INCOME OUTLOOK
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EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

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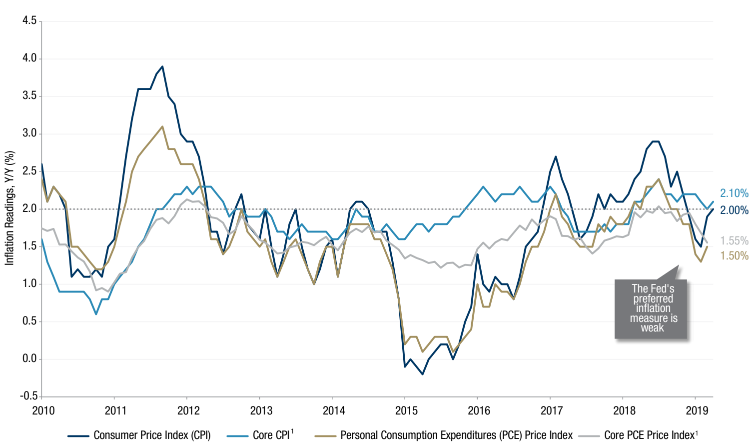
TRADE WAR Could Sap Confidence

It's wait and see in terms of the impact of the back-and-forth tariffs between the United States and China, especially if trade fears damage the "reacceleration of capital expenditures and reinvestment in business," said James Camp, CFA, Managing Director of Fixed Income and Strategic Income at Eagle Asset Management, an affiliate of Carillon Tower Advisers.

He worries that a protracted trade war between the U.S. and China could lead to a "puncturing of confidence" at the CEO/CFO level, where we saw, at long last, a reacceleration of reinvestment and capital expenditures last year. This "confidence is very vulnerable and could put us back into a sub-par growth environment if people start reigning in the spending," says Camp. He adds that trade concerns are already evident in the sharp pullback in the Purchasing Managers' Index (PMI) reports and other economic data. For now, however, he believes we have a relatively good scenario domestically, although his outlook is cautious and internationally it's potentially less encouraging.

In terms of a trade war, "the fear of what is going to happen is much more important than what is actually happening out there," says David Blount, CFA, CPA, and Managing Director of Equity Income at Eagle Asset Management. Blount takes a holistic view of trade tensions and clarifies that "this is not an embargo – you can still get whatever it was that you got before from China, but it is going to be more expensive." Overall, he said the indirect effects of a trade war "are clearly going to be the possibility of higher inflation." But, he added, "a modest increase in inflation in the United States is unlikely to be problematic given the benign inflation readings domestically."

U.S. Inflation Readings (Year-Over-Year)



[1]Core measures exclude goods with high price volatility, such as food and energy prices.
Source: Bloomberg, Bureau of Labor Statistics, Dallas Federal Reserve, and Cleveland Federal Reserve; monthly data as of April 30, 2019.

Correlation breakdown

Unlike the breakdown in trade talks, Camp is encouraged by the change in Federal Reserve policy and the breakdown in correlations.

Camp points to the Fed's departure from its previous "zero interest-rate policy," which he believes subdued and manipulated rates down to zero for most of the decade, as the reason for the positive correlation across asset classes. The result of relatively tighter Federal Reserve policy has been a decrease in positive correlations across asset classes. "This is the beauty of not having bonds correlated to risk assets," said Camp. The Sharpe Ratio (a measure of excess returns to market risk) of the S&P 500 peaked in early 2018, he said. The risk-free rate and volatility – two of the underlying factors in the equation for the Sharpe Ratio – have been kept artificially low by record low interest rates and central bank balance sheet expansion. He believes that for the first time since the Financial Crisis, we are seeing a period with a real separation in the correlation between individual securities. "This means we have a market of stocks and bonds and not simply a stock-and-bond market," Camp said.

Positive signs for active management

Camp believes that this breakdown in asset correlation will reward active management over passive. "Active management will be buoyed by the fact that fiscal and economic policies of the United States are no longer exclusively Fed Reserve based," Camp said. He thinks that the deployment of capital, in a more normal interest rate environment, will be geared toward corporate reinvestment and productivity and less financial engineering.

Fed shifts, yield curve inversions

Adds Camp: "Expansions don't die of old age – a policy event usually kills them." He characterized the market sell-off in late 2018 as both the stock and bond markets voting that if the Fed was going to intentionally tighten conditions, the economy was likely to find a recession. Camp believes that the Fed's dramatic dovish shift from January 2019 through March satisfied risk markets early on, but he also points to the development of a noticeable divergence between risk markets and U.S. Treasuries, with the latter pricing in the next Fed move as likely a cut in rates.

He interprets this shift in policy to indicate that the Fed under Chairman Jay Powell is not as beholden to the dual mandate of using monetary policy to maximize employment and minimize inflation, and seems willing to consider other risk factors such as tightening financial conditions. Camp said that the reasoning behind previous monetary policy, "as flowing through and being causally related to inflation," was a market misread. "I think that the Fed has finally got the message that inflation targeting is a fool's errand," says Camp. He is watching the yield curve inversion, as measured by the difference between the 3-month Treasury bill to the 10-year Treasury note, which was driven by the massive rally in longer dated Treasuries. Historically, yield curve inversion has been a reliable indicator of a pending recession. However, Camp believes the inversion will matter more if it holds for an extended time, especially if it makes financial conditions tighter, meaning loan growth stalls and the monetary velocity stalls.

About Eagle Asset Management

Eagle Asset Management provides a broad array of fundamental equity and fixed-income strategies designed to meet the long-term goals of institutional and individual investors. Eagle's multiple independent investment teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.

About Carillon Tower Advisers

Carillon Tower Advisers is a global asset-management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our partner affiliates – ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments) and Scout Investments – we offer a range of investment strategies and asset classes through a number of vehicles, each with a focus on risk-adjusted returns and alpha generation. We believe this lineup of institutional-class portfolio managers may help investors meet their long-term business and financial goals.

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Indices are unmanaged, and one cannot invest directly in an index.

Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors that may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. The risk of a change in the market value of the investment due to changes in interest rates is known as interest-rate risk. Interest-rate risk is subject to many variables but may be analyzed based on various data (e.g. effective duration).

The risk that the issuer may default on interest and/or principal payments is often referred to as credit risk. Credit risk is typically measured by ratings issued by ratings agencies such as Moody's and Standard & Poor's™. Bonds issued by the U.S. Government have significantly less risk of default than those issued by corporations and municipalities. However, the overall return on Government bonds tends to be less than these other types of fixed-income securities. Finally, reinvestment risk is the possibility that the proceeds of a maturing investment must be invested in a lower-yielding security, all other things held constant, due to changes in the interest-rate environment. Investors should pay careful attention to the types of fixed-income securities which comprise their portfolio, and remember that, as with all investments, there is the risk of loss of capital.

Definitions:

Sharpe Ratio – Sharpe Ratio is a risk-adjusted measure calculated by using standard deviation and excess return to determine reward per unit of risk. The ratio is equal to the excess return divided by the Standard Deviation of the portfolio. The higher the Sharpe Ratio is the better the portfolio's historical risk-adjusted performance.

The U.S. Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rates represent the inflation rate.

The Core Consumer Price Index (CPI) is the Consumer Price Index (CPI) excluding energy and food prices.

The Personal Consumption Expenditures Price Index (PCE) is a measure of the prices that people pay for durable and nondurable goods and services. The index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. The PCE Price Index is the component statistic for consumption in gross domestic product (GDP) collected by the U.S. Bureau of Economic Analysis.

The Core Personal Consumption Expenditures Price Index (PCE) is the Personal Consumption Expenditures Price Index (PCE) excluding energy and food prices.

The Purchasing Managers' Index (PMI) is an indicator of economic health for manufacturing and service sectors.

The S&P 500® Index is based on the average performance of 500 widely held common stocks and is a broad-based measurement of changes in stock-market conditions.

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