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# Geopolitical risks abound

But we reject the pervading pessimistic view about the U.S. economy.

Published 05-31-2019

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**BOTTOM LINE**

Amid a growing chorus of trade-related economic concerns, benchmark 10-year Treasury yields plummeted to a nearly 2-year low of 2.15% today, moderately inverting the yield curve (the upper band of the fed funds rate is at 2.50%). At the same time, stocks have continued their swoon, with the S&P 500 down nearly 7% since its May Day record high. That marks its weakest month since December 2018's 9% plunge and its first negative May since 2012's 6.3% decline. So we're now more than halfway through the temporary 5-10% correction we had envisioned, with our next downside technical target at 2,650.

But this current 35-basis-point inversion is sparking recessionary concerns, and many investors now believe that the Federal Reserve's next monetary policy move will be to cut interest rates at least once before year-end and perhaps several times over the next 18 months. We continue to reject this pessimistic view.

Why are we so constructive? In our view, U.S. economic fundamentals remain solid, the recent decline in inflation appears to be transitory and bond-market pressure from Germany and Japan are contributing to low U.S. yields. And we believe the Fed wants to keep some dry powder in reserve for when it needs to fight the next recession, which we do not think will hit until 2021.

We are not unsympathetic, however, to the concern over widening geopolitical risks associated with the ongoing trade war with China and President Trump's threat to increase tariffs on Mexico if it doesn't stem the tide of illegal immigration into the U.S.

As result, in light of this growing uncertainty and expanded downside risk, we opted to pull in our horns a bit today and lowered our 8% equity overweight in our PRISM® asset allocation moderate-growth portfolio to 5%. We took a tick out of emerging markets, lowering that asset class to a neutral weight at 4%. We also lowered domestic large-cap value by 2%, which leaves that category at a 1% overweight at a 16% allocation. We added the 3% into our cash overweight, which is now 4% over neutral at a 6% allocation.

**Foreign bonds pressure U.S. yields** German bunds are now yielding a record negative 20 basis points, and Japanese government bond yields are sitting at negative 10 basis points. These reflect recession concerns in both countries, as each posted negative GDP growth figures in the third quarter of 2018. We believe these negative foreign yields have exerted considerable downward pressure on Treasury yields, which are now artificially low as global investors have bid up prices here due to strong demand.

**U.S. economic fundamentals solid** The labor market is strong, consumer spending this spring has rebounded nicely from its December/February funk and key consumer confidence metrics have begun to reaccelerate from winter troughs. To be sure, manufacturing has clearly weakened over the past several months, so the powerful build-up in inventories we've seen over the past three quarters may soon recede. But on balance, we do not believe the domestic economy is on the verge of recession.

**Inflation starting to firm** With April readings of core PCE at 1.6%, core PPI at 2.2% and core CPI at 2.1%, inflationary pressures appear to be relatively benign at present, which should give the Fed more flexibility over the next two years to be patient with regard to future rate hikes. Importantly, the recent decline in inflation over the last several months appears to have bottomed, with the recent up-ticks in April, so it's unlikely the

Fed will need to cut rates now to help stimulate greater economic growth and spark rising inflation.

- Core PCE (the Fed's preferred measure of inflation) hit a 6-year high at 2% year-over-year (y/y) growth in July 2018. But it fell to 1.5% in March 2019 (rapidly approaching its August 2017 trough of 1.4%), before bouncing back up to 1.6% in April. Still, core inflation is well below the Fed's oft-stated 2% target.
- Core PPI wholesale inflation (which strips out food, energy and trade) peaked at an upwardly revised cycle high of 3.1% y/y growth in September 2018. But it fell to 2% in March 2019 and bounced to 2.2% in April.
- Core CPI retail inflation (which strips out just food and energy prices) peaked at a 2.4% y/y gain in July 2018 (which matches its highest reading in four years). But core CPI fell to 2% in March 2019 before rising to 2.1% in April.

**Commodities volatile** The three most important domestic agricultural commodities (corn, wheat and soy beans) have seen their prices here in the U.S. plunge more than 25% over the past year, likely due to trade and tariff pressures from China, which has reduced food inflation in the pipeline. But prices have gone vertical by 25% or so in just the past three weeks due to weather-related problems with the planting season. Flooded fields will likely result in poor crop yields. West Texas Intermediate crude oil (WTI) had rallied 57% from December through April, to a recent peak of $67 per barrel, due to tighter supply/demand balance. But WTI has plunged 20% over the past month to $53 today due to fears of slower global demand related to the ongoing trade and tariff wars.

**Fed keeps its powder dry for now** Federal Reserve Vice Chair Richard Clarida spoke to investors in New York yesterday, saying that the U.S. economy is in a "good place," and that the central bank would "allow the data to flow in and inform our future decisions." We continue to believe that the Fed is not inclined to either hike or cut interest rates for the foreseeable future, unless economic growth decelerates toward recession. But Clarida acknowledged that the Fed's monetary policy could become more accommodative if global developments began to impact domestic growth or inflation. As a result, investors will remain hyper vigilant on the escalating trade and tariff war with China, the potential for a trade conflict with Mexico, rising Brexit uncertainties, recession risks in Japan and Germany, and continued oil market volatility, relating to developments in Iran and Venezuela.

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**DISCLOSURES**

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Consumer Price Index (CPI): A measure of inflation at the retail level.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

Producer Price Index (PPI): A measure of inflation at the wholesale level.

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