Risk Revival

January 2020

Coronavirus, U.S. GDP, Yield Curve Inversion

Risk assets were off to a strong start in 2020, but that abruptly reversed in the last week of January as unknowns surrounding the coronavirus outbreak widened. Economic data revealed the pace of economic growth accelerated in the fourth quarter, but underlying demand weakened. The Fed held its first open market committee meeting of 2020 and stated it stands ready to change policy if necessary.

Key Observations

- Rapid outbreak of the coronavirus stoked concerns about social and economic implications.
- Fourth quarter GDP ticked up on *lower* demand. *Can trends in consumer spending persist if corporations cut spending on headcount and discretionary items in 2020?*
- Business activity improved for the third straight month, led by service sector expansion, but profit trends do not bode well for labor market conditions.
- The Treasury yield curve inverted in January, signaling economic conditions warrant more dovish monetary policy.

Market Recap

The S&P 500 Index recorded a new all-time high during January until fears the coronavirus may derail a soft rebound in global business activity tempered investor optimism. The index gave back its gains and ended the month unchanged, but outpaced the MSCI EAFE and MSCI Emerging Market indices by 2.1 and 4.7 percent, respectively. The U.S. dollar index (DXY Index) rose 0.9 percent in January and contributed to weakness in foreign asset returns.

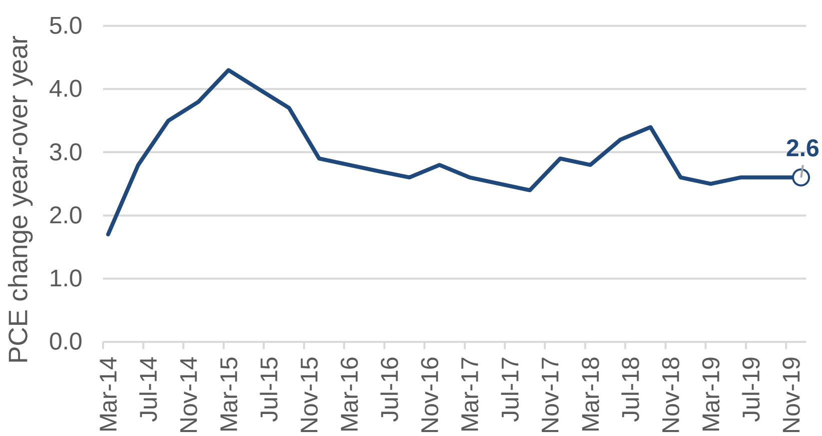
Global bond indices benefited from falling nominal yields (the 10-year U.S. Treasury fell 36 basis points), and credit spreads widened as greater economic uncertainty weighed on investor sentiment. The Bloomberg Barclays Aggregate Bond Index returned 1.9 percent.

Real asset returns were mixed. Lower interest rates benefitted U.S. REITs, which returned 1.2 percent in January, but negative sentiment weighed on all things energy-related. West Texas Intermediate (WTI) oil prices slid 15.6 percent in January, pulling the Alerian MLP Index down 5.6 percent.

Market Outlook

Fourth-quarter GDP was 2.1 percent and beat expectations by 0.1 percent, but details in the release support our cautious view on household financial conditions. Consumption and business investment contributed just 0.12 percent to the total 2.1 percent growth rate; while a decline in imports accounted for 1.57 percent of that growth rate, (recall GDP growth includes exports less imports, so a fall in imports boosts domestic GDP). In short, household and business demand fell sequentially in the fourth quarter compared to the third quarter. On a positive note, personal consumption expenditures continued to grow at a slow but steady pace through January.

Real Personal Consumption Expenditures



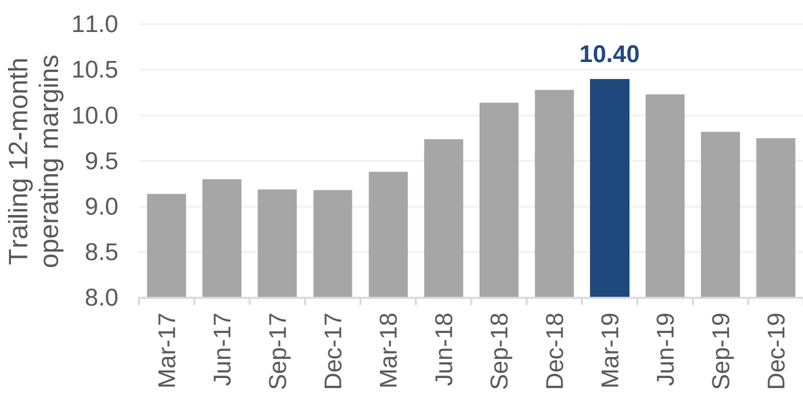
Source: U.S. Bureau of Economic Analysis

Will the deteriorating labor market outlook be a headwind for household consumption? Preliminary Purchasing Manufacturing Index (PMI) estimates for January showed the U.S. service sector expanded at the fastest pace since March 2019 while the manufacturing sector growth rate continued to slow.

In our view, business conditions are a key metric to observe because corporate profits peaked in the first quarter of 2019 and factor into our outlook for household financial conditions.

Falling profits, amid a backdrop of slowing household consumption, underpins our view that labor market conditions (trends in job growth, wages and average hours worked) may have peaked. Deloitte's latest CFO Signal Survey[1] corroborates this view. The survey indicates that corporate leaders expect to cut discretionary spending and headcount in 2020 to alleviate potential headwinds from slowing consumer and business spending.

S&P 500 Index operating margins peaked in the first quarter of 2019



Source: Bloomberg

According to Deloitte's survey, CFOs expect to cut discretionary and headcount spending in 2020. In response to the slow but positive growth outlook, Fed officials left the policy rate unchanged last month and reiterated intentions to drawdown its repo operations. In our ***In Focus: Fed Stays Course,*** we stated that the yield curve recently inverted again and sent policymakers a message that financial conditions were too tight. The federal funds futures market seemed to agree. As of January 31, the market priced in one 25 basis point rate cut and more than a 50 percent chance for a second rate cut in 2020. Time will tell.

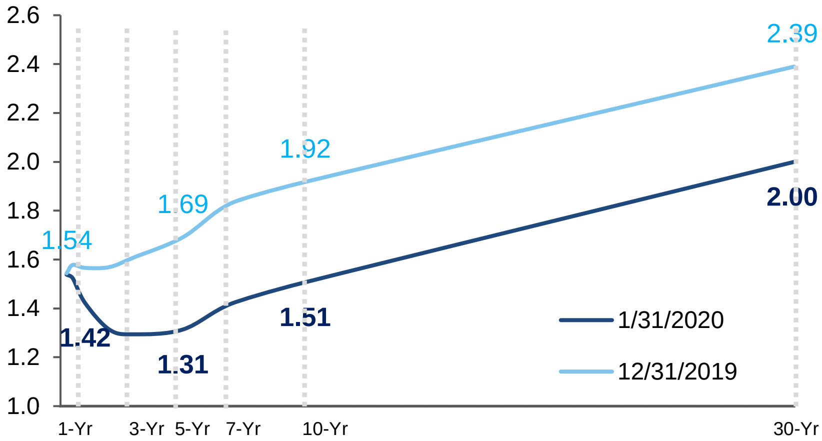
1. https://www.cnbc.com/2020/01/09/deloitte-cfos-say-economy-is-going-to-slow-stock-market-overvalued.html

APOLLON

WEALTH MANAGEMENT

U.S. Treasury Curve

The Treasury curve inverted in January – a signal that prevailing economic conditions warrant more dovish monetary policy.



Source: Bloomberg

In summary, investors had much digest in January. Uneven economic growth and corporate profit trends bear monitoring. Household spending trends have been resilient, but falling operating margins and sluggish manufacturing activity may test that resiliency. Therefore, we continue to believe that investors should be patient and adhere to a well-constructed, diversified investment portfolio anchored to your goals and time horizon.