MONTHLY MARKET REVIEW

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ROCKEFELLER
CAPITAL MANAGEMENT

Democracy's Winter of Discontent

Fractured & ungovernable; Fed "put" to the rescue

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In light of the S&P 500 Index's 7.9% gain in January, let's hope the adage "as January goes, so goes the year" turns out to be prescient. This January barometer has worked especially well when the market had gains of 5% or better in January – since WWII, there were 14 such occasions, and 11 of them turned out to be up years. Unfortunately, the pattern failed miserably last year – the S&P 500 Index lost 6.3% in 2018 in spite of a January return of 5.6%. Well, nothing is infallible, and Fed Chairman Powell would be the first to admit to it. After his hawkish messages triggered steep sell-offs last quarter, the Fed has completely turned around to the delight of financial markets. The Federal Open Market Committee statements in late January not only signaled that rate hikes were on hold, but also hinted at flexibility in the pace of quantitative tightening.

The Fed was apparently reacting to softening economic data and tightening financial conditions. In fact, a synchronized global deceleration appeared to be gaining momentum as the weakness in China's economy has been felt around the world. Various purchasing manager indices (PMI) from Europe, Japan and Australia hit multi-year lows in January. Multinationals in the auto, technology and industrials sectors have also cited China as the culprit for earnings misses. The weaker macro backdrop has reduced the Street's 2019 earnings growth expectation for the S&P 500 Index by a couple of percentage points to around mid-single digits. In spite of the softer data, the risk-on sentiment sharply lifted commodity prices, with WTI crude oil price surging 19% during the month. However, the U.S. yield curve flattened further and gold continued its steady rise. In the currency markets, the dovish Fed has weakened the greenback, especially against emerging market currencies. The British pound gained in spite of Prime Minister May's inability to get the Brexit deal done; the market appeared to be betting on lower odds of a hard Brexit.

Historically, V-shaped rebounds from sharp declines would be followed by a period of consolidation, and in many instances, retests of the prior lows. Given that the S&P 500 Index has rallied 15% off the Christmas Eve 2018's closing low, it may be time for a breather and investors should brace for the return of volatility.

EQUITY MARKETS INDICES[1]	12/31/18 Price	1/31/19 Price	MTD Change	YTD Change
MSCI All Country World	456	491	7.8%	7.8%
S&P 500	2507	2704	7.9%	7.9%
MSCI EAFE	1720	1831	6.5%	6.5%
Russell 2000®[2]	1349	1499	11.2%	11.2%
NASDAQ	6635	7282	9.7%	9.7%
TOPIX	1494	1567	4.9%	4.9%
KOSPI	2041	2205	8.0%	8.0%
Emerging Markets	966	1050	8.7%	8.7%
FIXED INCOME				
2-Year US Treasury Note	2.49%	2.46%	-3	-3
10-Year US Treasury Note	2.69%	2.63%	-6	-6
BarCap US Agg Corp Sprd	1.53%	1.28%	-25	-25
BarCap US Corp HY Sprd	5.26%	4.23%	-103	-103
CURRENCIES				
Australian *(AUD/$)*	1.42	1.37	3.2%	3.2%
Brazilian Real *(Real)*	3.87	3.65	6.5%	6.5%
British Pound *($/GBP)*	1.28	1.31	2.8%	2.8%
Euro *($/Euro)*	1.15	1.14	-0.2%	-0.2%
Japanese Yen *(Yen/$)*	109.69	108.89	0.7%	0.7%
Korean Won *(KRW/$)*	1115.85	1112.75	0.2%	0.2%
U.S. Dollar Index *(DXY)*	96.17	95.58	-0.6%	-0.6%
COMMODITIES				
Gold	1282	1321	3.0%	3.0%
Oil	45.4	53.8	18.5%	18.5%
Natural Gas, Henry Hub	2.94	2.81	-4.3%	-4.3%
Copper *(cents/lb)*	263	278	5.8%	5.8%
CRB Index	170	180	5.8%	5.8%
Baltic Dry Index	1271	668	-47.4%	-47.4%

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FICKLE ELECTORATES

The palace intrigue in London was getting interesting in the spring of 1945, shortly after the Allied victory in Europe. The Conservatives wanted an early election to cash in on Prime Minister Churchill's popularity. Churchill had preferred to keep the wartime coalition until Japan was defeated, as he was privy to the progress of the Manhattan Project. With many Labor Party MPs also clamoring for a clean break, Churchill later decided to hold a general election on July 5th. The results were to be declared on July 26th as it would take weeks to transport the votes of Brits serving overseas.

On July 15th, Churchill journeyed to Potsdam, Germany where the heads of the U.K., the U.S., and the Soviet Union gathered to work out the post-war world order. He was alarmed by Joseph Stalin's aggressive moves as the Red Army had occupied much of Central and Eastern Europe. He was hoping to lobby President Truman to halt the spread of the communist expansion. However, nine days into the Potsdam Conference, Churchill had to return to London to preside over what he believed to be his certain electoral victory. To his dismay, the Labor Party won by a landslide – the British people who greatly admired Churchill's wartime leadership had jilted him for the Labor Party's promise of peacetime social security and full employment. Churchill immediately resigned as the Prime Minister and his successor, Clement Attlee, flew to Germany to take his seat at the Potsdam Conference. We suppose Churchill's electoral defeat must have been amusing to Stalin, to whom the quote "It's not the people who vote that count, it's the people who count the votes" was attributed.

After overcoming a bout of depression, Churchill went back on the world stage to galvanize support against the Soviet expansion. In March 1946, he delivered the memorable line – "From Stettin in the Baltic to Trieste in the Adriatic, an iron curtain has descended across the continent" – in a speech at the invitation of President Truman to the Westminster College in Fulton, Missouri. This famous "iron curtain" speech was condemned by Stalin, and some considered it the opening salvo of the Cold War. Six months later, in a speech at the University of Zurich, Churchill proposed the formation of a "United States of Europe" as a sovereign remedy to let the Continent dwell in peace, safety and freedom.

The West eventually won the Cold War, and the vision of a "United States of Europe" was fulfilled with the creation of the European Union (EU). Ironically, Churchill had never explicitly stated his view on Britain's role in this union. In 2016, seventy years after his "United States of Europe" speech, British electorate voted to exit from the European Union.

WINTER OF DISCONTENT

More than two and a half years after the Brexit vote, and less than two months before the self-imposed official exit date of March 29, 2019, Prime Minister Theresa May has yet to secure a post-Brexit deal. At this point, no one really knows how this surreal movie will end – a hard or soft Brexit, a second referendum, or a delay? We suspect there may be a delay, but a few extra months may not change things that much unless anti-Euro populist candidates score enough victories in the upcoming European Parliamentary election in May to shift the dynamic of the Brexit negotiation.

Across the English Channel, French President Macron, who was once hailed as the new Sun King (Roi-Soleil, the epithet of the great Louis XIV), has seen his stardom crashing down to earth. His reform agenda was derailed by the Yellow Vest movement, which started as a peaceful protest against rising fuel taxes but morphed into months-long anti-government demonstrations and riots. These protests not only damaged France's economy, but also hobbled Macron's European ambitions at a time when German Chancellor Angela Merkel, once the EU's de-facto leader, was limping along as a lame-duck in her final term. Sensing that earlier concessions to the protestors were insufficient to quell the discontent, Macron launched a "grand débat national". The two-month long consultation seeks to engage French citizens on four major themes: taxation, the transition to a low-carbon economy, democracy/citizenship, and the functioning of the state. With his approval rating having fallen to the low-20's, this move may be Macron's last chance to salvage a presidency that has not even crossed the half-way mark of the five-year term.

After 13 years atop Germany politics, Frau Merkel's days as the German Chancellor may be numbered. While Merkel would prefer to stay in power until the next general election in October 2021, her lame duck status may prompt CDU party members to force her to hand the power over to the new party chief, Annegret Kramp-Karrenbauer before the next election.

One definitive changing of the guard is at the helm of the European Central Bank (ECB), where President Draghi's term will expire at the end of October. The politics of selecting his successor will soon move into full swing. There have been three ECB presidents since the founding of the central bank in 1998 – a Dutch, a French, and currently an Italian. One could argue that the next ECB president ought to be a German, but Bundesbank President Jens Weidmann may be considered too hawkish for the post. The eurozone's recent economic softness will make it difficult for Draghi to start policy normalization – i.e., lifting the benchmark rate from the current negative 40bps

– before he leaves office. His successor will also face the continued challenge of running monetary policies for nineteen countries with varying and at times contradictory needs.

These political problems – and we did not even get to Italy's fractious coalition – and the region's disappointing economic performance of late have made Europe the new "sick man" in global equity. It's hard to find investors with a bullish view on the region. That said, low expectations and cheap valuations could set the stage for Europe to deliver upside surprises. In short, while the region may not look appealing on the surface, it should be fertile ground for contrarian investors.

MAKE GRIDLOCK GREAT AGAIN

On this side of the Atlantic Ocean, the political drama may be even more surreal. The country had to endure the longest government shutdown in U.S. history over $4.4 billion of border wall funding dispute. To put the $4.4 billion into perspective, it is a mere 0.1 percent of the $4.4 trillion federal budget for fiscal year 2019. Political purists would argue that it's the principal not the money that matters. However, isn't politics about compromising rather than grandstanding and petty tit-for-tats?

While the negative impact of the shutdown was temporary, there is the risk that further political dysfunction could start to undermine confidence and disrupt business investment and consumer behavior. Indeed, the political calendar will likely turn more hostile to financial markets as the year progresses – it will be open season for Democratic presidential hopefuls to bash big business and the wealthy while the House ratchets up the regulatory threat against sectors ranging from financial services, healthcare to technology.

THE LEFT TURN

In an era of the cult of political personality, AOC and Beto – Alexandria Ocasio-Cortez, the newly minted congresswoman from Bronx/Queens, and Beto O'Rourke, the former three-term congressman who narrowly lost to Ted Cruz in the 2018 Texas senate race – have captured the imagination of the Democratic base. They are both young, photogenic, and masterful with social media. AOC sports an in-your-face socialist firebrand style that has already triggered debate even at Davos 2019 over her call for a 70% marginal tax rate on income over $10 million. A recent Axios/SurveyMonkey poll found that 74% of Democrats would consider voting for the 29 year-old AOC if she were old enough to run for president. Beto, on the other hand, has been crafting a softer image with a solo road trip across the Southwest to find himself and deliberate on his political future.

The meteoric rise of AOC and Beto reflects the Democratic party's leftward shift, especially among the millennials. In a September 2018 poll, 48% of millennial Democrats labeled themselves as either democratic socialists or socialists. It is likely to pressure many traditional Democratic politicians to out "left" each other in the party's presidential primaries. "Medicare for all" and free college tuition are widely popular with the base, but don't ask detailed questions about how these programs will be funded. The standard playbook is income redistribution through taxation, and most Americans are actually supportive of tax increases for high-income earners. A recent Fox News poll had 70 percent of voters approving tax increases on families making over $10 million a year, and the support among Republicans was 54%. Similarly, 65% of voters supported higher taxes on income over $1 million, including 47% among Republicans. Senator Elizabeth Warren has even proposed a wealth tax scheme – 2% on assets above $50 million, and 3% above $1 billion. These are hardly market-friendly developments. Fortunately, the wealth tax scheme may be unconstitutional, as the 16th Amendment only empowered the Congress to lay and collect taxes on incomes, not on wealth.

DEAL OR NO DEAL

While Democrats are clamoring for higher taxes, the Chinese Communist Party has been aggressively cutting taxes in an effort to reflate its economy. Presently, the biggest threat to the global economy and financial markets is a Chinese economic hardlanding, in our opinion. That would be a black swan event as China accounts for nearly 30% of global GDP growth, not to mention its impact on many other countries' economic performance. With that in mind, we were pleased to see more monetary and fiscal stimulus being introduced, and we suspect more infrastructure projects will be rolled out after the Lunar New Year. As a case in point, the Sichuan Province, with a population of over 80 million people, announced in late January the establishment of 64 economic development zones. Each development zone will designate a sizeable swath of land for one or more local industries. While one can question whether there would be overcapacity if other provinces also pursue the same strategy, the near-term impact is higher construction activity to juice GDP growth.

China's decelerating economy puts more pressure on its policymakers to resolve the Sino-U.S. trade disputes. Our base case remains that a trade deal gets worked out in the coming months in spite of the negotiation's ups and downs. The U.S. government's various actions against telecom giant Huawei – filing criminal charges, extraditing its CFO, getting allies to ban the use of its equipment – could potentially complicate the situation. However, we suspect the Huawei case will be dealt with separately, as it appears that both Presidents Trump and Xi want a trade deal – the former could declare victory to boost his polls and the latter needs to minimize further disruption to the economy. The upside case would be a roll-back of the 10% tariffs, though we are not banking on it as long as the self-proclaimed Tariff Man remains in charge.

In short, China's reflation is not yet a foregone conclusion as confidence and animal spirit still appear to be in hibernation. For now, we will give Chinese policymakers the benefit of the doubt, but it's admittedly a tense wait for green shoots.

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