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MARKETS

Markets Send Mixed Signals on Trade Battle

Stocks approach records while bonds show caution; Fed hints at rate cut

Relatively risky assets like stocks have continued to climb toward fresh highs. Here, a trader works on the floor of the New York Stock Exchange earlier this month. **PHOTO:** DREW ANGERER/GETTY IMAGES

By Akane Otani and Gunjan Banerji

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Markets are sending conflicting signals about how big a threat the global trade rift presents, underscoring the difficulty investors face in sizing up the fallout from the U.S. and China's spat.

As the trade standoff has intensified and the Federal Reserve has suggested its next move might be a rate cut, some investors have turned to safer assets, sending Treasury yields to their lows for the year. But relatively risky assets like stocks have continued to climb toward fresh highs, with the S&P 500 finishing Friday just 2% off a record.

Investors also haven't rushed to take out protection in the options market against potential declines—a somewhat unusual development, since stocks tend to fall alongside bond yields when investors believe the economy is heading toward a soft patch. Yields fall as bond prices rise.

One yardstick measuring stock swings, the Cboe Volatility Index, has fallen 40% in 2019, on pace for its biggest annual decline in a decade. Volatility measures tracking crude oil and currencies have also dwindled this year.

The disconnect between markets points to lingering debate among investors about just how much the U.S. and China's trade fight will hit consumer spending, investment and other key drivers of economic growth.

"Who's right? I want to go with the bond market at this point," said Zhiwei Ren, a portfolio manager at Penn Mutual Asset Management. "I don't see equities making significant new highs."

Mr. Ren has bought shorter-dated bonds in anticipation of the Fed cutting interest rates. He added that he doesn't see a trade truce between the two largest global economies coming soon.

The Fed will conclude a two-day policy meeting Wednesday, where it is expected to hold interest rates steady and potentially offer clues about the likelihood of future rate cuts.

Although the central bank had at the end of 2018 signaled it was likely to raise rates this year, it has since retrenched. Fed Chairman Jerome Powell in early June said the central bank could cut rates if the trade spat causes a deterioration in the economic outlook. Now, investors have priced in a roughly 30% chance of two rate cuts and about a 38% chance of three rate cuts by the end of the year, according to CME Group, up from 24% and 6% respectively in mid-May.

With the Fed hinting it is willing to step in and cut interest rates if necessary, some investors say it is still too early to slash bets on U.S. stocks. That is especially true because economic data haven't shown a recession on the horizon: The Labor Department's latest employment report showed that the U.S. jobless rate hovered at a half-century low, though the pace of hiring slowed. Corporate earnings are also expected to grow at a single-digit percentage pace this year overall, according to FactSet—a slower pace than in 2018, but not the rollover that some had feared heading into the year.

The Fed's posturing shows "they're not asleep at the wheel," said Jim Tierney, chief investment officer of concentrated U.S. growth at AllianceBernstein. Mr. Tierney's fund, which holds large positions in shares of companies like Microsoft Corp. and Mastercard Inc., has risen 25% this year—outpacing the S&P 500's 15% gain. "What that does is it takes the disaster scenario for equities off the table."

Still, others warn it may not be wise to assume that trade tensions will have a limited impact on consumers or to bet that the Fed will slash rates.

"We have an idea of how tariffs will affect inflation and GDP, but what's uncertain is how does that impact companies, consumers and stock volatility…and that's where we come into a lot of uncertainty," said Saira Malik, head of global equities at Nuveen, which has been trimming exposure to risky assets since the U.S. stock market rallied in the spring.

Commerce Department data in May showed even though U.S. economic growth was robust in the first quarter, consumer spending slowed. A measure of U.S. household sentiment also fell in May from earlier in the month, weighed down by expectations of increased tariffs pushing prices higher.

"There are significant headwinds that markets aren't pricing in," said Alexis Crow, who leads PricewaterhouseCoopers's geopolitical investing practice.

Nervousness has showed up in the bond market, where investors have been placing bets on interest rates falling. The yield on the 10-year Treasury note has fallen this year and settled at its third-lowest level of 2019 on Friday.

Bond funds investing in relatively safer debt recently recorded strong inflows, according to Deutsche Bank AG. Investors also ramped up bullish bets on eurodollar futures, a derivative used to bet on central-bank moves, increasing positions that pay out if rates fall, according to the firm.

Either way, many feel the current disconnect between the bond and stock markets is unsustainable. Fresh economic data ahead could spur one market to converge with the other.

"This divergence cannot last," said Mandy Xu, an equity derivatives strategist at Credit Suisse Group AG .

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