Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

Investment Outlook, June 2019

The financial markets were shocked by renewed trade tensions on two fronts in the last month, as bond yields collapsed and the S&P 500 Index fell 6.5% from its April 30th high.

Hopes for a successful conclusion to U.S. – China trade negotiations were dashed when China (apparently) reneged on previously agreed to policy reforms, setting off a new round of U.S. tariffs and Chinese retaliation. An agreement between the world's two largest economies, once considered likely, now seems further away than ever.

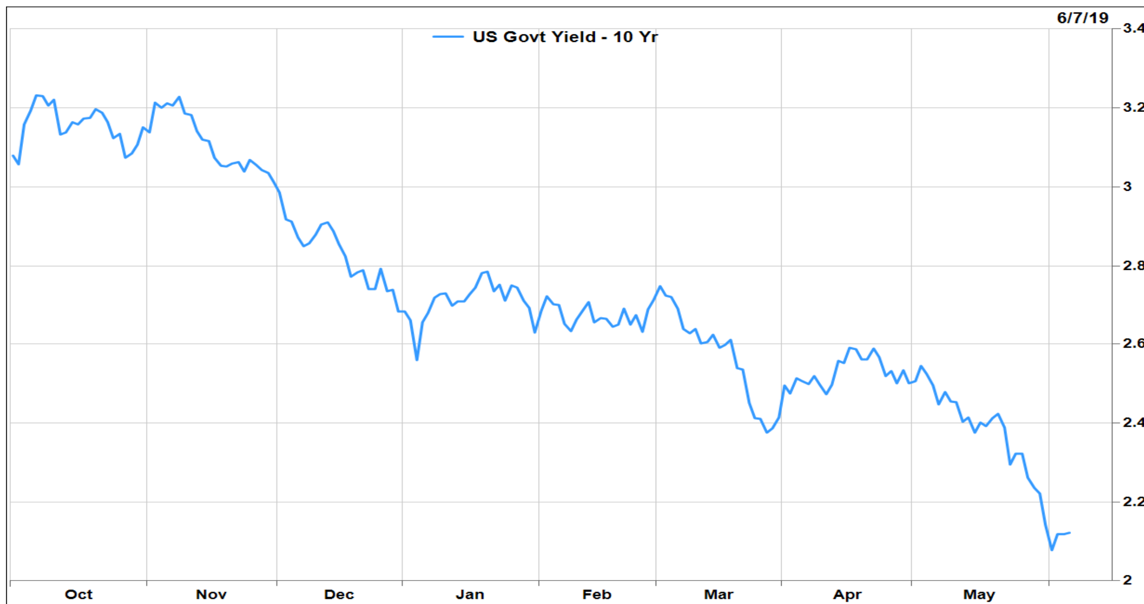
Following this development, President Trump announced the imposition of new tariffs on Mexico, in response to his ongoing concern over illegal immigration on our southern border. Mexico is almost as large a trading partner as China, and this action would have resulted in serious economic pain to U.S. consumers and manufacturers alike. The President has since rescinded this threat, but the idea that completed trade deals might suddenly be reopened for non-trade reasons adds another element of uncertainty for businesses and the markets, alike.

Thus far, the escalation of trade tensions is having a much bigger effect on the financial markets and oil prices than on the real economy. That said, there is clear evidence that global growth has slowed following a solid first quarter. The U.S., in particular, has seen a sharp drop in manufacturing data. The Institute for Supply Management (ISM) manufacturing index fell to a 31-month low in May, and is now at a level consistent with GDP growth of only 1.5%, annualized. Meanwhile, construction spending was unchanged in May, but only because state and local government spending on roads and infrastructure offset a decline in private construction.

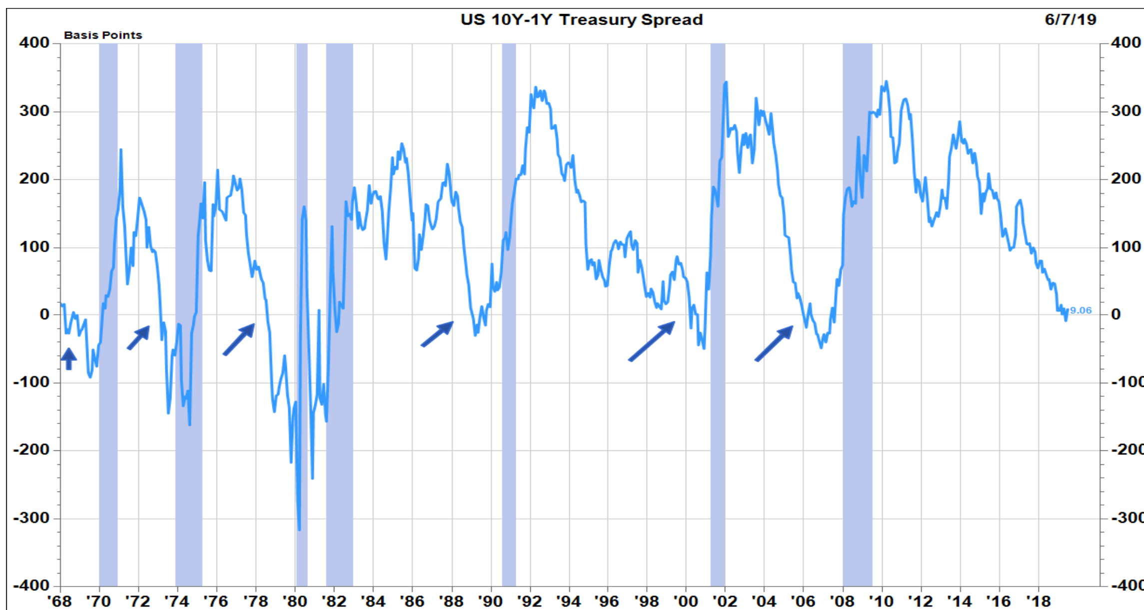
Further signs of slowing economic growth were seen in the May employment report which was just released. It showed that the economy added just 75,000 non-farm jobs in May, less than half of the average employment gains over the prior three months. Adding to the negative tone of the report, the 75,000 gain was exactly offset by downward revisions of an equal amount to the March and April reports.

That GDP growth both in the U.S. and globally would decelerate in 2019-2020 has long been forecast and factored into interest rates and equity valuations. But those forecasts were generally predicated on the successful completion of a new U.S. trade agreement with China. Now, with both countries hardening their stances, it is estimated that further escalation in the U.S. – China trade war is likely to leave global GDP growth 0.5% lower than it would have been otherwise. That represents a significant hit to a global economy that had been expected to slow to a sub-2% growth rate even before the most recent escalation. It also represents a significant risk for corporate earnings for the rest of this year and 2020, at a time when the equity market is still within 2% of its all-time high.

In response to lower growth forecasts, the U.S. Government bond yield (chart, below) has plummeted to below 2.1%, 50 basis points less than it was a month ago and more than 110 basis points below last October's level, when economic growth was peaking.



More significant is the fact that the 10-Year rate, which reflects economic growth expectations, briefly fell below the 1-Year rate (chart, below), which largely reflects the



Federal Reserve's tightening policies as evidenced by nine increases in the Fed's target rate between December 2015 and December 2018. The chart shows that there have been seven economic recessions (shaded areas) since 1970, and each of them were preceded by an "inversion" of the yield curve, wherein the 10-Year rate had fallen below the 1-Year rate. The current inversion is a recent phenomenon and is not yet as deep or persistent as

prior inversions. It should also be noted that past inversions have occurred months or even years before the onset of a recession. But the current condition should clearly signal to the Federal Reserve that it needs to change course and lower short term rates soon to avoid turning the current economic slowdown into an actual downturn.

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