A Tale of Two Sectors
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It was the best of times (for consumers), it was the worst of times (for manufacturers), it was the age of wisdom (at the Federal Reserve), it was the age of foolishness (the trade war).

2019 played out to be a year of extreme dichotomy in the U.S. and to a lesser extent the rest of the world. On the one hand, consumer confidence remained high and consumers continued to spend their growing wages, thanks to extremely low unemployment and rebounding real estate activity. On the other hand, the manufacturing sector fell into recession during the year as the global slowdown spread and intensified, and trade tensions continued to beat down manufacturers’ confidence (see Chart 1). To counteract the slowing economy and prolong the economic expansion, central banks worldwide provided huge amounts of monetary stimulus by cutting interest rates. The U.S. Federal Reserve cut policy rates three times in 2019, helping to right the inverted yield curve and, so far, appearing to have successfully avoided an economic hard landing. Likewise, a total of 35 central banks globally eased monetary policy in 2019.

Despite the diverging trends between the robust consumer sector and weakening manufacturers, global equities reached new highs in the fourth quarter, but not without significant corrections along the way each time trade tensions intensified (see Chart 2, next page). Hand in hand with every equity market sell-off in 2019 came a wave of bond-buying that sent yields lower, reflecting the destabilizing conditions caused by deteriorating trade flows. 2019 was certainly a year of alternating “risk on” market action followed by “risk off” action, and trade was the catalyst for each of the reversals.

That Was Then, This Is Now
Even though the U.S. and China seem to have reached an agreement on the first phase of a bilateral trade deal, ongoing protectionism and trade conflict will be a very large, dark cloud hanging over the global economy. In early 2018 we wrote about the risks to the global economy posed by the impending trade war (War! What Is It Good For?). Since then, we’ve witnessed extreme market volatility whenever tensions heat up, with the U.S. and China as the epicenters of volatility. But these market risks have spread to the rest of the world as well. With every tariff threat, so-called risk assets (commodities, junk bonds and stocks in general, but especially cyclical stocks) have sold off with a rotation into defensive stocks, government bonds, gold, and cash. Any easing or outright resolution to this tit-for-tat tariff-slinging could push risk asset prices higher, as business confidence and the outlook for corporate earnings improves.

2020 will be a pivotal year in the future path of economic performance and associated asset allocation decisions. The U.S. presidential and congressional elections will be a key turning point to determine which way the trade winds blow. The two principal combatants in the trade war — the U.S. and China — have the most to gain or lose. But as they are the two largest economies in the world, the future trajectory of their economies will also have a global impact.

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**Chart 1: Buoyant Consumers & Sinking Manufacturers**

[Graph showing consumer and manufacturer confidence indices with annotations for data visualization]
Re-election of President Trump would embolden the White House. A second term would be seen as a green light to maintain or even intensify the trade war. On the other hand, should the White House turn blue in November and trade negotiations return to a more conciliatory tone and tensions simmer down as tariffs are unwound, there’s likely to be a stimulative effect on risk assets. That’s not to say that each of the Democratic nominees becoming president would have identical economic and market results, only that a blue president would reduce the single greatest economic risk linked to trade disruptions. In fact, as we consider potential November 2020 outcomes, we are indeed analyzing differences among potential Democratic victors, where they each fall on the liberal/conservative scale, and in turn the likely policy initiatives and associated economic impact and market repercussions.

Of course, November 2020 will also bring important congressional elections, with 35 seats in the Senate up for grabs along with the entire 435 seats in the House of Representatives. There are several combinations of a divided government that we can foresee next year, with the only certainty being that any divided government, which we consider to be a high-likelihood event, will result in congressional gridlock.

Meanwhile in the background of all these political outcomes and related risks, we are in the 11th year of an American economic expansion, which is the longest in history and looking increasingly wobbly. Similarly, the global economy has seen positive growth since the end of the Great Recession in 2009. Equities are very expensive globally, and especially in the U.S., highlighting the vulnerability to these risks. For these reasons, we continue to focus clients’ equity exposure on well-run companies, with strong balance sheets, which should be relatively protective during market volatility. Likewise, we are focused on sectors which also provide relative safety during market corrections. In addition, we are holding larger short-term fixed-income positions than we have in recent years as another form of protection.

From all of us at Zevin Asset Management, we wish you and your family a happy, healthy, and peaceful end to 2019 and hope that 2020 is filled with more of the same!

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