Sabal Trust

Market Volatility Update
Dated (8/15/19)

Background:

- During July, the economic cycle crossed a significant threshold by becoming the longest expansion on record. This milestone signaled the stability and durability of the U.S. economy compared to other global regions. Furthermore, the S&P surged to all-time highs as investors recalibrated to the abrupt and unexpected monetary easing by several central banks, including the Federal Reserve. In fact, the current bull market is now the second longest during the postwar period.
- However, volatility has returned in dramatic fashion during August with investors experiencing 12 consecutive intra-day swings greater than 1% for the S&P 500.
- The primary sources of stress reflect the very real impacts of 1) monetary tightening over the past two years 2) an ongoing trade war between the world's two largest economies, and 3) heightened political uncertainty around the world in places like Hong Kong, UK, and Argentina. Secondarily, the Federal Reserve disappointed investors by remaining non-committal to a specific number of future rate cuts even as growth faltered in major economies like China, Germany, and the UK.

Primary Contributors to August Volatility:

U.S. – China Trade:

- Trade discussions broke down earlier this summer when China and the U.S. failed to reach agreements on tariffs, intellectual property protections, barriers to market access, cyber-espionage, and other complex issues.
- Attempts to jumpstart negotiations failed and the Trump administration responded by increasing tariffs by another 10% on approximately $300B of Chinese goods. China retaliated by allowing the Yuan to weaken against the U.S. Dollar to levels not seen in over a decade. Recent willingness by the Administration to delay the 10% tariff increase until December appears to have provided a temporary reprieve.
- Trade relations matter because many imports from China are integral to the US economy (electrical equipment, machinery, and consumer products, etc.) and the same can be said for exports to China (aircraft, machinery, semiconductors, software, and optical/medical equipment).
- Trade-related fallout in the real economy was initially limited, as companies pre-bought inventories and leveraged temporary price concessions from suppliers. As time progressed, supply chains began to recoil, impacting firms in the global manufacturing sector.

- Note that trade is mostly confined to the manufacturing sector, which has declined in importance for the US, representing a little over 10% of GDP compared with 20% in Germany and 30% in China.

Federal Reserve:

- During July, as the bond markets climbed the proverbial wall of worry, all eyes were fixated on the Federal Reserve and their month-end decision on interest rates. A dimming view of the global economy culminated with the first interest rate cut in over a decade.
- After the rate announcement, further declines in the yield curve signaled that the bond markets expect additional rate cuts in the September, October, and December meetings.

Bond Markets:

- Bond and stock market investors took note as a critical segment of the yield curve inverted. Specifically, the spread between the 10-year and 2-year treasury yields turned negative for the first time since 2007.
- An upward sloping curve signals a healthy economy including faster economic growth and greater levels of inflation. A flat yield curve signals a transition period and indicates a transition from a more robust economy to one that is less sustainable. Finally, an inverted yield curve is indicative of economic challenges ahead.
- The inversion of the yield curve is a signal not an event and the current readings from the bon markets should be analyzed with other important inputs and data. Over the last 40 years, the yield curve has only inverted 5 times – a relative small sample size. While these episodes do -tend to signal a recession with some accuracy, the relationship with equity returns is less straightforward.

Going Forward:

- Signposts continue to indicate the economy is reaching a late-cycle stage with high utilization, low unemployment, and inflated asset prices. Consequently, investors should regularly revisit their ability and willingness to incur risk across their investments. Given the trade headwinds and the growing risk of exogenous shocks, volatility will likely remain elevated. Re-evaluating asset allocation targets and making appropriate adjustments will help protect assets during periods of volatility.
- Regarding the Sabal Dividend Growth strategy, we remain focused on solid, predictable cash flows from dividend-paying stocks, which is prudent and appropriate given our client mandate. The portfolio's income continues to grow even during those periods where stock prices fluctuate. We will continue to strategically re-position the Sabal Dividend Growth Portfolio as the volatility profile of the market plays out. Any changes will be designed to protect our clients' underlying capital from the inherent risks in the market.

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