May 31, 2019

The Big Picture and Key Takeaway - *Global Trade, from Resolution to Escalation*

Top Trading Partners – Year-To-Date Totals – March 2019 – U.S. Census Bureau

Rank	Country	Exports ($ billions)	Imports ($billions)	Total Trade ($billions)	Percent of Total Trade
1	Mexico	64.0	86.6	150.6	15.0%
2	Canada	72.3	74.3	146.6	14.6%
3	China	26.0	106.0	132.0	13.1%

The month of May was dominated by trade actions and tariff threats, and the stock market didn't like it. Bonds on the other hand, did quite well as investors sought safe haven investments amidst the geopolitical uncertainty. Many global fronts are being pursued on trade right now, but let's start with China.

After months of hope and market optimism that a new trade agreement with China was getting closer, discussions fell apart in early May. As a result, the U.S. raised tariffs on $200 billion of Chinese goods from 10% to 25% and threatened to levy additional tariffs. China retaliated to those tariffs with their own and contemplated using other tools against the US, like restricting access to rare earth minerals used as components for many technological and consumer goods. In a further escalation, the US deemed the Chinese Telecom company, Huawei, a national security risk. The company is now effectively prevented from buying or licensing American technology without U.S. permission. China has now threatened to create a blacklist of American companies in response.

Why does this matter? About $730 billion of goods and service flow between the U.S. and China annually. China needs America's export markets, and U.S. companies depend on China for making goods that keep them profitable. While there are clearly issues that need to be addressed, the escalation risks becoming more expensive for companies and consumers.

But China was not the only trade surprise to arrive in May. As the month ended, in an unexpected turn of events, President Trump threatened to levy a 5% escalating tariff on Mexico that would go into effect on June 10^{th}. The justification for the tariff was that Mexico needed to reduce the flow of illegal immigrants into the U.S. or else face economic penalty. While the reasoning for the tariff threat has raised some legal eyebrows, the timing is what is most surprising. The threat was made on the *day* that the new NAFTA, the United States-Mexico-Canada Agreement (USMCA), was sent to Congress for debate and potential approval. The Mexico trade conflict was supposed to be over, so the new tariff threat seems to have caught everyone off-guard, and has now thrown the fate of the USMCA into some disarray.

So, why does this matter? Because as a result of the Chinese tariffs, Mexico is now the largest total trading partner of the United States (see table above). If you combine Mexico and Canada, the US trade relationship with its North American neighbors dwarfs that of China. Beyond the direct U.S. impact, companies in Japan and many countries in Europe have established supply chains in Mexico that would be deeply impacted by any economically-induced disruptions.

While interest rate policy and decent domestic economic data seemed to drive markets higher to start the year, it did so under the assumption of trade conflict *resolution*. The events of May have dented that assumption as trade resolution has morphed into *escalation*.

May & YTD Market Performance

Market Returns		Returns (%)	
Index	Description	May	YTD 2019
S&P 500 TR USD	US - Large Company	-6.35	10.74
Russell 2000 TR USD	US - Small Company	-7.78	9.26
MSCI ACWI Ex USA NR USD	All International, excluding US	-5.37	7.15
MSCI EAFE NR USD	International, excluding Emerging Markets	-4.80	7.64
MSCI Emerging Markets NR USD	Emerging Market Stocks	-7.26	4.09
Bloomberg Barclays US Agg Bond TR USD	High Quality US Bonds	1.78	4.80
ICE BofAML US High Yield TR	Lower Quality US Bonds	-1.27	7.52
XAU Gold Spot $/OZ	Gold	2.75	1.80
*Through May 31, 2019 Source: Morningstar, MSCI, Bloomberg			

Global Stocks

After a stellar first 4-months of 2019, the S&P 500 took a step back in May, losing -6.35% as trade concerns caused stock investors to reassess the economic backdrop. The negative performance was broad-based and spread across sectors. More defensive sectors, such as real estate, utilities, communications services and healthcare fared best in relative terms. Energy stocks suffered most as crude oil prices tumbled by approximately 13% as global economic slowdown fears escalated. Tech stocks also suffered given concerns about the impact of China trade talks on the sector. International Stocks also retreated as the MSCI EAFE Index (Developed Markets) and the MSCI Emerging Markets Index, lost -4.80% and -7.26%, respectively in May. International stocks performed slightly better than the U.S. on a relative basis in May as the MSCI All-Country World Index excluding the U.S. outpaced the S&P 500 by a shade under 1%. The U.S. dollar, which has gained in value versus a basket of global currencies this year, retreated slightly in May.

Bonds

Global bond yields tumbled, leading to bond price increases in May, as fears of an economic slowdown pushed investors into safe-haven investments. The yield on the benchmark 10-year U.S. Treasury note dropped by 0.42% in May to a near-term low of 2.12%. Inflation expectations over the next 10-years have dropped to a modest 1.74%, as defined the difference between 10-year Treasury and TIPS (Inflation-Protected Securities) yields. The level is below the 2% inflation target of the Federal Reserve, so expectations for a Fed Rate cut in 2019 continue to rise. The yield curve also inverted by the most since the financial crisis, as measured by the difference between 3-month bills and 10-year yields. An inversion has historically been a reliable predictor of economic recession on the horizon. As a result, the Barclays Aggregate US Bond Index delivered a healthy 1.78% for the month and is up 4.8% year-to-date. Lower credit quality bonds, often referred to as “High Yield”, retreated in May as credit spreads increased on along with economic fears.

The Key Takeaway

The post-World War II global economic order has been one of ever-increasing global economic integration, with the U.S. being the financial and security focal point that holds it all together. If the trade wars are more apparent symptoms of a less cooperative and integrated global economy, the tentacles of economic uncertainty have the potential to have a profound impact. If the rules of the game change and global supply chains need to re-orient themselves, it can hurt economic growth and corporate profitability. Markets hate uncertainty. How the trade conflicts resolve, or don’t, will likely play an increasingly important role in determining market sentiment & economic stability in the months to come.

If you have any questions regarding this report, please contact us at info@today2b.com or 914.302.3233

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Index and Category Definitions
The S&P 500 Index *is a capitalization-weighted index of 500 U.S. stocks.* ***Russell 2000 TR USD*** *is a market cap weighted index* The Russell 2000 measuring the performance of approximately 2,000 smallest-cap American companies ***The MSCI All Country World ex-USA Index*** *is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI All Country World ex-USA Index consists of 22 developed and 24 emerging market country indices.* ***The MSCI EAFE Index (Europe, Australasia, Far East)*** *is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada.* ***The MSCI Emerging Markets (EM) Index*** *is a free float-adjusted market capitalization index that is designed to measure equity market performance of 24 emerging markets countries.* ***Bloomberg Barclays U.S. Aggregate Bond Index*** *is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.* ***ICE BofAML U.S. High Yield Index*** *is an unmanaged index of below-investment grade U.S. corporate bonds.* ***XZU Gold Spot $/Oz*** *reflects the exchange rate of* ***Gold*** *against the US dollar* ***index***

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