



TARIFFS VERSUS THE FED

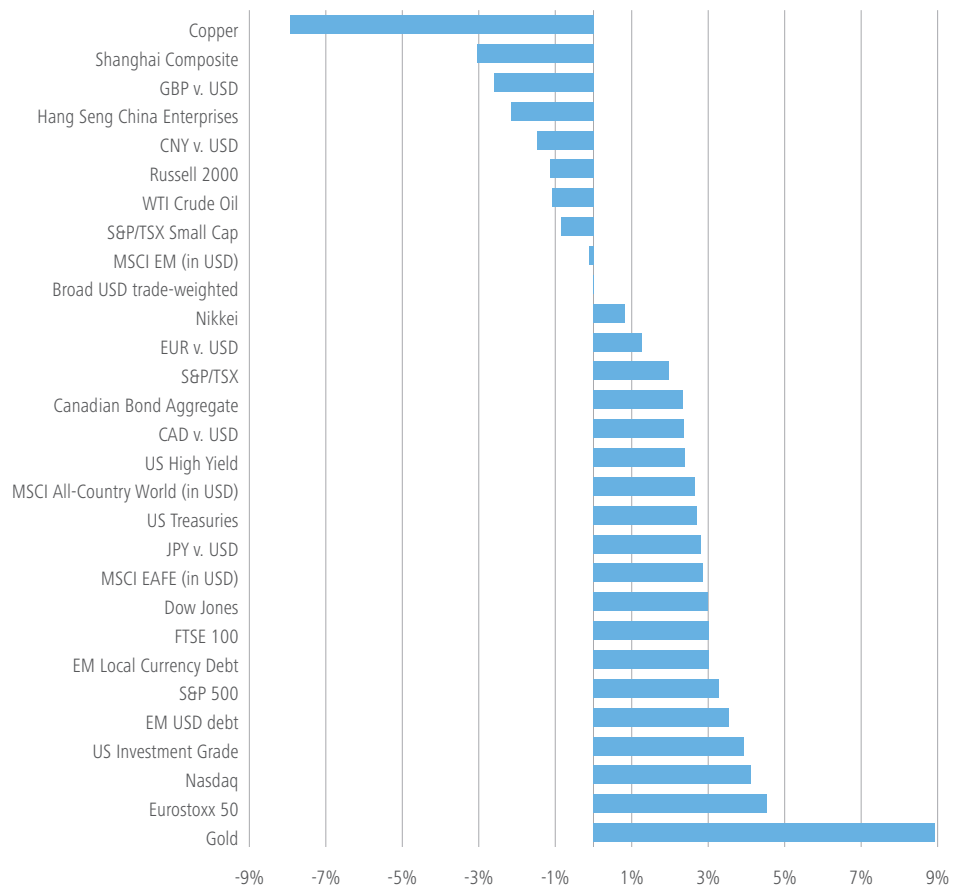


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A Rocky Quarter, But Not a Bad One

If asset prices moved up in a straight line in the first quarter of this year, the second quarter was more of a winding road. U.S. equities still managed to register a positive quarter, but with large swings in the process. Even if it ended the quarter in positive territory, the S&P 500 was down 8% from its peak at some point in early June, almost entering correction territory. Moreover, global asset prices did not perform uniformly in Q2, with asset classes tied to the Chinese growth story and global trade (copper, Chinese equities) underperforming.

Q2 2019 Total Returns (%)



Data as of June 27, 2019

Tariff Man Strikes Again!

This was largely due a pair of tweets from the “Tariff Man”, released on May 5, which shook global markets and represented a defining feature of the quarter (and probably of the rest of this year):



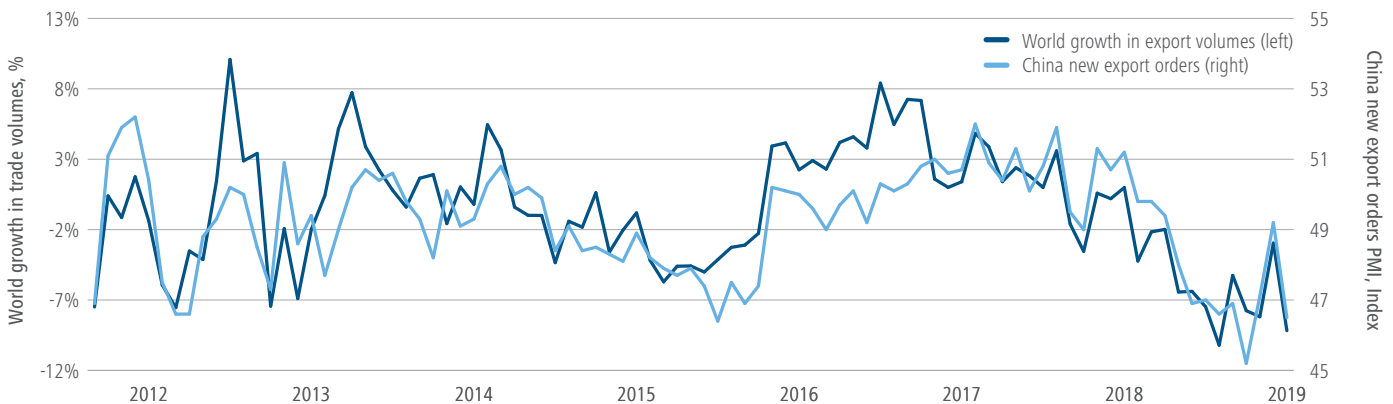
These tweets unsettled an assumption that had underlined the Q1 risk rally: the idea that the U.S. and China were close to a comprehensive trade deal, which was to take place in May. While a deal may still take place in the coming weeks or months, it looks unlikely to us that it will address the U.S.’s long list of demands, ranging from intellectual property safeguards and trade deal enforcement mechanisms. We also think it is unlikely that the U.S.-China bilateral will return to the pre-2017 state, no matter who wins the 2020 U.S. Presidential election. Chinese official media’s use of the word “humiliating” in referring to U.S. trade demands suggest to us that something has been irremediably broken in the bilateral relation. For this reason, the potential hits to business confidence and disruptions to supply chains resulting from the trade war must be taken seriously.

China’s Response

China has continued to post underwhelming growth numbers amid the difficult global trade environment. We also think it is unlikely that the country will resort to the kind of massive stimulus that it applied in 2009 and 2016, in response to global slowdowns. This is partly because of the country’s commitment to deleveraging, de-risking and a general move away from an infrastructure-focused, debt-fuelled growth model and toward a more domestic consumption-driven economy.

Chinese Sensitivity to Global Trade

World export volumes and Chinese new export orders %



Source: Mackenzie Investments (CPB, China Federation of Logistic data via Bloomberg)

However, we also think that Chinese policy makers retain sufficient flexibility to ease policy and put a floor under growth if the situation were to deteriorate further with the United States. Targeted measures can be used both on the monetary and fiscal sides to provide support to growth. Against this backdrop, we do not think that China will represent a large negative surprise to markets in the next few months.

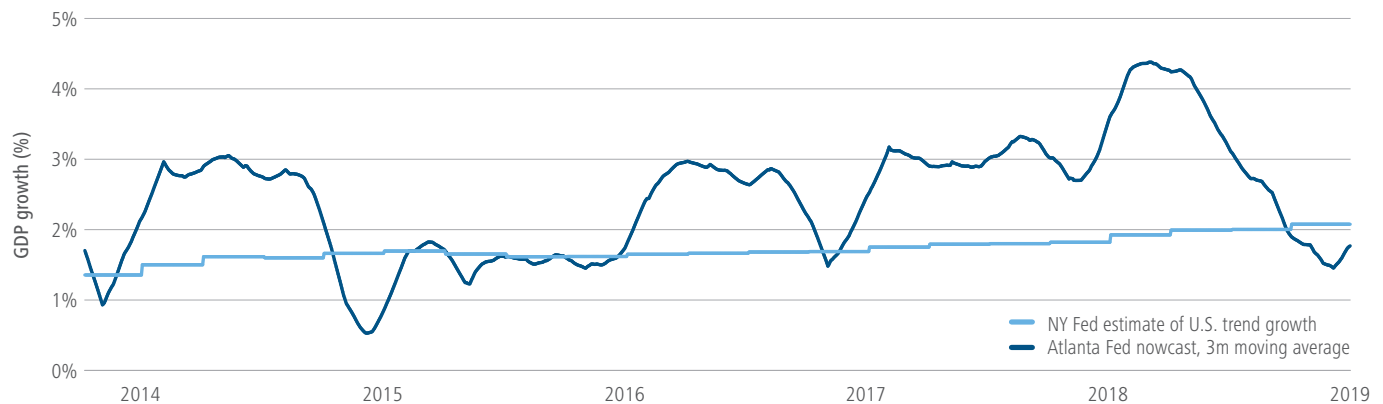


The U.S. Cycle: Soft Landing or Recession?

The key question for markets is: is the trade war enough to topple the U.S. economy, a USD 21 trillion, largely domestically-driven economy? More and more observers have raised the specter of recession recently, based on a combination of trade issues and signs of domestic weakness. Our view is slightly different: as opposed to a sudden plunge into recession, we are interpreting the current U.S. slowdown as the normal, delayed response from the Fed's policy tightening of the last few years. It is often said that monetary policy works in "long and variable lags". Over the last two years, the Fed raised rates by 200 basis points and shrank the size of its balance sheet by 5 percentage points relative to GDP. These measures are nothing to scoff at, especially given the absence of material inflationary pressures. So, after this kind of tightening, it is perfectly normal for the U.S. economy to take a breather, especially after the fiscal stimulus-induced burst of growth experienced last year.

US Estimate of Current Growth Versus Trend

Atlanta Fed GDPNow vs. NY Fed Estimate of Trend Growth



Source: Mackenzie Investments (Atlanta Fed, NY Fed data via Bloomberg)

In fact, growth appears to be at about the level of late 2016, when the Fed resumed its tightening campaign after a one-year hiatus. The difference now is that Fed tightening appears to be over and *the central bank appears to be in the process of communicating a shift to an easing cycle*. It is also important to note that historically, when the Fed cuts, it does not tend to cut just once, but at least a few times. This change in Fed thinking has been a key support for our tactical overweight to equities since the month of February, as the Fed pivot has created a more positive environment for risk assets.

Overall, a tally of the positive and negative current forces affecting the U.S. economy shows a nuanced picture, albeit one which we think is tilted toward the continuation of growth. Despite trade-related fears, this remains our base case for the months ahead.

The U.S. Economy: Pros and Cons

Negative factors	Positive factors
Inverted yield curve has historically spelled trouble	Soft landing currently at play in housing market
Loss of growth momentum in manufacturing	Lower rates will stimulate mortgage refinancing and housing activity
Capital expenditures/durables cycle rolling over	Potential for more Fed easing
Auto sales are flat at best	Labor market internals (quit rate, job openings) still solid
Commodity prices falling suggests weak global demand	Consumer financial positions are still favorable
Trade situation remains shaky	Low inflation suggests few excesses or no overheating
Labor market improvements (job creation) losing steam	Credit markets are resilient; banks still willing to lend to companies/households



The Case of the Missing Global Inflation

While U.S. growth remains close to trend, inflationary pressures have declined significantly. Around the world, inflation — both realized and expected — has fallen. Against this backdrop, some of our indicators of bond market attractiveness improved considerably, and we increased our weight in fixed income assets during the second quarter. Again, a Federal Reserve which is moving to an easing stance is likely to be better for fixed income returns than the tightening we saw in the last few years.

This lack of inflation is even more pronounced in the Eurozone. The persistence of deflationary pressures in Europe been a long-held view in the Multi-Asset Strategies Team, which we have generally expressed by being underweight the euro against the broad basket of currencies, a position that remains in place today. Recently, we also expressed our pessimistic European inflation view in our alternative strategies (Mackenzie Multi-Strategy Absolute Return Fund and Mackenzie Global Macro Fund) by taking advantage of the fall in German government bond yields, which were low to begin with, but fell further. We continue to think that the European Central Bank will be unable to normalize its monetary policy and may in fact have to provide additional easing in the coming quarters. We think this remains unfavorable for the euro relative to other currencies such as the Canadian and U.S. dollars.

Aside from these tactical views on inflation and interest rates, the second quarter reminded investors of the key role that bonds and duration play in constructing portfolios which are robust to a variety of economic scenarios. Even in a low yield environment, there is value to owning government bonds for those more volatile times, as they continue to provide effective diversification against equity-driven portfolios.

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