

Demystifying and Demilitarizing Trade

In a recent speech concerning risks to the US economy, noted economist Robert Shiller discussed the term “trade war” and how its meaning has evolved over time. During the First World War, Shiller reflected, it had more literal connotations; attacking merchant ships to try to disrupt another country’s access to trade goods. Thankfully, today’s context is much more benign, and when the press refers to a trade war between the US and China, the weapons of choice are tariffs, not torpedoes. That distinction has not made the events of this conflict any less dramatic, of course. Given the importance of this subject to investors, we have made trade war a recurring topic in recent commentaries. We thought our quarterly letter was an excellent opportunity to add context and clarity by delving more deeply into global trade and its connection to the US economy and capital markets.

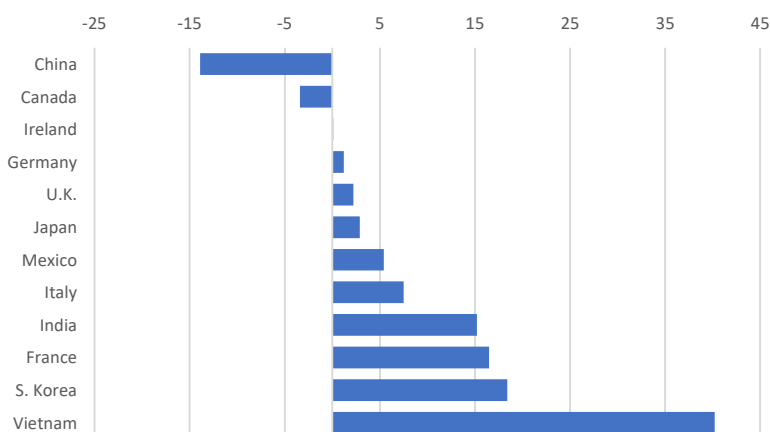
Trade deficits are at the heart of this conflict. Classical economics holds that trade deficits occur when a nation’s public and private spending exceeds public and private savings, rather than from unfair trade terms. In plain English, if a nation “spends” more than it “makes,” then a country has to import more than it exports. This tells us two things; that tariffs are not likely to close a trade deficit, and that unilateral tariffs are a game of whack-a-mole. If tariffs make imports from one country more expensive, purchases are shifted to countries not subject to those levels of tariffs. This is essentially what we’ve observed since the start of the current trade war. The US trade deficit is little changed, and while trade with China has slowed, it has been largely redirected elsewhere, notably Vietnam, Argentina, Chile, and Malaysia. China, meanwhile, has made up for much of their lost US trade by expanding trade with partners such as Canada, the UK, Argentina and Brazil. Arguably the biggest direct impact has been altering long-standing trade patterns, giving us skittish markets and disrupted supply chains.

Tariffs also tend to boost inflation. This is primarily driven by how sensitive consumer demand is to changes in price; the less sensitive, the more of the tariff will be passed on to domestic consumers. Yet surprisingly, inflation has remained muted. This appears to be due to both participants’ negotiating strategies; the Trump Administration made a conscious effort to minimize consumer impact over the first few rounds of Chinese tariffs, while the Chinese have focused their retaliation on goods and sectors to maximize immediate US economic effect. For US consumers, if the deflationary effect of lower Chinese demand for US goods is bigger than the inflationary effect of tariffs being passed along on Chinese imports, then the total impact would indeed be muted inflation. We argue this has been the case – so far. However, the initial round of tariffs that are likely to introduce greater acute consumer impact are just now coming into effect.

Economic forces will only partially influence how the trade war evolves and markets ultimately react. What economic theory tells us, however, is that tariffs alone won’t solve this trade war. They will likely have greater impact on economic growth than trade deficits. The US and China have weathered the slowdown reasonably well to date, and we’ve been pleasantly surprised by the resilience of US consumer spending. Nonetheless, as investors, we’d like to see healthier growth with fewer economic and market headwinds. This would likely contribute to a modest but productive steepening of the yield curve, while bolstering consumer and business confidence. As US and Chinese representatives prepare to once again meet, we are hoping for greater stability in the form of a trade truce whereby both sides refrain from additional tariffs.

Arguably, though, the root of the issue here is how accustomed we’ve grown to discussing trade in military terms. Thinking about it in this way encourages thinking of trade as an adversarial process where every winner requires a loser. This framing doesn’t really work; however convenient the metaphor, tariffs are not torpedoes that can be aimed at one participant while sparing all others. If imposing trade barriers causes mutual harm, reducing them should provide mutual benefit, both to consumers and investors. These benefits are something we’ve perhaps come to take for granted. Trade barriers have progressively fallen since the Second World War, as the global economy has become increasingly interconnected. While there are still trade abuses, we feel needlessly reversing this trend will be harmful for the global economy and markets. And in the meantime, maybe it’s time we drop the trade war metaphor in favor of something a little more cooperative.

Year over Year Change (%) in American Imports
During First Quarter



Source: Bloomberg, U.S. Census Bureau

MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Strong technicals drove positive Q3 municipal performance. Yields moved lower over the summer, influenced by expectations for 3 Fed rate cuts in 2019. Although September saw yields bounce up, they ended Q3 lower by 20 bps for 20+ years, while 2-10 AAA yields fell 3-21 bps.
- Curve flattening continued as 2-10 year spreads dropped 18 bps despite 1-7 year yield spreads rising 1 bp.
- Municipals underperformed as UST yields ground lower in September. The 10-year AAA muni/UST ratio rose to 84% after a late July low of 74%. We anticipate ratios in a 78-84% range for the foreseeable future. With ratios now at the upper end, municipals could outperform in Q4.
- Given extreme front-end curve flatness, Variable Rate Demand Notes (VRDNs) warrant consideration. Tax-exempt VRDNs can be an effective vehicle for very short-term, high quality assets, particularly in accounts able to tactically allocate between VRDNs and short municipals. SIFMA, the proxy for VRDN yields, ended Q3 at 1.49%.
- Retail continues to drive demand, with YTD tax-exempt fund inflows of \$69B. Long-term funds have accounted for about \$43B.
- After lagging through mid-year, Q3 issuance surged 18% vs. 2018. The market will now likely meet 2019 expectations in the \$360-370B range. Taxable debt issuance, led by refundings, has increased 45% YTD, with a good portion soaked up by non-US buyers.
- Nonetheless, the overall municipal market continues to shrink. JP Morgan projects \$81B of 2019 net negative issuance, and through mid-year the overall market has declined 1.5% to \$3.81T. Bank and P&C holdings are down 8% and 9% YOY respectively.
- We have lowered our 10Yr UST trading range to 1.40–1.90% and see more risk on the downside. Treasuries are trading wide relative to comparable sovereigns. We expect municipal curve re-steepening and at least one more Fed rate cut in Q4. This coupled with a strong bid, leaves us maintaining intermediate duration of 4.60-4.70 years.

Investment Grade Corporates & Treasuries

- Alternating between risk-on (July, Sept.) and risk-off (August) sentiment, the Bloomberg Barclays US Credit Index ended Q3 flat on a spread basis. Quarterly total return of +2.98% raised YTD to a robust +12.61%.
- Falling UST rates are driving IG performance as excess returns have recently been minimal. Riskier credits widened 54 bps during Q3 as measured by the Bloomberg Barclays Global High Yield Index, due largely to August turbulence.
- IG Credit issuance in 2019 is lagging 2018 by just under 4%. However, tighter spreads and low rates led to a surge in September (3rd highest month ever) and \$322.5B overall in Q3. Investor appetite has remained strong with new IG deals well received. Concessions have been average, and spreads are holding steady.

Equities

- Despite growing concerns, the S&P 500 gained 1.7% in Q3, bringing YTD total return to 20.6%. The S&P 500 hasn't returned over 20% over the first three quarters of the year since 1997.
- Value and cyclical at least temporarily benefited from a late quarter rotation out of growth, momentum, and quality. We will be monitoring the sustainability of this shift and any broader ramifications.
- An inversion of the UST yield curve also jolted markets during Q3. A 2-10 year inversion has preceded each of the last seven recessions, although the timing of this potential signal is highly uncertain. For now, we're comforted by ample market liquidity and stable credit spreads.
- Although S&P 500 Q3 earnings growth expectations of -3.7% offer evidence of economic slowdown, we are more attuned to 2020 forecasts. At present, consensus is for corporate earnings to rebound at a healthy +10.3% rate.
- Looking forward, investors are grappling with global economic worries, trade policy uncertainty, and mounting geopolitical turbulence. Tailwinds for risk assets remain accommodative monetary policy, low inflation, low interest rates, a resilient US consumer, and cautious investor sentiment.



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