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Which way will it break?

Is this soft patch and sell-off an omen of things to come or a pause that refreshes? For now, the evidence suggests the latter.

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I returned to my favorite state this week, my annual visit to Honolulu. Each year I get the best table on the hotel's veranda, the one benefit of being on Eastern Time. Lingering over my Kona coffee (m 'mm m 'mm m 'mm!), I watch the surfers catching the waves with ease. As the wave moves into shallower water, the bottom of the wave decreases speed. There comes a point where the top of the wave overtakes it and starts to spill forward—the wave starts to break. They're surfing! For a beginner, all waves are the same: the bigger, the better. Advanced surfers know how a wave will be breaking. From my perch it is much fun to pick the beginners from the masters. The advisor meetings began Tuesday morning after Monday's big down day, the worst of the year for stocks. Then, after a 1-day respite, volatility ensued on Wednesday. The Dow closed off 0.1%, or 22 points, but was down 589 points at one point. Panic down days such as Monday, when 91% of the market fell, tend to appear in a series. Further out, they tend to represent opportunities. The last 24 times the S&P 500 fell 3% or more in a day, equities were higher three and six months later 87% and 96% of the time, respectively. If the market truly had been exhibiting risk-on/risk-off behavior, correlations should have been negative between stocks and bonds. Instead, they were closer to zero, as has been the case over the past 12 months and, except for emerging markets, the past five years. As long as a slowing global economy avoids recession, lower yields typically support risk assets. As of Monday's close, stocks, bonds, gold and REITS were all up roughly 14% year-to-date. So, which way do you think it will break?

Most meetings this week started with "Any tweets?" And then lots and lots and lots of presidential election debate. "Michelle (Obama) ought to run." "Biden needs a woman VP ... *Gabbard* (the military veteran serving Hawaii's 2nd U.S. congressional district)!" There was much discussion about the trade war. Language accompanying yuan weakening indicates China's leaders are weaponizing the currency and moving toward other potential non-tariff barriers, such as restricting FedEx activity and limiting big tech's access to critical rare earth materials. But the retaliatory actions aren't necessarily good for China's slowing economy. Its banking system already was under pressure, and this week's devaluation could make it worse. As Third Seven puts it, China may have the political capital to do whatever it pleases but money doesn't just talk, it walks. When China devalued its currency in 2015, it saw massive capital flight. Ironically, the yuan devaluation works to offset much of the negative inflationary impact of tariffs on U.S. consumers and businesses, which is one reason tariffs to date aren't showing up in any meaningful way in U.S. inflation and spending (*more below*). The reality is the trade war really isn't about tariffs. It's about two countries battling over who will dominate artificial intelligence and the digital age. Politically for Trump, it's also all about playing to, and keeping, his agricultural/rural base.

Most meetings also turned to the Fed and the yield curve. Futures markets now predict an 80% chance of a 50 basis-point cut by October, and a growing number of Wall Street firms are suggesting the U.S. eventually will have negative government bond yields (I'm getting too old for this!). Globally, negative-yielding debt now tops a record $15 trillion, with eurozone countries leading the way. "Where can I get income for my clients?" "Should I buy gold?" Short of recession, lower yields offer benefits. They reduce corporate borrowing costs, facilitate mergers, acquisitions and home purchases, boost wealth and make stocks relatively more attractive. While forward guidance has been somewhat pessimistic—Q3 earnings-per-share growth estimates are now running at -1.8%, feeding worries companies are pulling back—corporations' actions suggest they're doing fine. They continue to raise dividends, add employees and make capital expenditures (core capital spending orders are near recovery highs). On the macro front, initial jobless claims are at a 50-year low, money supply is growing at more than a 10% pace, unemployment is near historic lows and consumer spending is robust. It "boggles" SIS Research's mind how "group thinkers" are in a near panic about the economy given that the S&P has never been at an all-time high just prior to a recession. With the yield curve inverting and fiscal stimulus expanding, these two equally impressive and historically accurate recession indicators are sending *entirely contradictory signals*. This has "never" happened in at least the past 55 years, Leuthold Group says. Stocks ... bonds ... gold ... REITS .... Which way will it break?

POSITIVES

- **The labor market is tight** June job openings slowed but remained near record highs, while the quit rate—a sign of worker confidence measuring employees willingly leaving—rose to an 18-year high. Weekly initial jobless claims tumbled to their 7th-lowest level out of 2,590 reports *over the past 50 years!* This is significant because claims always are the first indicator to go awry when the economy is about to falter.
- **The consumer is spending** Chain store sales jumped last week and, on a year-over-year (y/y) basis, are running at their fastest pace since April, according to the International Council of Shopping Centers weekly survey. Redbook's survey showed sales also rebounded strongly in July, with y/y sales up nearly 4.8%. The increases bode well for Q3 economic growth.
- **This should provide room for another Fed cut** This morning's read on July producer prices showed the core rate falling for the first time since 2015, lowering the y/y rate to 1.7%. Notably, personal consumption prices that the Fed closely follows barely budged—up 0.1% month over month.

NEGATIVES

- **Summer slowdown** The ISM gauge of service activity fell for the fourth time in five months in July to a 3-year low, following in the footsteps of weaker manufacturing activity. Ned Davis Research estimates the combined ISM reads on manufacturing and services correspond to 1.7% real annual GDP growth. Markit's separate services survey was more optimistic, rising to a 3-month high.

- **Summer slowdown** The OECD U.S. composite leading indicator fell in June for the 14th straight month to its lowest level since December 2009, adding to signs of weakening growth momentum. Wholesale inventories were flat in June and the inventories-to-sales ratio remains at a 3-year high partly because of the escalating trade war. The Atlanta Fed says real GDP growth for Q3 is tracking at 1.9%, down from Q2's estimated 2.1% rate.
- **Global summer slowdown** The global manufacturing PMI fell in July for the 15th consecutive month, with 75% of the world's manufacturing now in contraction territory. In Germany, manufacturing activity crumbled and is now down more than 5% y/y, raising fears of a possible recession. U.K.'s economy contracted in the second quarter for the first time since 2012.

WHAT ELSE

Election watch Except for Joe Biden, Democratic candidates with the best chance of winning the Democratic nomination often suggest corporate profits are tantamount to exploitation. Most likely that framework is going to govern the thinking, and policy agenda, of the nominee. Cornerstone Macro says investors ignore this at their peril as, post second-debate, the odds are 50-60% that the nominee will be Warren, Harris or Sanders.

Hong Kong watch There is mounting evidence that weeks of protests in Hong Kong will continue if not accelerate. Hawaiian advisors are watching these events closely. One suggested that if troops are sent in to silence the protestors "big money will leave Hong Kong." He related that Asian investors have been increasingly buying multimillion-dollar condos in Honolulu in recent months.

Hawaii's hero As in prior visits, lifelong residents complained Hawaii′s middle class is suffering, with an Army veteran advisor lamenting the loss of U.S. Sen. Daniel Inouye, who died in 2012. A Democrat, Inouye was known as a "dealmaker" who got things done for his state. President pro tempore in 2010 until his death, he was third in the presidential line of succession, making him the highest-ranking Asian-American politician in U.S. history. He also was the first Japanese American to serve in both the U.S. House and Senate. He fought in World War II, losing part of his arm, and was a posthumous recipient of the Presidential Medal of Freedom.

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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.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Correlation expresses the strength of relationship between distribution of returns of one data series and its benchmark. The coefficient correlation is always between +1 (perfect positive correlation) and -1 (perfect negative correlation).

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The Global PMI is compiled by Markit Economics and is derived from surveys covering more than 11,000 purchasing executives in 26 countries.

The OECD composite leading indicator is designed to provide early signals of turning points between expansions and slowdowns of economic activity in member countries.

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