



**In this month's *Insight***

**“One Policy Error Waiting on Another”**

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## One Policy Error Waiting on Another

The market has long been (rightly) accused of testing each new Federal Reserve chair. Jay Powell's first 18 months on the job have been no different. Out of the gate, the Powell Fed effectively continued the course of quantitative tightening and Fed funds rate hikes that had begun under his predecessor, Janet Yellen. But by September of last year, after just seven months on job, Chairman Powell's suggestion that Fed policy was “a long ways from neutral,” in combination with the advertisement of an additional hike in CY'18 (what became the Dec'18 hike), as many as three hikes proposed in CY'19, and the potential for more in CY'20 – not to mentioned the advent of increasingly hostile rhetoric on the trade front from the Administration – proved too much. Investors sold the S&P 500 sharply, taking -20% off the Index from its all-time high in

late-September to a closing low of 2,351 in the abbreviated Christmas Eve session. Chairman Powell, Vice Chairman Richard Clarida, and their contemporaries on the FOMC were quick to pivot. By the first week in January, the Fed effectively put monetary policy on hold for the foreseeable future and began discussing how to curtail their program of balance sheet run-off (now slated to end in Sep'19). In the midst of the 35-day government shutdown and less-than-robust 4Q'18 corporate profit reports – with trade negotiations slipping off the front page – the market had what it needed. Investors bid the market to its strongest four-month start (+17.4%) since CY'87 (19.1%) and in the process made a new all-time closing high (2,945 on April 30th). The Fed certainly knows how to talk themselves out of a jam. But – and most importantly – the bar for the Fed to do more than just talk is higher.



Source: Standard & Poor's

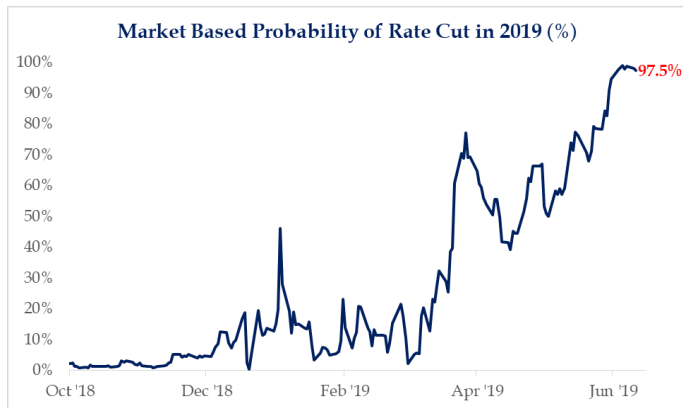
Enter the President. The breakdown in trade negotiations with China (as we discussed in *Insight* last month) and the

Administration's increasingly frequent engagement of tariffs (or the threat of tariffs) to extract both economic and non-economic concessions (e.g. increased border security from Mexico) from international trading partners has served to markedly increase the level of uncertainty among the business and investor communities. While the heft of U.S. trade is a powerful weapon and likely to bow most onto whom it is trained, the negative implications – even if the long-term results of the extracted concession is in the U.S. national interest – appear threefold. Longer-term, we risk irreparable damage in our international relationships. Don't underestimate the lasting implications and latent resentment from bullying sovereign nations to your will. Intermediate-term, economic and market headwinds persist. The Administration appears emboldened by its (apparently successful) run at Mexico over border security. The President intimated during both his press conference with British Prime Minister Theresa May (June 4th) and an impromptu call-in interview with CNBC's Squawk Box (June 10th) that tariffs could be used during other, non-economic, disagreements (i.e. to compel our NATO allies to adhere to the Treaty's provision for defense spending, etc.) Tariffs could pop up anywhere we don't get our way... Tough to operate a business in that environment. More near-term, the prospect of a trade war, particularly one with several theaters of conflict (China, North America, Europe, Japan, etc.) – even with the apparent resolution of the recent border flare-up with Mexico, the USMCA trade agreement has

yet to be ratified by the U.S. Congress – will continue to be a headwind to business sentiment which, in turn, will dull the economic expansion and, ultimately, will negatively impact corporate profits.

The President has suggested this expanded course of tariffs is reasonable because the economy is strong, unemployment is low, and the stock market is up. The reality may be less robust. As our chief economist Don Rissmiller noted over the weekend, the economic outlook is softening. The manufacturing sector is slowing; it's likely only a matter of time until the service economy also comes under downward pressure. U.S. GDP is likely to be weaker after 1Q's inventory build; coupled with the recent slowdown in momentum, it might even come in with a 1%-handle. Employment data has softened. U.S. payroll employment rose just +75,000 M/M in May, with downward revisions of -75,000 to prior months. Average hourly earnings were up +0.2% M/M and slowed to +3.1% Y/Y from a high of 3.4% in February. The workweek was flat, the labor force participation rate was flat, the unemployment rate was flat at a low, and this jobs report likely reflects conditions before the full impact of recent trade uncertainty worked through the economy. From its highs in late-April, the S&P sold off more than -6.5% through the first week of June. Regardless of whether the President is right or current conditions prevail, the balance is delicate; at a certain point the impact of uncertainty will be too difficult to overcome.

With some acknowledgment by the Fed that present conditions warrant attention and an insistence that they remain “flexible,” the equity market has managed to recapture some of the recent sell-off. The bond market, however, has gone a step further and has leveled a 97.5% probability that the Fed will cut rates before year-end. That seems aggressive to us.



Source: Bloomberg

The Fed will likely disappoint investors (and the President, who has been merciless in calling for the FOMC to ease) near-term. The Administration has indicated that the next chance for substantive progress on trade negotiations with China would be at the G20 in Japan at the end of the month. The Fed will want to see what comes from that meeting and to what extent the data have softened further in June and July before taking action. With no meeting planned for August that makes September the first meeting at which the market could reasonably expect a change in policy based on economic data. Further, while rate policy is on hold, the Fed is technically undertaking a course of quantitative tightening by

allowing balance sheet proceeds to run-off, as opposed to re-investing them. This program is scheduled to end in September. Before then, any moves to ease monetary policy (short of further curtailing the run-off program itself) would be in conflict with the program. The bond market, however, now places a 75% probability that the Fed will cut rates at their July meeting! Hold on tight.

As we wrote in Insight last July, “Assessing the Four Horsemen of the Economy,” policymakers are vested with control of four distinct policy levers (Fiscal, Monetary, Regulatory, and Trade). In the 1930s, the U.S. tightened Monetary, Fiscal, and Regulatory policy while engaging in a global Trade war. Is not difficult to see how a recession turned into a 13-year depression. Today, Fiscal and Regulatory policy are easy. Unfortunately, Monetary policy is likely too tight for an extended trade war, but the implications of the Administration’s escalation of tensions with China have yet to be fully addressed in the economy, leaving the market to handicap the impact of one policy error (Trade) while increasing the risk of another (Monetary).

While we have increased our own odds of a downside shock to 30% and reduced our odds of an upside surprise to 15%, as our chief investment strategist Jason Trennert recently wrote, the greatest source of solace we could imagine would be the idea that the rebound in cyclicals is likely to be as violent as the sell-off we’re seeing now – perhaps more so – if trade tensions dissipate. It is not

hard to imagine the trade war ending after the Fed has had to ease twice. In such a scenario, positive developments in global trade could lead to an almost instantaneous steepening of the yield curve and a rally in risk. The Fed will eventually help but it seems unlikely until headline economic data get bad enough to give them cover to be “preemptive.” Stay tuned.

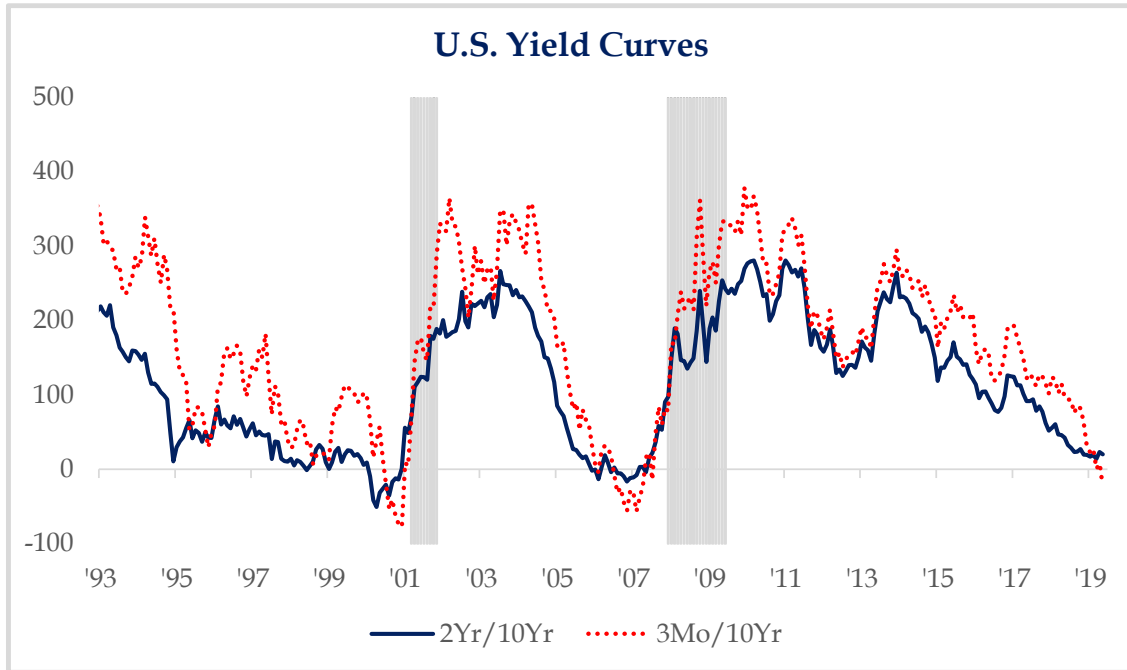
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## Recommended Asset Allocation

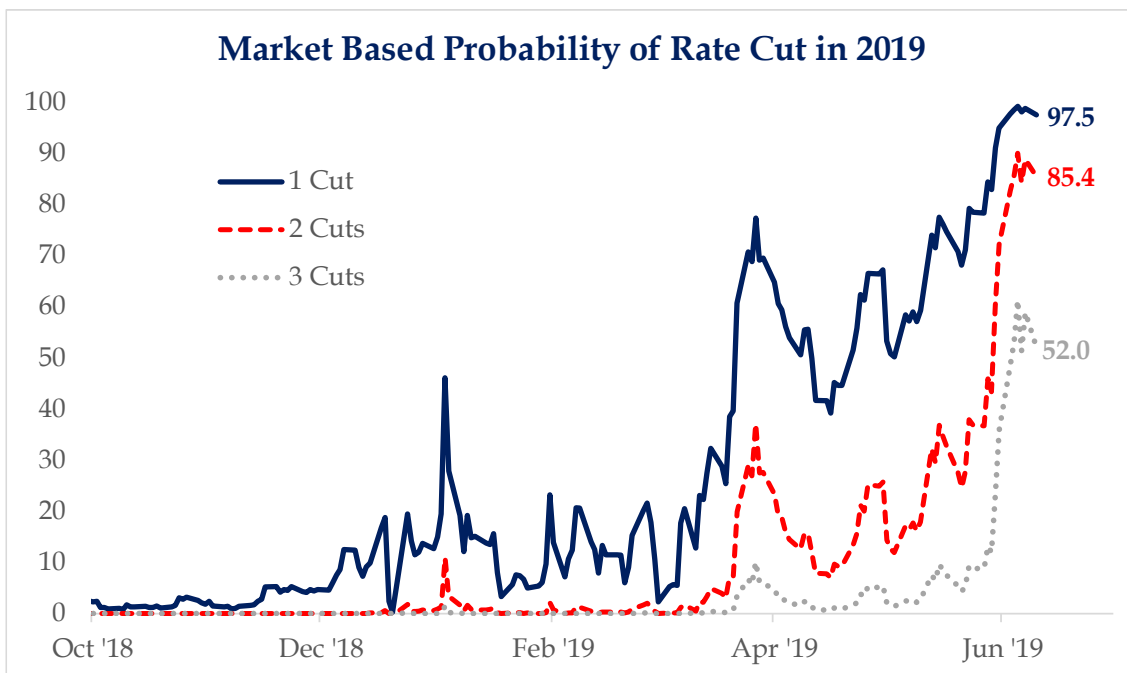
Strategas Recommended Asset Allocation (May'19)						
Equities				Bonds		Cash
		<b>69%</b>			<b>25%</b>	<b>6%</b>
B'mark	MSCI ACWI	60%		Barclays Agg	38%	Cash 2%
			M/M CHG		M/M CHG	M/M CHG
	Domestic	37%	+200bps	Core Credit	21%	Cash 6%
	International	32%	-300bps	Extended Credit*	4%	+100bps
<b>Overweight</b>	Dev AC Core	23%	-200bps	Local Currency EMD*	2%	Cash 6%
	US LC Value	11%		US Dollar EMD*	1%	+100bps
	EM AC Core	9%	-100bps	US High Yield*	1%	
	US MC Value	5%				
	US MC Growth	3%	+100bps			
<b>Neutral</b>	US MC Core	2%		Agencies	1%	
	US SC Core	1%		TIPS	0%	
	US LC Growth	9%	+100bps	IG Corporates	9%	
<b>Underweight</b>	US LC Core	6%		US MBS	8%	
				U.S. Treasuries	3%	
				ABS/CMBS	0%	

## The 3Mo/10Yr Yield Curve Is Decidedly Negative While The More Widely Watched 2Yr/10Yr Remain Slightly Positive



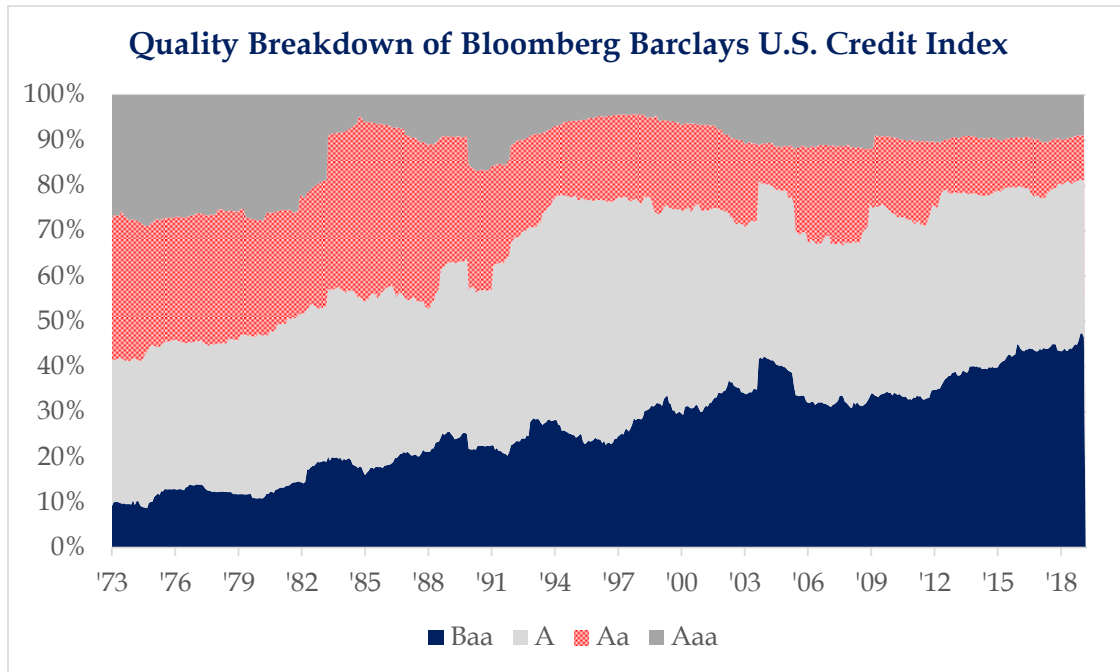
Source: Bloomberg

## The Market Expects At Least Two Cuts By The Fed This Year



Source: Bloomberg

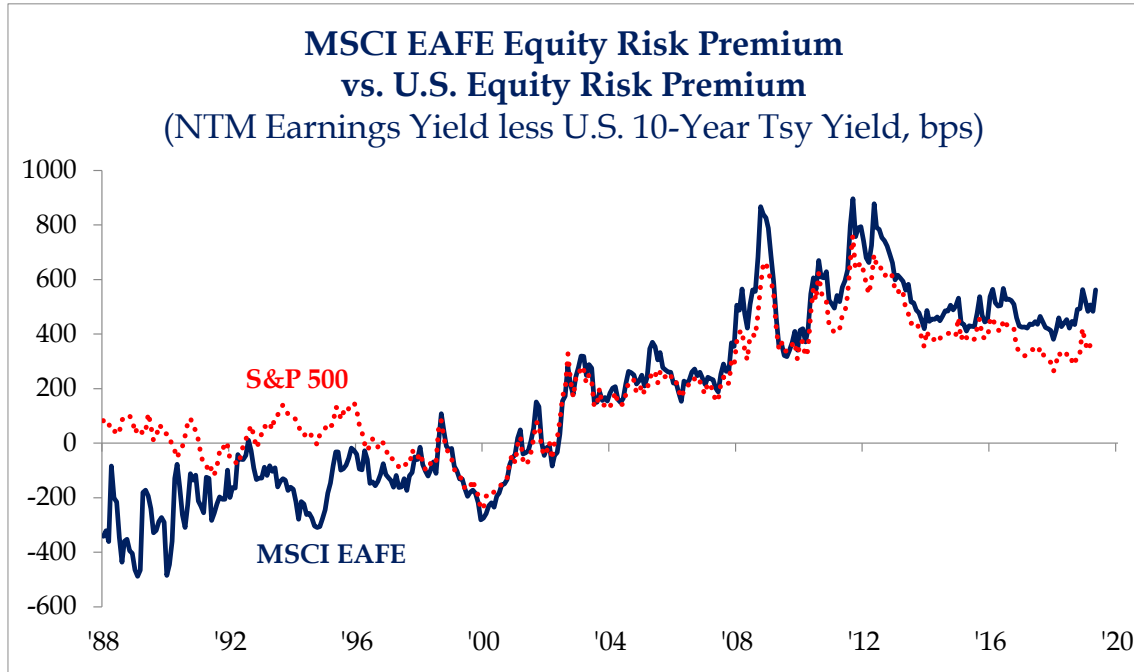
## The Dramatic Increase In Lower Quality Credits Is Garnering More Attention



## Dollar Strength Appears To Have Stalled Out Here



# Equities Remain More Attractive Than Bonds Both Domestically and Abroad



Source: FactSet

# While HY Spreads Have Jumped Recently The Widening Is Not Yet Concerning



Source: Bloomberg, Barclays



## APPENDIX – IMPORTANT DISCLOSURES

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