to present a framework for assessing the resiliency of the U.S. financial system and to present the findings of that assessment. The framework consists of identifying vulnerabilities in four broad categories including 1) elevated valuation pressures; 2) excessive borrowing by businesses and households; 3) excessive leverage within the financial sector, and; 4) funding risks among financial institutions. At a very high level, the Fed judged that conditions in categories three and four were sound, concluding that:

"The nation's largest banks are strongly capitalized, and leverage of broker-dealers is substantially below pre-crisis levels. Insurance companies have also strengthened their financial position since the crisis…Funding risks in the financial system are low relative to the period leading up to the crisis. Banks hold more liquid assets, and money market mutual funds are less vulnerable to destabilizing runs by investors."

However, the Fed did identify certain vulnerabilities in the first two categories, saying:

"Valuation pressures are generally elevated, with investors appearing to exhibit a high tolerance for risk-taking, particularly with respect to assets linked to business debt…Borrowing by households has risen roughly in-line with household incomes. However, debt owed by businesses relative to gross domestic product (GDP) is historically high, and there are signs of deteriorating credit standards."

In saying that, "Overall, asset valuations and risk appetites are elevated," the Fed specifically pointed to higher than historical valuations in equities, commercial real estate, farmland and to a lesser degree residential real estate. It also pointed out the relatively low spreads on corporate high yield bonds and leveraged loans, despite a deterioration of credit protections. The Fed also warned of the increase in corporate debt, particularly by companies, "With weaker earnings and higher leverage." And the Fed went to lengths to point out the amount of debt now rated just one notch above junk would be susceptible to significant selling pressure in the event of a downgrade.

Investors' Appetite for Risk May Be Declining

The Fed went on to identify various risks to the current economic and market outlook, saying, "An escalation in trade tensions, geopolitical uncertainty, or other adverse shocks could lead to a decline in investor appetites for risk in general. The resulting drop in asset prices might be particularly large, given that valuations appear elevated relative to historical levels…Markets and institutions that may have become accustomed to the very low interest rate environment of the post-crisis period will also need to continue to adjust to monetary policy normalization by the Federal Reserve and other central banks."

First, it is important to point out that the Fed was not making a market forecast. Rather, it was appropriately pointing out that excesses exist in certain asset categories, making them vulnerable to significant declines in value should conditions deteriorate. It was not forecasting that this will happen, but rather that it could, and investors should be aware of it. In that regard, these excesses are not atypical of those seen in past cycles that can and have resulted in meaningful losses when conditions deteriorated.

Second, what the Fed had to say is no secret, but because it is the Fed saying it, the resulting headlines are attention grabbing. Historically high valuations and deteriorating credit quality are there for all to see. We, and no doubt many others, have been pointing this out for some time. In particular, the following two passages from our third quarter Quarterly Capital Markets Digest dated October 19 are particularly relevant:

"We are watching the senior secured loan space closely and may recommend reducing or eliminating loan exposures as the Fed approaches "neutral" mid-next year. Covenant protections have become stretched and could lead to more defaults, and more substantial losses in our view. With the potential for neutral Fed rates next year, and the return of yield to core fixed-income, the timing may soon be right to exit senior secured loan investments."

“As we previously expressed in the July edition of Quarterly Capital Markets Digest, tactical investors should continue to take a cautious approach to the markets and their investments today. Though there are reasons to be optimistic about traditional asset prices, secular clouds are forming on the horizon. Aside from escalating trade tensions with China, U.S. interest rates are rising, and inflation pressures are building across the economy. At some point, riskier assets could have more difficulty trending higher in such an environment.”

As with the Fed, we were not making a market forecast of an impending significant market decline. Rather we were, and still are, appropriately pointing out where we believe valuations to be stretched and investor risk appetites to be exhibiting a lack of discipline, creating vulnerabilities in the face of rising risks.

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