PCM
PEAK CAPITAL MANAGEMENT

Last Country Standing

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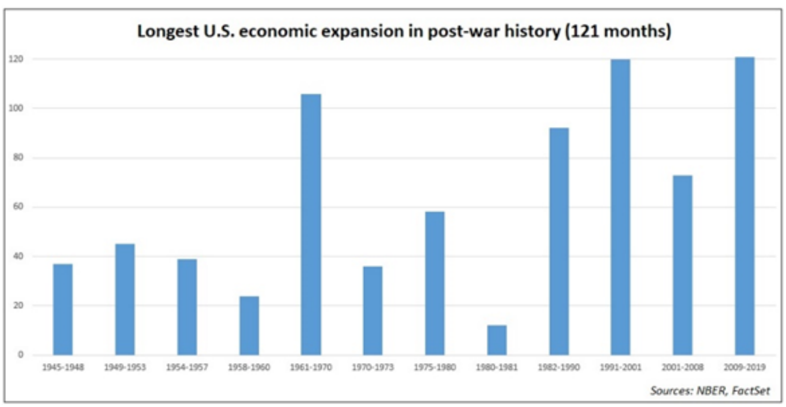
Notwithstanding the dire predictions about the demise of the U.S. economy from pundits and politicians, the data suggests economic expansion in the U.S. is likely to continue for the immediate future. The U.S. has enjoyed continuous growth in its economy since March of 2009, making this expansion the longest in post-war history. It is the rest of the world that appears to be headed toward economic contraction, or recession.

Concern was sparked in August when the yield curve inverted with the yield on the 2-year Treasury above the 10-year Treasury; a reliable predictor of recession over the last 50 years. While reliable indictors should not be ignored, they are not as important as the actual economic data from each country or region.

For example, Consumer Confidence remains near all-time high levels after a brief drop in the June reading. The Unemployment Rate is hovering around 3.7% — near a 50-year low for those without work. The National Federation of Independent Businesses (NFIB) data suggests the outlook for business remains optimistic. Citizens Bank just released their Business Conditions Index of corporate and public data with a reading of 61.2, down just slightly from the highs recorded in the first quarter of 2019. Even with the Trade War with China, corporations showed strong revenue growth, productivity gains and plans to add new jobs.



The rest of the world, sadly, is not faring so well. The Purchasing Managers Index (PMI) in the UK, Germany, Italy and Japan all suggest their manufacturing sectors are in contraction. Nowhere is that more troublesome than in Germany, where the PMI reading has fallen from 63 in January 2018 to just 43 in August 2019. Most analysts agree that Germany is already in a recession and very likely to drag the balance of Europe with it.

Asia is equally struggling with exports from Japan, a critical part of their economy, falling for 3 consecutive quarters. The slowdown in China has been well-documented with growth estimated below 5% for the first time in decades. The protests in Hong Kong are disrupting the global economy and could tilt much of the world into recession.

Politicians have seized on global economic turmoil, often caused by tweets emanating from the White House, to suggest the U.S. economy is in dire shape. If they make the economy the centerpiece of their campaign, however, they may live to regret that strategy. The volatile but prescient GDPNow published by the Atlanta Fed indicates that 3rd quarter GDP is trending higher and forecasts growth of 2.2%. The current economic data is too strong today to suggest that a contraction or recession is imminent.

Strong Consumer Spending +
Higher Government Expenditures –
Business Investment = Slow Growth

There are significant risks that are worth noting and watching. Exports to China represent just .2% of U.S. GDP, so the Trade War with China simply will not result in a recession here. My biggest concern is that the U.S. will experience a contraction in corporate credit and lending that has the potential to lead to a recession. The inverted yield curve is a profit squeeze on banks as the margins on bank loans contract. As banks become less willing to lend, credit necessary for businesses to grow becomes scarce even though rates are at very low levels.

Wages are growing at the fastest pace in almost two decades, making consumers resilient to claims of economic doom. Housing has slowed dramatically at the high end of the market, but remains robust in most markets at median price levels. Business confidence is weak and companies that rely on exports are facing high levels of uncertainty, but history suggests weak business investment is not enough to tilt the U.S. economy into contraction.

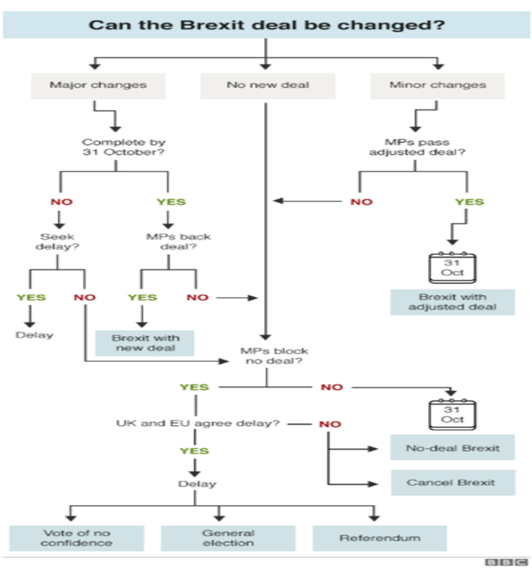
Strong consumer spending plus higher government expenditures less weak business investment (capex) equals slow growth, not a recession. Even the flashing red light of the inverted yield curve does not suggest a recession before the 2020 election is complete. Over the last 50 years, the average time between the yield curve inverting and the start of a recession is 18 months. Also interesting is that the stock market has gained, on average, 15% from inversion to recession. It makes sense to be vigilant from a risk-management standpoint but likely too early to be in panic mode.

Saved by Zero

Yields on U.S. Treasury bonds plunged to all-time lows in August over concerns for a global economic slowdown and the rising tide of negative yielding bonds. The 30-year US Treasury bond traded below 2% for the first time at 1.98% in mid-August and remained at 2.02% at the end of the month. The rate is sharply down from the 3.46% level hit in November 2018. The benchmark 10-year Treasury is hovering at 1.50%, also at historic lows. There are two factors causing yields to fall. First, the explosion of negative yielding investment grade sovereign debt in Europe and Japan. Second is demand from foreigners for positive yielding Treasuries. European and Japanese pensions and insurance companies are buying massive amounts of U.S. government debt in an attempt to match future liabilities.

- The total value of negative yielding bonds has exceeded $15T as of August 2019. According to BAML analysts, the blended yield on the $28T non-U.S. global investment-grade bond market is just 0.11%.
- Corporate bonds of more than $1T are now trading at negative yields up from just $20B in January according to Bloomberg data. Some junk bonds in Europe are irrationally trading at negative yields as well.
- The Bid-to-Cover ratio for the latest Treasury bond auction remained a healthy 2.24 on the benchmark 10-year UST. Strong demand was present from both domestic and foreign buyers and Central Banks.

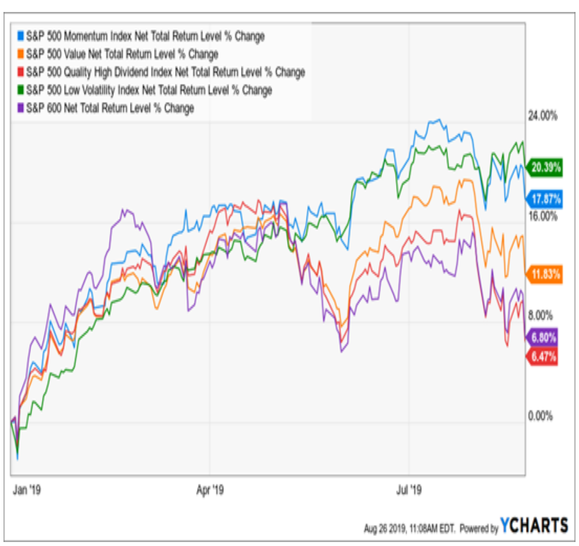
Boris Brexit



As the Brexit decision approaches, the results are likely to impact markets in the immediate and long term. A successful Brexit may open the door for other members of the European Union to exit the EU. To that end, eyes are focused on Italy. The fate of Brexit rests largely in the hands of newly appointed United Kingdom Prime Minister, Boris Johnson. Johnson has recently pivoted from stating that the odds of Brexit not happening were a "million to one," to the Brexit deal being "touch and go" (BBC). In coordination with the recent G7 Summit meeting, world leaders are beginning to evaluate the implications of Brexit not occurring and how the U.K. would honor or not honor economic commitments made to the EU before Brexit talks began.

- A successful Brexit deal likely hinges on Boris Johnson and Donald Trump's ability to negotiate a trade deal between the U.S. and the U.K.
- President Trump described a trade deal between the U.S. and the U.K. as an increase from current trade by "three to four, five times" (BBC).
- The flowchart from the BBC shows how Brexit can pass or be blocked.
- A trade deal between the U.S. and the U.K. could take over a year to agree on the terms, execute on the terms, and see the results of the agreement.

YTD Equity Factor Returns

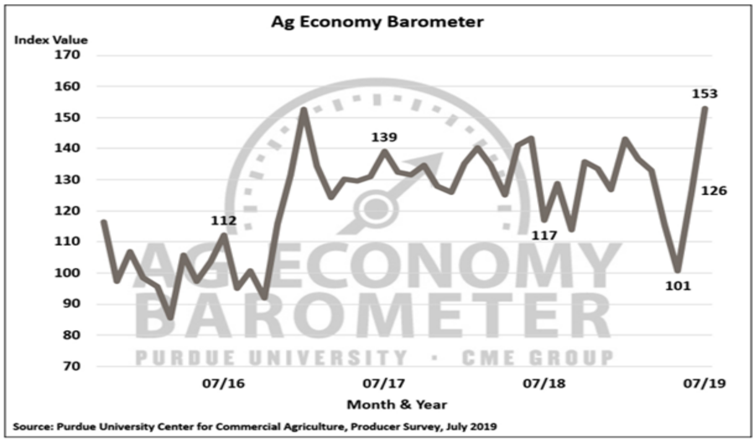


Despite recent market volatility, U.S. equities have delivered attractive returns so far this year. If we look under the hood and segment the broad market by factors, we can determine what has been driving the markets higher. So far this year (as of August 23rd), the low volatility and momentum factors are higher by roughly 20% and 18%, respectively. While still higher, the size and high-quality factors have lagged on a relative basis, delivering returns of just 6% and 7%, respectively. Meanwhile, value is in the middle of the pack, gaining roughly 12%. By comparison, the broader S&P 500 Index is higher by approximately 15%.

- The relative underperformance of small capitalization stocks (i.e. the size factor) could be due to a heightened liquidity premium as we approach the end of a market cycle. As investors perceive greater risks to the overall market, they prefer the liquidity of larger capitalization stocks and begin to shun less liquid, smaller capitalization names.
- The low volatility factor separated from the other factors during May and August, as market risk was elevated. Typically, the holdings in the low volatility index exhibit a lower beta to the broader market, and can provide a cushion to the downside.

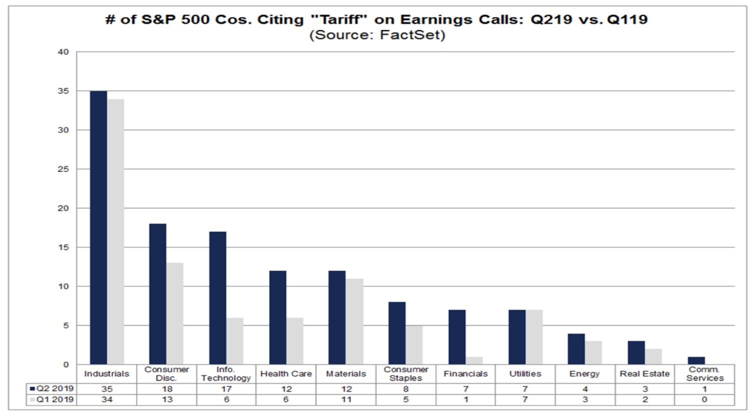
Macro View – Jump in Agricultural Confidence

While consumer confidence has been waning, the abrupt increase in agricultural confidence caught the attention of the team at PCM. The Purdue University/CME Group Ag Economy Barometer reading was at 153 in July, an increase of 27 points from June, and an increase of 52 points from May (https://purdue.ag/agbarometer). The barometer is the result of a survey of 400 agricultural producers across the U.S. There is also a sub-index of the barometer that measures expectations of current conditions which drove much of the increase in the barometer. Also, producers are asked if now is a good or bad time to make large investments in farming operations. This question produces the Large Farm Investment Index. This measure was also up significantly in July (https://purdue.ag/agbarometer). The change in confidence is largely attributed to rising crop prices and USDA payments being announced.



Taking Stock – Tariff Talk

Factset provides a very valuable data point in determining how often a particular topic is mentioned on a company's earnings calls and quarter over quarter or year over year changes on the data point. As of August 12th, 90% of companies have reported earnings for Q2 (Factset). Factset measured how may companies mentioned the word "tariff" on earnings calls as the August 12th, measuring 438 S&P 500 firms. 124 earnings calls in Q2 mentioned "tariff" versus 88 in Q1, approximately a 40% increase. The chart below compares Q1 and Q2 2019 for each sector. There was an increase in practically every sector. Information technology, health care, and financials showed the most pronounced change from the first quarter to the second. It is also worth noting that S&P 500 companies citing "tariffs" on earnings calls declined for three straight quarters until Q2 2019. Companies and exporters are beginning to feel the current and potential strain of the trade talks with China.

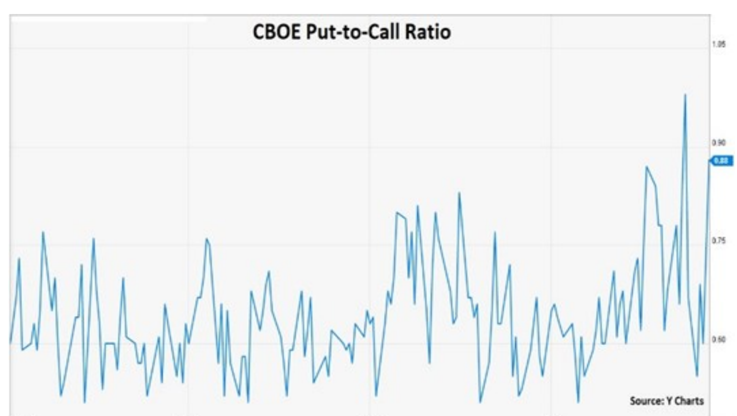


Fixed Income - Taking its Cue

It is normally presumed that the bond market takes its cues for trading from the Federal Reserve but that relationship, like the yield curve, seems to have inverted recently. Analyzing the July FOMC minutes and listening to Chairman Powell in Jackson Hole suggests the Fed is taking their cue from the bond market today. At the prior meeting Fed governors had difficulty expressing why they were cutting rates noting that the downside risks to the economy had diminished since their June meeting. More attention seemed to be given to not disappointing the markets than anything else. Powell stated, "Shifts in the anticipated path of policy. . . help explain why the outlook. . . remains largely favorable." Translation: the bond market is setting Fed policy. Pricing on inflation-protected bonds (TIPS) suggests inflation will average 1.6% for 30-years, an aggressive assumption.

Technical - No One "Call"ing

The Put-to-Call ratio provides a glimpse into the psyche of traders and what they expect the immediate future to hold. Traders buying puts are concerned about a fall in the equity markets while buyers of calls are expressing the belief that stock prices will rise. Because traders are generally bullish about stocks, the long-term average for the ratio is .7, meaning there are more buyers of calls. When the ratio moves above .7 it is a signal that traders are becoming more bearish about the markets. Through the end of July the Put/Call ratio averaged just below .6 for 2019, suggesting broad bullishness about future stock prices. Since August, however, the ratio has risen dramatically, almost touching 1.0, a level it has only touched 3 times in the past 10 years. The current level of .88 suggests there is still plenty of fear among equity traders.



The Mechanics of Negative Yields

Clint Pekrul, CFA

We've discussed negative interest rates in prior reports, but thought it would be appropriate to further the discussion in light of the recent move down in yields. The benchmark 10-year Treasury is trading at a yield-to-maturity of 1.52% (as of August 26th). The markets are watching this closely. The narrative a year ago was that interest rates were beginning to "normalize" as the 10-year yield was trading above 3%, and seemed to be steadily trending higher. But during the last quarter of 2018, amid heightened market volatility, the Federal Reserve reversed course and suggested that lower interest rates were likely, given a slowdown in global economic growth.

Since November of last year, the 10-year Treasury has essentially fallen by half (i.e. 3% to roughly 1.5%), and it appears that we're likely to retest the all-time lows of reached in 2016. The general perception a year ago was that the global economy was in a "synchronized" expansion. But as mentioned before, the narrative has changed rather quickly. If we do indeed enter a recession, which the current inverted yield curve might suggest, then there is a real possibility that nominal yields across the curve could break through the zero bound. Former Fed chairman Alan Greenspan has stated that going forward, there is no barrier to Treasury yields falling below zero. The current coupon on the 10-year Treasury is approximately 1.6%, but due to overall demand, the price is trading above par at roughly 100.88, which pushes the yield-to-maturity down to its current level of 1.52%. So, how would a negative yielding bond work?

A negative yielding bond typically would carry a very low coupon (perhaps close to zero). If the demand for the bond goes up, the price will rise and the yield-to-maturity will go down. For example, assume a bond with a 1% coupon over one year. At maturity you receive $101. If you pay $102 for that bond today, you're guaranteed to lose money if you hold the bond to maturity. Hence, the term "negative yields". Why would any rational investor choose to pay $102 today to receive $101 a year from now?

There are a few theories as to why yields could gap down below zero. First, from a purely speculative point of view, some investors might be wagering that yields will decline well below zero, particularly if we enter a recession. For example, consider a 10-year bond issued at a yield-to-maturity of 0% trading at par. If yields suddenly dropped by 100 basis points (go negative), then the value of that bond would rise to roughly $105. Some investors are perfectly willing to buy a bond issued at 0% yield-to-maturity if they think in the future rates will continue to go lower (obviously, speculators aren't looking for income).

Another reason is that from an investment policy standpoint, many large institutional pools of money are required to allocate a percentage of their portfolios to bonds, such as U.S. Treasuries, regardless of the yield. That is, a portion of their portfolio can't be subject to credit risk, which implies a set allocation to U.S. Treasuries. Changing an investment policy can take time, so these large pools of money can't suddenly reallocate to other assets, such as dividend paying stocks. Furthermore, some investors might see deflation over the intermediate to long term. Again, we don't necessarily see this happening, but some investors are willing to "lose less" today than to risk greater loss down the road. And finally, some portfolio managers use bonds as hedges against equity market risk, and are perfectly willing to allocate to bonds as part of a larger investment strategy.

Despite a likely rebuttal from president Trump, the Federal Reserve would likely step in with measures to mitigate the degree to which yields would fall below zero, such as selling some of its repository of Treasury bonds. This additional supply of bonds would help prop up longer-term rates. However, it's difficult to gauge the eventual demand. Given that the U.S. is essentially the only game in town, investors around the globe would likely snatch up the additional supply provided by the Federal Reserve. Thus, any action by the central bank might have short-term implications, but do little in the long run to avoid negative rates.

Q: When will emerging markets pay off?

It has been a difficult period for emerging market equity and debt investors for the last 5 years. While emerging market stocks are mostly flat for 2019, there has been a lot of volatility. Going all the way back to 2014, emerging markets are down around 15% for the trailing 5-year period. Developed international markets have fared better but are still down 7% over that same period.

Emerging markets continue to have headwinds that caused Goldman Sachs to cut exposure earlier this year. The strength in the US dollar creates a liquidity issue for emerging market companies because their debt is often denominate in dollars, but their sales are in local currencies. When the dollar rises, their debt becomes more difficult to service.

There are also political concerns with many of the emerging market economies like South Africa and Latin America. Changes of political leadership in these countries can result in broad-based rioting that negatively impacts the local economies.

It has historically been safer to invest in emerging markets when the Federal Reserve is easing instead of tightening, so that may help them attract more capital. The valuations are also compelling today for emerging markets. The forward price-to-earnings ratio in emerging economies is below 12 compared to almost 18 in the US. I would prefer country specific exposure like India or Mexico rather than a broad basket.

In the decade leading up to the Great Recession, emerging markets delivered very attractive returns. The MSCI Emerging Markets Index far surpassed the cumulative gain of the S&P 500 Index. If you believe in mean reversion across asset classes, you could argue that right now, emerging markets could be an attractive buy from a valuation standpoint. But there are headwinds. Higher interest rates in the U.S. make it more expensive for emerging markets to finance their debt and gain access to readily available capital. Likewise, a rising U.S. dollar can increase the credit risk of emerging market economies. Throw in the trade war, and it's been a tough road for less developed countries. However, think back to 2017, when the macro narrative was globalized growth and GDP expansion. Emerging markets were up 37% compared to gains of 15% - 20% across developed markets. Plus, the U.S. dollar was falling, which is in stark contrast to what we are seeing today. My point is that macro conditions can change quickly, and you need to maintain exposure to emerging markets in your portfolio.

Q: Who is the biggest threat to Trump's reelection?

The easy answer is Trump himself. If Trump were to lose in his 2020 reelection campaign, Twitter should be hailed by all on the left as the reason they won. Democrats have put themselves in a difficult political quandary this election cycle. According to Gallup polling, about 26% of Americans identify as liberal while 35% claim to be conservatives, about the same figure that claim to be moderates.

It is well established that most elections are about "winning the middle." Candidates also typically are forced to move far right or far left in order to secure their party's nomination during the primary season but then immediately move to the center of the political spectrum to win a general election.

Most astute political strategists know that Democrats need to nominate a moderate to run against Trump. Biden is perceived to be the candidate capable of securing the moderate vote, but he seems to be losing support as some question his "fitness" to run against Trump in the general election.

Elizabeth Warren is the Democrat candidate drawing the largest crowds and is now the seen as the most likely challenger to Biden. Many of her policies, however, are way outside of mainstream America. The quarter of the country that is liberal may think she is fantastic, but I do not believe she could win a national election as the country is today. If the economy continues to grow, I don't think it will matter who the Democrats nominate, it will be four more years of Trump.

Well, now president Trump has an opponent from the Republican party, although I doubt Joe Walsh (no, not the guy from the Eagles) will pose much of a challenge. Based on the current polls from realclearpolitics.com, it looks like a three-way race between Joe Biden, Bernie Sanders and Elizabeth Warren to win the Democratic nomination. The gap between these three candidates and the rest of the field is rather large, so I'm assuming we'll see more people drop out in the next several months. Regardless of your own political views, I think it's going to be tough for any of them to beat Trump, unless we enter a recession. If we do, then I think Joe Biden poses the biggest challenge to Trump. I think at the national level, Biden has the greatest appeal. Senators Warren and Sanders seem too far to the left to garner the necessary electoral votes to win. Plus, I think Trump has deeper pockets. I think Biden can appeal to a wider audience. It wouldn't surprise me though that if he does get the nomination, Biden would choose Elizabeth Warren as his running mate. That ticket would likely appeal to broad base, particularly if we enter a recession. Proposals of universal healthcare and student loan forgiveness would resonate with voters.

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All weights as of September 1, 2019

Income	
Mortgage Backed Bond	42.57%
Investment Grade Credit	15.20%
High Yield Bonds	9.25%
Preferred Stock	22.80%
US Dividend Equities	3.48%
US REITs	6.70%

Balanced Income	
US Dividend Equities	17.02%
International Dividend Equities	18.79%
US REITs	10.28%
High Yield Bonds	27.34%
Long Term Treasuries	26.57%

US Growth	
Low Volatility Factor	16.06%
High Quality Factor	12.86%
Small Cap Factor	10.65%
Value Factor	13.51%
Momentum Factor	12.91%
Long Term Treasuries	34.01%

Global Growth	
Low Volatility Factor	8.53%
High Quality Factor	6.22%
Small Cap Factor	5.11%
Value Factor	6.13%
Momentum Factor	6.41%
Developed Market Equity	19.56%
Emerging Market Equity	13.18%
Long Term Treasuries	34.86%

Weights are approximations only and subject to change.

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