SEVEN SUMMITS CAPITAL

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COMFORTABLY CAUTIOUS

Last month I wrote about my skepticism of the optimism around the announced "Phase I" trade deal with China. One month later, the U.S. equity markets are looking through the current period of slow economic growth, relatively flat corporate earnings, and a manufacturing sector recession. Markets appear to be betting on renewed economic and earnings growth becoming evident by mid-2020. What is allowing "the market" et al. to look through the facts on the ground is apparently the hope that the trade war with China will soon be de-escalated and the tariffs that have been weighing down the global economy will be reduced or eliminated. The long-teased, and at times hyped, trade war breakthrough cannot rationally be reliably forecast; instead, in our opinion, such a breakthrough needs to be treated as a "show me" event. I will believe it when I see it. The devil will be in the details to determine if almost two years of confrontational trade-related actions levied against China has produced or paved the way for real concessions and reforms in the way China interacts with its trading partners.

I believe that the direction of the stocks will not hinge on the substance of the trade negotiations. My feeling is that the market is only looking at whether tariffs are increased, remain the same, reduced, or eliminated. I suspect that the market's advance over the last month is based upon a practical belief that the President of the United States is under significant political calendar pressure to deescalate the tariff regime that he started in early 2018.

A Reuters article written by Herbert Lash, dated November 13, 2019, and titled Stocks, yields slip as investor sentiment wavers stated "World stocks edged lower, debt yields fell on Thursday as Chinese economic data slowed in October and Germany narrowly avoided a recession in the third quarter, adding to concerns about the U.S. – China trade war's impact on global growth." This opening sentence encapsulates a pattern that has become increasingly evident in which the market is reactive and positively correlated with the ebb and flow of public statements reflecting the sentiment surrounding the expectations for trade negotiation resolution. The Reuter's article quoted Kristina Hooper, Chief Global Strategist at Invesco, who stated "phase I (of the U.S.-China trade agreement) had been considered fait accompli, and it's not, and that's becoming clear."

As a professional fiduciary responsible for making informed decisions on behalf of Seven Summits Capital clients I must be able to separate rational forecasts and conclusions from both wishful thinking and irrational fear. Since the first threaten tariffs against China, in early 2018, we have been told how trade wars are easy to win, how a fruitful deal is right around the corner, and how "China paying hundreds of billions of dollars in tariffs" will bend their will to our demand.

A rational observer of what has unfolded over the last eighteen months would have to be very skeptical of any pronouncement by U.S. administration officials of the likelihood of a meaningful resolution of the U.S.-China trade dispute. This skepticism was articulated above by Kristine Hooper in the Reuter's article. Thus, as a fiduciary responsible for significant client wealth, I cannot suspend the rational distrust of any pronounced optimism regarding a trade deal resolution in spite of broad stock market reaction. The market is fixated on the adverse economic effects of tariffs and has been "fooled" several times over the last eighteen months by pronounced trade deal optimism only to be disappointed by reality. Earlier this year I wrote in the March 2019 Seven Summits Capital Investment Commentary:

The most reliable economist who I follow when it comes to predicting economic growth and potential recessions is Paul Kasriel, previously Chief Economist of Northern Trust. Dr. Kasriel is now retired, but thankfully he continues to publish his analysis periodically. He released his latest analysis on March 25, 2019. His research piece was published by Haver Analytics and is titled The Flattening Yield Curve – Maybe it is Not Different This Time. This economic analysis performed by Dr. Kasriel relies upon an extensive study of the relationship between several different leading economic indicators and what is called Gross Domestic Purchases. Dr. Kasriel concludes with the following statement:

"The fed began raising the federal funds rate regularly at the end of 2016, and the spread between the yield on the Treasury 10-year security and the federal funds rate began trending narrower in 2018 – the narrowing in the yield spread is a conclusive indicator that monetary policy was becoming more restrictive. As a result, the pace of economic activity has started to slow."

Dr. Kasriel ends his published research piece by stating that: "The Fed might have to lower the federal funds rate pronto if an outright recession is to be avoided in 2019."

The Federal Reserve, in the face of falling bond yields, a flattening yield curve, and a weakening of both U.S and Global growth rates, has lowered the Federal Funds Rate by 25 b.p. each meeting over the last three Open Market Committee meetings beginning in July. Dr. Kasriel appears to have been absolutely correct, which comes as no surprise to me. Below is the latest 2019 , GDP growth rate projections as of November 15th:

Tracking Estimates for the Q4 Change in Real GDP

	15-Nov	8-Nov	Change
St. Louis Fed	**1.50%**	1.87%	-0.37%
Now-Casting.com	**1.12%**	1.41%	-0.29%
New York Fed	**0.39%**	0.73%	-0.34%
Atlanta Fed	**0.30%**	1.00%	-0.70%
Average	***0.83%***	1.25%	-0.43%

Source: Federal Reserve Banks of St. Louis, Atlanta, and New York; IFR Markets (J. Hall)

I have previously referenced Dr. Kasriel numerous times since the beginning of the Chinese trade threats and imposed tariffs. Dr. Kasriel has pointed out that tariffs and threated tariffs against the second-largest economy in the world was distorting the supply chain of U.S. and global companies. Such distortion pulled forward demand for goods in order to get ahead of higher costs that would result from imposed tariffs. This pulling forward of demand over the last 12 to 18 months increased economic growth rates in the earlier quarters at the expense of growth in later quarters.

The two primary drivers of equity market sentiment have been the level of interest rates and tariff expectations. Market sentiment has turned markedly positive over the last 45 days as it became very likely that the Federal Reserve would cut interest rates for the third time in October and that current economic weakness will pressure the Trump administration to take tariff pressure off of China sooner than later. I do not currently expect Federal Funds interest rate cuts to have a meaningfully stimulative effect on the U.S. economy in the coming quarters because rates just before the cuts were neutral, not restrictive. However, it is possible that if the market's concern about further increases in tariffs is reduced and the distortion of inventory build normalizes, the U.S. economy could narrowly avoid negative growth.

My macro outlook over the next twelve months or so is that the probability of avoiding negative economic growth has increased over the last 45 days. Although Seven Summits Capital weighs bottom-up individual security analysis much heavier than top-down macro considerations, I believe that one cannot ignore considering the macro risk environment. Thus, the investment sentiment at Seven Summits Capital remains cautious, going forward. Until we see tariffs on Chinese imports significantly reduced or eliminated, and determine whether tariff threats against the European Union will be followed through on, caution is warranted.

In summary, caution is the default sentiment at Seven Summits Capital. We do not have confidence that monetary policy stimulus will accomplish anything more than to mitigate stagnating economic growth trends. We also conclude that China is not likely to agree to any meaningful trade deal with the current administration so long as tariffs are being overtly used to leverage concessions.

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