MONTHLY MARKET REVIEW

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ROCKEFELLER CAPITAL MANAGEMENT

Locked & Loaded

Big Tech in Washington's crosshairs; the Fed is ready to act

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Those who sold in May and went away were hit with seller's remorse in June. The sharp drawdown in May was erased as the S&P 500 Index gained 6.9%. Make no mistake, it was all about the Fed's further pivot to the dovish side. Inflation expectations in most developed countries continued to drift lower, and recent economic data indicated further weakening of the global economy, including manufacturing activity in the U.S. This combination prompted the Fed to signal that a rate cut was imminent, propelling equity valuations higher. It also fueled-speculation as shown by Bitcoin's parabolic surge. The 10-year Treasury yield fell to around 2%, and the 3-month/10-year yield differential inverted to as wide as 26 bps. The collapse in sovereign bond yields was a global phenomenon with the German 10-year Bund yield dipping to *negative* 33 bps. European Central Bank President Mario Draghi said additional monetary stimulus may be required to support Europe's flagging economy; but President Trump rebuked the comment as overt currency manipulation aimed at weakening the Euro. Trump won the verbal intervention race as the U.S. Dollar Index dipped to three-month lows. In the commodity space, copper and iron ore prices rallied despite concerns over weakening global demand. WTI crude oil prices surged on rising Middle East tensions and large inventory drawdowns.

President Trump also helped market sentiment by stepping back from brinkmanship. He called off the threatened 5% tariffs on Mexican imports and postponed Vice President Pence's planned speech on China's human rights violations in order to lure Chinese President Xi back to the trade talks in Osaka. The two sides have now agreed to resume negotiations with Trump having promised to hold off on additional tariffs and soften the ban on technology sales to Huawei. In the Middle East, after U.S. armed forces were "cocked and loaded" to strike Iran in retaliation for shooting down a U.S. drone, Trump aborted the mission 10 minutes before the strike. It remains to be seen if this reversal will lead to a diplomatic breakthrough with Iran, or instead embolden the Shia theocrats and other U.S. adversaries to escalate their aggression. All told, while these developments show that Trump can be highly flexible in negotiations, they also run the risk of exposing the blustering president as a paper tiger.

EQUITY MARKETS INDICES[1]	5/31/19 Price	6/28/19 Price	MTD Change	YTD Change
MSCI All Country World	492	523	6.4%	14.9%
S&P 500	2752	2942	6.9%	17.3%
MSCI EAFE	1817	1922	5.8%	11.8%
Russell 2000®[2]	1465	1567	6.9%	16.2%
NASDAQ	7453	8006	7.4%	20.7%
TOPIX	1512	1551	2.6%	3.8%
KOSPI	2042	2131	4.4%	4.4%
Emerging Markets	998	1055	5.7%	9.2%
FIXED INCOME				
2-Year US Treasury Note	1.92%	1.76%	-17	-73
10-Year US Treasury Note	2.13%	2.01%	-12	-68
BarCap US Agg Corp Sprd	1.28%	1.15%	-13	-38
BarCap US Corp HY Sprd	4.33%	3.77%	-56	-149
USD Performance				
Chinese Renminbi (CNY/$)	6.91	6.87	-0.6%	-0.2%
Brazil Real (Real/$)	3.92	3.85	-1.9%	-0.8%
British Pound ($/GBP)	1.26	1.27	-0.5%	0.5%
Euro ($/EUR)	1.12	1.14	-1.8%	0.8%
Japanese Yen (Yen/$)	108.29	107.85	-0.4%	-1.7%
Korean Won (KRW/$)	1190.91	1154.80	-3.0%	3.9%
US Dollar Index (DXY)	97.75	96.13	-1.7%	0.0%
COMMODITIES				
Gold	1305	1409	8.0%	9.9%
Oil	53.5	58.5	9.3%	28.8%
Natural Gas, Henry Hub	2.45	2.31	-5.9%	-21.5%
Copper (cents/lb)	264	271	2.5%	2.8%
CRB Index	175	181	3.2%	6.6%
Baltic Dry Index	1096	1354	23.5%	6.5%

Source: Bloomberg.

To borrow a catchy phrase from Chairman Powell's tormentor-in-chief, the Fed appears to be "cocked and loaded" to cut rates in the upcoming FOMC meeting at the end of July.

JOURNEY TO THE MOON

About 10,000 spectators gathered in front of giant screens in New York's Central Park on the evening of July 20, 1969. At the same time, 600 million people around the world also had their eyes fixated on their TV's. A quarter million miles above them, in the small confines of the Apollo 11 lunar module, astronauts Neil Armstrong and Buzz Aldrin were busy preparing for extravehicular activity. At 10:51 pm EDT, Armstrong began his slow descent. Five minutes later, with his left foot landing on the powdery dust covered lunar surface, he uttered, *"That's one small step for a man, one giant leap for mankind*."

This momentous occasion fifty years ago was the culmination of an arduous technological and political journey that started on May 25, 1961, when President Kennedy announced the goal of landing Americans on the moon before the decade was over. It was intended to rouse Americans in the midst of the Cold War, after the Soviet Union had successfully sent the first human into orbit just a month earlier. Over the years, nostalgia has romanticized the Apollo program into a story of a resolute nation that rallied around an inspirational young president who chose to go to the moon and do other great things not because they were easy, but because they were hard. In reality, most Americans did not approve of the massive spending on the Apollo program, which was dubbed a "moondoggle."

By the autumn of 1963, even Kennedy's enthusiasm for lunar landing was wavering after learning that NASA could not get it done before the end of his second term in January 1969. Congress also appropriated less money than what NASA had requested. In Kennedy's speech in San Antonio on November 21st, as well as in the remarks prepared for the following day in Dallas, there was no mention of the moon landing even though the space program was lauded. Then tragedy struck – Kennedy was assassinated in Dallas. Ironically, his death rejuvenated the Apollo program. President Johnson, a true believer in the space program, harnessed the grieving nation's eagerness to honor the late president's legacy by not only renaming the space center in Florida the John F. Kennedy Space Center, but also getting Congress to increase funding for NASA.

Before the lunar module blasted off for the journey back home, the astronauts planted a commemorative plaque on the moon's surface with an inscription that read, *"Here men from the planet Earth first set foot upon the Moon, July 1969 A.D. We came in peace for all mankind."* Below these two sentences were facsimiles of four signatures: Neil A. Armstrong, Michael Collins, Edwin E. Aldrin, Jr., and *Richard Nixon*. There is a tinge of irony that Nixon, who became the president just months before the lunar landing, had his name immortalized on the moon while the signatures of his two predecessors who shepherded the Apollo program were left out. Several months after the lunar landing, Nixon cut NASA's budget and eventually ended the agency's human exploration of space beyond low-Earth orbit.

NATIONAL INDUSTRIAL POLICY?

At the inception of the Apollo program in 1961, NASA's budget accounted for less than 1% of federal government spending. Under President Johnson's staunch support, it soared to as high as 4.4% of federal disbursements in 1966. It was a golden era for government funded R&D, which peaked at nearly 12% of federal spending in the mid-1960s, compared to less than 3% in 2018. While the federal receipts today, at roughly 16% of GDP, are similar to those in the mid-1960s, the composition of federal spending has changed substantially. In the mid-1960s, defense accounted for 54% of the federal outlay due to the Vietnam War as well as the Cold War, but social spending was just 11%. Today, while defense has dropped to 15% of federal outlay, social spending has surged to 63%. Federal debt has also ballooned from 40% of GDP in 1965 to 105% today. In short, the U.S. now depends on the private sector's R&D to maintain the country's technological leadership.

According to the National Science Board's biennial *Science and Engineering Indicators* report, the U.S. still leads the world in overall R&D spending, though China is quickly catching up. Between 2000 and 2015, China grew its R&D spending at 18% per year as compared to the U.S.'s 4%. Last year, China's $475 billion of R&D spending was only 14% less than that of the U.S. at $553 billion. China has created some dominant global companies such as Huawei Technologies in telecom equipment, and CRRC in rail transit equipment. While China has toned down the publicity of its "Made in China 2025" initiatives, it is clear where its ambitions lie. China's rising technological prowess has led to some soul searching in the West for an effective policy response. Earlier this year, French and German governments were livid that the EU blocked a proposed Alstom-Siemens merger designed to create a European rail champion capable of competing with Chinese rivals. French and German economy ministers then jointly published a manifesto calling for a European industrial policy. Meanwhile, some U.S. think tanks and policymakers have begun to advocate for a national high-tech industrial policy. However, most free market disciples still prefer to leave it to the market to pick winners and losers, with some believing that the threat of China's technological dominance is overblown like our misplaced fear of Japan's ascendancy in the 1980s. Time will tell if laissez-faire capitalism can withstand the challenge of China's state directed and subsidized development policies. Suffice to say that the U.S., the original inventor of cellular communications, has fallen way behind China in 5G technologies that are deemed critical for cyber and national security.

DON'T KILL THE GOLDEN GOOSE

The political and ideological divide in Washington will make it difficult to forge a consensus on national industrial policy. However, in the context of the global technology race, the least that Washington can do is avoid harming our most innovative companies. Is there any instance of European, Japanese, or Chinese regulators seeking to break up one of their national champions? Yet we find a growing number of U.S. politicians on both sides of the aisle jumping on the Big Tech Breakup bandwagon. The Justice Department and the Federal Trade Commission have set their crosshairs on Alphabet and Facebook, with Amazon and Apple not too far behind.

We do not dispute that there are real issues to be addressed – the winner-take-all nature of certain markets, privacy, editorial obligations vs. censorship, etc. However, these four companies are among the key enablers of America's leadership in technology and have collectively spent $75 billion in R&D last year. These companies are funding research in artificial intelligence, renewable energy, quantum computing, robotics, and other emerging fields that may be a long way from commercialization. The American psyche loves to romanticize entrepreneurship and vilify big businesses, but the reality is that the former lacks the scale and profitability of the latter to sustain R&D in some critical fields. A drawn-out antitrust war against these companies runs the risk of stifling the pace and scope of future innovation. Ironically, breaking these companies up may unleash value in some of the projects that are currently loss making. For example, some believe that Waymo, Alphabet's self-driving technology subsidiary, could command a valuation as high as $200 billion. That said, breaking up Alphabet could also reduce each new unit's future capacity to fund R&D for the so-called "moonshot" projects.

DON'T FIGHT THE MARKET

The Fed left its policy rate unchanged at the June Federal Open Market Committee (FOMC) meeting, but Chairman Powell made it clear that the case for more accommodative policy has strengthened. The latest FOMC dot-plot showed that seven of its seventeen members forecasted a 50 bps Fed funds rate cut by year end. To borrow a catchy phrase from Chairman Powell's tormentor-in-chief, the Fed appears to be "cocked and loaded" to cut rates in the upcoming FOMC meeting at the end of July.

Some may argue that there is not yet a strong enough case for monetary easing as the U.S. economy, by and large, remains healthy, and the recent string of softer-than-expected data reflects growth slowing down to the 2% trendline rather than an imminent recession. Market-based signals have also been mixed. The yield curve inversion coupled with collapsing Treasury yields portent higher recession risk and should have widened high yield bond spreads. Yet in June, the U.S. corporate high yield bond spread narrowed from 433 to 381 bps. New issue volume surged in response to strong investor demand, and most deals were oversubscribed. This divergence meant that either the junk bond market was too giddy, or that Treasury investors were too gloomy.

The issue for Powell is that he may have been boxed in by a meddling President and an unforgiving market that could react violently to a policy status quo. Powell's every move seems to be second-guessed by Trump, who has no qualm in undermining the Fed's independence. Given the lack of sustained inflationary pressure, cutting rates as an insurance policy for the economy looks like an easy way out, unless incoming economic data are so strong as to render such a move untenable. However, the Fed runs the risk of being perceived as caving to external pressure – the adage "Don't fight the Fed" may be morphing into "Don't fight the Market". Indeed, the recent surge in the price of gold to six-year highs may reflect the concern that the Fed is potentially losing its independence.

HISTORY RHYMES

The last two instances of the Fed kicking off the easing cycle, which were in January 2001 and September 2007, turned out to be opportune times to cut back on risk exposure before the onset of prolonged bear markets. Those two occasions predated the subsequent recessions by just a few months. In perfect hindsight, there was so much imbalance in the system that the rate cuts were simply too little, too late. In 2001, the downturn was triggered by the implosion of the dot-com bubble. In late 2007, the subprime mortgage crisis and heavy consumer indebtedness led to the Great Financial Crisis.

During the decade-long expansion in the 1990's, however, the Fed's monetary easing did lead to the desired outcome. In 1998, the Fed cut interest rates three times in reaction to overseas financial crises that culminated in the collapse of the hedge fund Long- Term Capital Management. The quick succession of rate cuts stabilized the environment and fueled a rally that turned into the dot-com bubble. In 1995, following the subpar growth in the first half of the year, the Fed's three rate cuts successfully rekindled growth. Former Fed Chairman Greenspan called the soft-landing of 1995 one of his proudest accomplishments at the Fed.

Time will tell if the upcoming rate cut turns out to be a replay of the 2000's or the 1990's scenarios. We see some parallel to 1995 as the U.S. economy does not yet exhibit huge imbalances on the cusp of implosion. U.S. consumers appear to be in good financial health. U.S. non-financial corporate leverage is elevated, but debt service has been helped by low interest rates. Interestingly, markets have already done some easing for the Fed as collapsing Treasury bond yields have driven the average 30-year mortgage rate from roughly 4.5% at the start of the year to 3.8% now. The biggest risk to the U.S. economy, in our view, remains President Trump's unpredictable trade policy. That said, he just may be the "very stable genius" who manages to goad the Fed into rate cuts and then make a partial deal with China. Hope springs eternal, but it pays to be vigilant.

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