PPM AMERICA

Market Brief

AUGUST 2018

TRADE, TRUMP AND TRILLION DOLLAR COMPANIES

August continued to be a month of noisy market performance, driven by geopolitical headlines, trade and tariff action from the US, domestic economic strength buoying markets, the ongoing emerging markets meltdown and a tightening Federal Reserve. Essentially these are the same stories that have driven markets year-to-date, but they continued to cause friction through what would traditionally be a quieter month. Eyes also began turning to the end of the year in the US, with midterm elections looming on the horizon and an increasingly vulnerable administration fighting on multiple fronts.

One significant headline developed regarding the US and Mexico reaching something of a provisional trade agreement toward the end of the month. However, to what extent this would replace NAFTA, or supplement it, and implications for Canada, remain to be seen.[1] Canada has been noticeably absent from negotiations so far due to some political disagreement between President Trump and Prime Minister Trudeau.[2] Whether Congress, which is ultimately responsible for trade agreements, would acquiesce to the administration's demands regarding trade policy or insist on including Canada remains to be seen. Tariffs also continued to dominate conversations between the US and Europe, and the US and China.

President Trump made public and provocative statements regarding the Federal Reserve during the month, as to the (upward) course of interest rates, as the Fed looks set to hike twice more this year. Chairman Powell studiously avoided commenting on Trump's admonishments during his recent public remarks, and many expect the policy of the Fed defending its independence to continue. We also believe the Fed should remain independent. Trump very well might address these topics again – he has shown such a tendency – but we do not believe it will go anywhere.

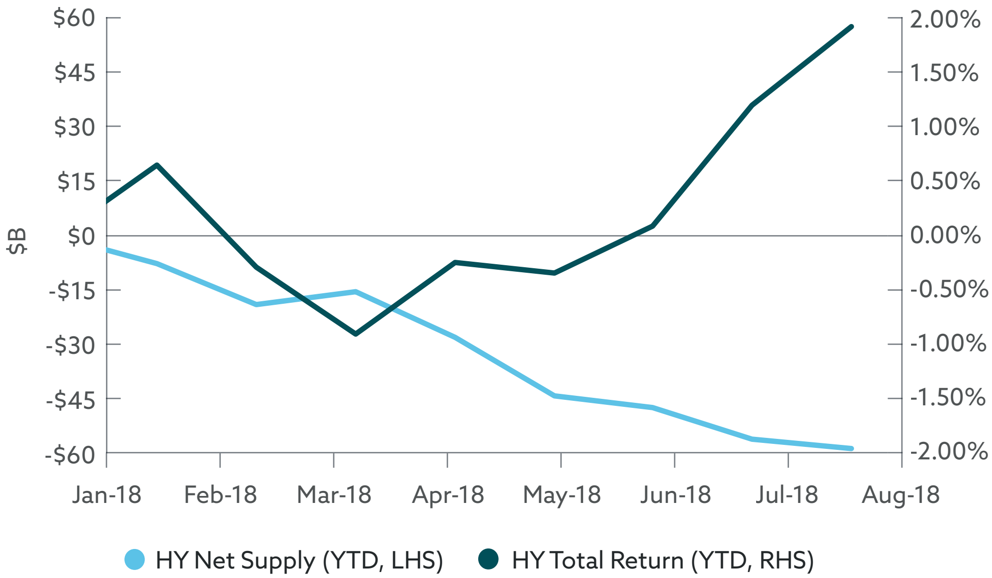
There is some growing noise among Fed watchers around the point at which the central bank should pause the current hiking cycle, with some eyeing a potential December 'surprise' halt. However, strong GDP numbers and core PCE inflation steadying around the Fed's 2% target broadly push the markets to believe that the current cycle will continue while the data supports it. Market forecasts currently show a slowing rate hike pace in 2019.[3]

Through this noise equity markets reached new all-time highs, and Apple was the first US company to reach a $1T market capitalization.[4] Amazon followed across the $1T line in early September, and Alphabet (Google's parent company) looks set to be next. Technology and Consumer Discretionary names (the sectors that contain the FAANGs) continued to drive S&P 500 market performance, up 6.93% and 5.13%, respectively, through August.[5] Returns are being driven by a very narrow segment of the market, which is a concern. Energy and Materials were the only negative sectors in August, falling -3.30% and -0.45%, respectively. Continuing broad trends, Growth outperformed Value and small caps outperformed large and mid.

Treasuries rallied during the month, with the 2-year yield falling 5 bps while the 10-year fell 10 bps. This left spreads even flatter, with the 2s10s spread now down 27 bps YTD at 24 bps.[4] Bonds saw positive total returns, but Investment Grade had negative excess returns as supply fears re-surfaced, foreign demand dropped off and the long-end continued to underperform. Higher-rated high yield bonds outperformed (i.e., BBs), as would be expected in a risk-off environment.[6] Bank loans saw steady but unspectacular returns, driven by coupons, resulting in 12 months of consecutive positive performance. We reiterate our constructive outlooks for US investment grade, high yield and bank loans.

[1] Oxford Economics. 31 August 2018. [2] ABC News. 2 July 2018. [3] Oxford Economics. 24 August 2018; BMO Capital Markets. 23 August 2018; CME FedWatch. 5 September 2018. [4] FactSet. 5 September 2018. [5] Morningstar. 5 September 2018. [6] Barclays. US High Yield Corporate Update. 4 September 2018.

HIGH YIELD RETURNS COMMENSURATE WITH SUPPLY[8]



High yield has been in an environment of negative net supply through each year since 2015, and so far every month this year apart from March. This acts as a technical tailwind. Despite outflows from high yield funds, supply has been constrained.[6] Across 2018 we have seen this relationship especially clearly, with the size of the high yield universe shrinking at a faster pace from April onward, which coincides with stronger returns for US high yield. High yield firms are also being buoyed by strong earnings growth, which is further acting to drive performance this year, and as such we remain constructive on US high yield.[7]

LARGE CAPS REGAIN ALL TIME HIGHS, SMALL CONTINUE OUTPERFORMANCE[9]

Following the late January/ early February sell-off in equity markets, it took some time before confidence returned. However, strong earnings growth and a supportive macro environment have driven the S&P 500 back to its all-time-high, with more domestically-focused small caps benefiting from additional trade related sentiment. If earnings growth continues to be realized, we expect strong equity market performance through the rest of 2018, although performance driven by a few names or sectors (namely Tech and Consumer Discretionary) is a cause for concern.

[7] BAML. 3 August 2018. [8] Barclays, Morningstar. Supply data is for the US high yield primary market. Return data is for the ICE BofAML US High Yield Index. 5 September 2018. [9] FactSet. 5 September 2018.
Past performance is no guarantee of future results.

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The **S&P 500 Index** provides a broad, market capitalization-weighted measure of US large cap stocks. It includes approximately 500 publicly-traded stocks of the largest US companies.

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