MARKET
Insights

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May 2019

The China Syndrome

As of this writing (May 15th), investors have not reacted well to President Trump's resumption of tariff threats toward China. The S&P 500 index is down **-3%** from the all-time high of 2,954 reached in the middle of the day on May 1st. The bond market also is registering its concern about the impact on future growth rates. Yields on the benchmark US Treasury ten-year note dropped from **2.55%** on May 2nd to **2.40%** by May 13th. This month has witnessed similar slides in foreign stocks, small company stocks and high-yield bonds.

Much Ado About a Little Thing?

The markets' current focus on the US-China trade talks strikes us as unnecessarily pessimistic. As mentioned above, US stocks have sold off by **-3%,** while rates on government bonds have fallen. This reaction follows a lot of good news recently. GDP year-over-year growth in the first quarter registered **+3.2%**, its highest rate since Q2 2015 and the third highest reading of the current expansion. Corporate earnings in the first quarter of the year ended up only **-0.5%** lower, versus consensus expectations of a **-4%** decline. Over 75% of S&P 500 companies reported positive earnings surprises, and the apparently small earnings slowdown coincided with actual sales growth of **+5.3%** for the quarter (FactSet Earnings Insight, May 10th).

We think financial markets are reacting more to the political theater of the Trump administration than to the actual economic impact of the threatened tariffs. The President's unofficial Twitter threat would raise tariffs by 15 percentage points, from **10%** to **25%**, on $200 billion of annual imported goods from China. This is akin to an additional tax of $30 billion per year on those goods, which sounds like a lot of money by itself. However, compare this figure to the $19.5 trillion US economy. With this perspective, the potential tariff effect is similar to that of a family earning $195,000 annually and facing a $300 increase in their property taxes.

Bumps In The Road: Market Returns Year-To-Date in 2019

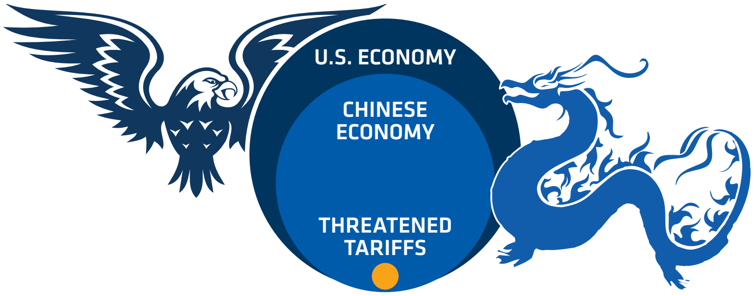
Asset Class	Market Index	January - April Return	May 1 - 15 Return
US Large Cap	S&P 500	19.3%	-3.0%
US Small Cap	Russell 2000	19.4%	-3.1%
International Developed	MSCI EAFE	13.6%	-2.6%
Emerging Markets	MSCI EM	12.6%	-6.1%
US Investment Grade	Barclays US Agg	3.2%	0.8%
Municipal	Barclays US Municipal	3.3%	1.0%
US Inflation-Indexed	Barclays US TIPS	3.7%	0.5%
US High Yield	Barclays US Corporate High Yield	9.0%	-0.7%
Absolute Return	Credit Suisse Equity Mkt Neutral	1.6%	n/a
REITs	MSCI US REIT Diversified	16.3%	2.3%
US T-Bill 90 day	US T-Bill 90 Day	1.0%	1.0%
Averages		**9.8%**	**-0.8%**

Source: Morningstar database, as of May 15, 2019. Total returns in US dollars.

MARKET Insights

That is not a calamitous outcome and doesn't merit marking down one's net worth by 3% or more. Likewise, $30 billion of additional tariffs is not a doomsday outcome for the $12.2 trillion Chinese economy. The threatened tariff amounts are rather trivial in light of the overall economic activity that surrounds them. (As of this writing, the US and Chinese trade representatives are still in negotiations).

Size of Threatened Tariffs vs. US and Chinese Economies



Sources: Bureau of Economic Analysis, US Dept. of Commerce, International Monetary Fund. Based on stated additional tariff of 15% on $200 billion of goods.

Conclusion – The Path Forward

Prior to this month's selloff, the environment for stock investors seemed calm. After a somewhat harrowing ride in 2018, markets zoomed upward in an almost straight line. This seemed to have left investors very complacent by the end of April. While the current bout of volatility is uncomfortable, it does not indicate the kind of outright panic that we saw last fall or in the fall-winter of 2015-2016. We based this assessment on the fact that the CBOE VIX index (a common measure of stock market volatility) has failed to close above 30 this month. Readings well above that level indicate market expectations that stock prices will vary by at least +/- 30% over the coming year. We are not there yet.

We believe an episode of profit-taking could be helpful to long-term investors for a few reasons. It would discourage Johnny-come-lately investors that chased performance following the first quarter. Market volatility tends to punish investors that had piled into the more speculative companies during the previous rally. These kinds of short-term investors (often more machine-driven than human) have the least conviction and can make markets unstable in the short-term. After the pace of selling subsides, investors with cash to reinvest may find attractive prices for positions that would benefit significantly in the next market rally.

We continue to expect that the surprises for investors will be to the upside this year. We view the environment as a time to seek opportunities, use periods of market declines to rebalance portfolios and add to stock holdings where appropriate.

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