TPW
INVESTMENT MANAGEMENT

As The Tri Polar World Turns - May 2019

May 10th, 2019

MACRO THEMES

A month ago we were worried about yield curve inversion in the US and what that meant for the global growth recovery, what we call: "the Lower for Longer Global Growth Path". Well, the yield curve inversion has inverted back to normal with about a 20bp spread between the 2/10yr UST bond while the Bund fluctuates around zero and the China 10yr backs up to about 3.35%. As April built on the first quarter's impressive risk asset performance we had thought a pullback would be healthy (see Musings link - You Say Pullback, I Say Healthy); well we got one.

Following several Trump tweets about the potential for additional tariffs on China imports, risk asset markets have sold off beyond original weakness in metals and miners. The good news: risk assets are no longer overbought & extended; the bad news: as we go to print tariffs have been raised from 10% to 25% on $200B of China exports to the US while talks continue. Absent a breakdown of talks or a 25% tariff imposition on all China imports which we think unlikely given the impact on US consumer goods pricing (the Full Monty) we plan to stick to our positioning. Our view remains that a global growth bottom is upon us supported by Fed policy and China stimulus bearing fruit. In addition, Q1 earnings are coming in better than expected in both the US and Europe and EPS revisions are turning up across the globe.

ECONOMICS: The timing & magnitude of the 3.2% US Q1 GDP print served to highlight the divergence between US growth and the ROW coming as it did just after weak South Korean GDP data suggested the global economy remained weak. Upon reflection, the US report seems overstated with imports and inventory build a big part of the upside surprise while consumption numbers were low and down sharply on the prior Q. Outside the US, subsequent China data suggests a stabilizing growth picture there while better than expected European Q1 GDP data lends further support to the idea of ex US growth bottoming.

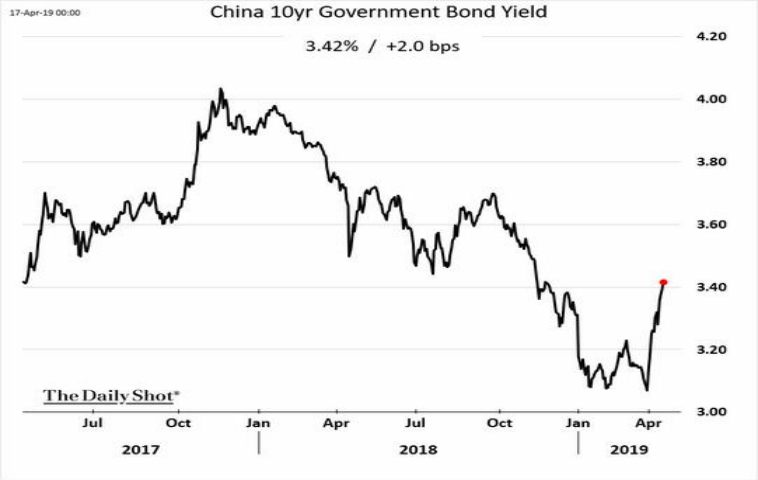
We continue to focus on the DM service sector & consumer. Here the news remains solid across Europe, the US, and even Japan where retail sales and housing starts have both been better than expected. Sequencing suggests that China's PMI data provides a better window on global growth prospects than either US or EU PMI data (seen as coincident or lagging). Given that China provides 30% of global Industrial Production (IP) its leadership role makes sense (See Chart 1).

Chart 1: European PMIs should bounce with a lag to China

Source: Credit Suisse

So in Step 2 of our 3 Step **Risk Asset process (RAP)** we are looking for growth bottom confirmations in China (check) & Europe (in process as shown by Q1 GDP, German IP, Service PMIs, etc) coupled with market confirmation based upon long rates backing up in China (check) and Europe (not yet) (**See Chart 2**). In essence the confirmation process continues to unfold; absent a US Full Monty as noted above we continue to expect a growth bottom in Q2/Q3.

Chart 2: China 10 Year Confirms Growth Bottom



Source: WSJ

POLITICS: Until Sunday May 5th positioning continued to fade headline risk, especially political headline risk with the latest example being the release of the Mueller report and new S&P all-time highs in the same week. Then came Pres. Trump, aka Tariff Man, and political risk led to markets selling off hard. While there is a lot of he said, Xi said (hat tip HSBC) it does seem cold to implement tariffs while the China team, led by Vice Premier Liu He, is still in town. Should a trade deal be pushed out it would seem to imperil the fate of the US-Japan, US-EU talks and the passage of NAFTA 2.0. Other countries might then start to play for time and thus little would get done on these fronts which in turn may inspire more tariff threats from the US, perhaps towards Europe (Not good).

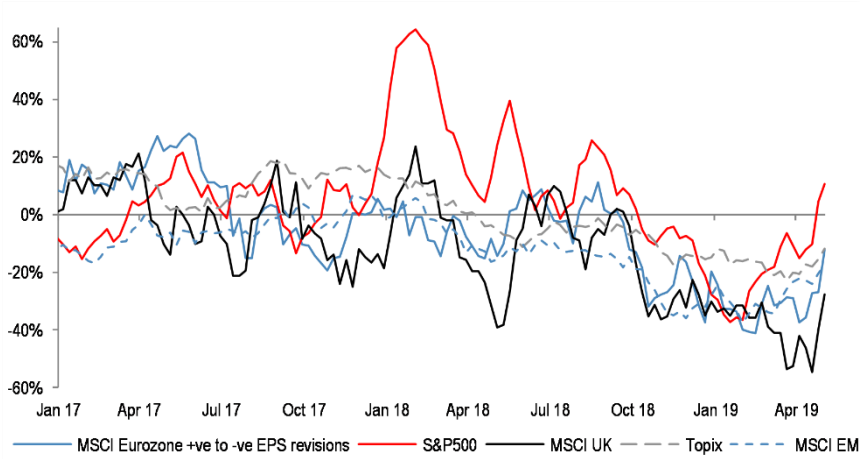
Outside of the trade threat not much else needs to be said here - Brexit remains a pundit whodunit but markets don't seem to care while Spain's elections suggest the EU Parliamentary elections at month end might not be the populist showfest folks were worried about. Elections in Indonesia and India have gone off smoothly to date while in Latin America, Brazil's pension reform process continues to move slowly ahead.

POLICY: Prior to Sunday night (remember back then) China stimulus policy was the center of the news with fears that tightening might be back on the cards after a solid Q1 GDP print. Trade uncertainty should take that worry off the table. There is little new in monetary policy with the Fed, ECB and BOJ clearly on hold while the PBOC remains active (though Chair Powell's inflation flip flop from major challenge to transitory has been less than stellar). The global easing cycle we have been expecting may well get a push from greater trade uncertainty - we continue to expect EM Central Banks to be among the leaders in this exercise. On the fiscal side, it's feasible that Japan's Fall VAT tax hike may be pushed out which would be helpful to consumer demand.

As we approach summer it seems that both fiscal & monetary policy makers want to give the real economies time to reflect the actions already taken. On the trade policy front, a US - China deal still seems most likely; raising tariffs on consumer goods does not seem like a good reelection strategy.

MARKETS: From April to May and from new all-time highs in US equities to weakness across the board. Earnings season in both the US and Europe has been good with 76% of US companies reporting better than expected while with roughly 60% reporting European earnings have likewise come in better than expected. As Chart Three suggests the earnings picture is improving and not only in the US, but broadly. If global growth is in process of bottoming and earnings expectations are starting to turn up current equity market turbulence could be the healthy pullback that sets markets up for a good 2H.

Chart 3: From Earnings Recession to Earnings Recovery?



Source: JPM

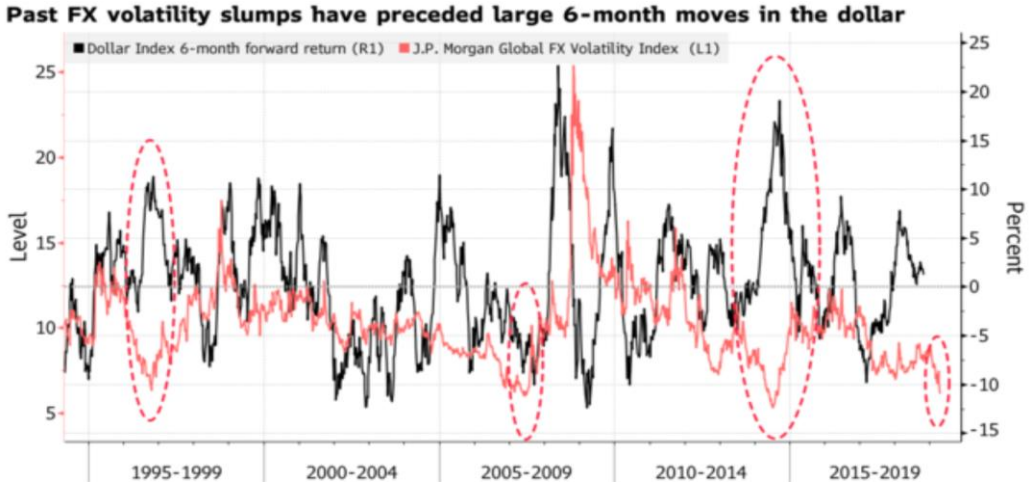
The Trump trade tweet storm was timed just perfectly as better than expected EPS growth and lack of a pullback had led to extended positioning, especially in the US. Complacency was building with Morgan Stanley reporting that April ended with the VIX at a 6 month low while speculative positioning was at a 10 YEAR low. With the China trade selloff, markets have once again surprised the most people as the VIX has now spiked back towards 20.

In Fixed Income, Trump's trade tweets have taken the 10 yr UST back towards 2.45% and the Bund back below zero. The most recent 10 year UST auction was quite weak - something worth watching. Corporate credit has

been solid as growth fears recede & fundamentals remain intact. Local currency EM debt has been weak reflecting worries in Turkey and Argentina; it's worth noting that real yields are much, much higher today & currencies much better priced than a year ago suggesting much less EM wide risk.

Outside of EMFX the major currencies have been quiet for the most part. As more and more offshore buyers buy USD assets without hedging it seem like we are setting up for a nice USD reversal but as we have suggested before, ROW economic growth needs to bottom first. JPM highlights the unusual stability in the G10 and notes that big USD moves usually follow - we expect this time to be no different. (See Chart 4)

Chart 4: Will Stability Give Way to USD Weakness?



Source: Bloomberg, JPM

Within the commodity space it remains all oil, all the time. Base Metals has been quite weak while mining stocks got caught up in the China, EM sell off. What began as healthy profit taking has morphed into worrisome weakness, perhaps signaling more anxiety over growth. The entire commodity complex is close to support levels and worth watching carefully for global growth implications.

On a strategic basis, we continue to believe that a Lower for Longer Global Growth Path would be a reasonably good one for risk assets, trading potential lower earnings growth for less Fed risk. Such a growth path would suggest looking to equity markets with potential for multiple expansion (EU, Japan, parts of EM) and those fixed income assets with attractive yields (EM debt, US & EU HY, mortgages, preferred securities, etc.). The US equity market trades at 17x forward EPS, is up over 9% in the past year and sits only 3% off it's all time high, while ROW (ACWX) trades at roughly 13x forward EPS, is down 5% over the past year and sits roughly 15% below its recent high.

Confirmation of growth bottoms is key; investors should be preparing for Step 3 in our RAP process, ReAllocation as confidence grows. Focus should be on the Developed Markets ex-US; the outflows, including the past week, have been significant with Europe seeing outflows in 58 of the last 60 weeks while Japan seems to have dropped off the equity map. Should (or rather when) the flows reverse it is likely to be a bit of a feeding frenzy. Along the same lines, this past week's foreign selling of Chinese equity through the Connect programs reached a record. China remains down roughly 10% over the past year and roughly 30% off its 2018 highs while Lat Am is down close to 5% over the past year and remains roughly 22% off its highs of the past several years. There would seem to be much more equity upside outside the US.

PORTFOLIO STRATEGY AND ASSET ALLOCATION (GMMA)

We have made limited portfolio changes this month given our view that markets were extended and due to pause. We remain slightly overweight equity, underweight bonds and overweight alternatives & cash.

Within equities, we remain OW the non US equity markets. As we reiterated above both monetary (central banks on pause) and fiscal (China stimulus) policies are accommodative for risk assets.

In Fixed Income we maintained the bulk of our positions including our US HY, Preferred and Mortgage backed. We continue to hold a position in European HY believing Europe's imminent growth bottom will prove supportive. We also maintain our USD EM debt position expecting the lower for longer global growth path to support continued interest in higher yielding instruments.

We remain overweight Alternatives with a position in broad commodity exposure and a tilt to energy via a MLPs position. We have high conviction in OPEC, specifically Saudi, desire to maintain production cuts to ensure higher oil prices (Saudi Arabia's 2019 budget has a $80 av price estimate). We continue to expect both supply concerns and demand pickup based on growth bottoms to support our commodity overweight. We maintain a small cash positions as we await the economic & political signals noted above to add to our preferred risk positions.

GLOBAL MACRO SUITE PORTFOLIO CHANGES

Global Macro Multi Asset (GMMA)

- We made only one change which was in Europe where we switched our Spanish equity position Germany which is more exposed to China's growth bottom.

Global Macro Income (GMI)

- We exited our short term UST position and our Gold position and added to Cash.

Global Macro Equity (GME)

- As in the GMMA portfolio, we exited our Spain position and added a Germany position.
- We reduced cash and our MLP position to add to our China equity position.
- Within the Americas portion of the portfolio we reduced our Latin American exposure and added to our US Industrials position

I hope you find this monthly piece of value and look forward to engaging with you on a monthly basis as we go thru 2019.

Jay Pelosky, CIO & Co-Founder
TPW Investment Management

Disclosure:

Past performance is no guarantee of future results. The material contained herein as well as any attachments is not an offer or solicitation for the purchase or sale of any financial instrument. It is presented only to provide information on investment strategies, opportunities and, on occasion, summary reviews on various portfolio performances. Returns can vary dramatically in separately managed accounts as such factors as point of entry, style range and varying execution costs at different broker/dealers can play a role. The material contains the current opinions of the author, which are subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities. Forecasts are inherently limited and should not be relied upon as an indicator of future results. There is no guarantee that these investment strategies will work under all market conditions, and each advisor should evaluate their ability to invest client funds for the long-term, especially during periods of downturn in the market. Some products/services may not be offered at certain broker/dealer firms.

There can be no assurance that the purchase of the securities in this portfolio will be profitable, either individually or in the aggregate, or that such purchases will be more profitable than alternative investments. Investment in any TPWIM Portfolios, or any other investment or investment strategy involves risk, including the loss of principal; and there is no guarantee that investment in TPWIM's Portfolios, or any other investment strategy will be profitable for a client's or prospective client's portfolio. Investments in TPWIM's Portfolios, or any other investment or investment strategy, are not deposits of a bank, savings and loan or credit union; are not issued by, guaranteed by, or obligations of a bank, savings and loan, or credit union; and are not insured or guaranteed by the FDIC, SIPC, NCUSIF or any other agency.

The investment descriptions and other information contained in this are based on data calculated by TPW Investment Management, LLC (TPWIM) and other sources including Bloomberg. This summary does not constitute an offer to sell or a solicitation of an offer to buy any securities and may not be relied upon in connection with any offer or sale of securities. This report should be read in conjunction with TPWIM's Form ADV Part 2A and Client Service Agreement, all of which should be requested and carefully reviewed prior to investing.