Market Commentary

June 30, 2018

Talk of "Trump's Trade War" has dominated business and financial headlines for much of the quarter. Despite gloomy predictions of a tariff-induced slowdown, US stocks continue to rally. In addition, the current consensus estimate for Q2 GDP is approximately 4%, which would be the highest quarterly rate of growth since 1990. Given this apparent strength, it's no surprise that inflation, virtually nonexistent for the past several years, is rising again. The Core Personal Consumption Expenditure Index (Core PCE), the Fed's preferred measure of inflation, is now at its highest rate of annual growth since 2012. So while "trade war" headlines have garnered massive attention, we see very little evidence, so far, that tariffs are having an appreciable impact on US markets. (The lone exception is soybeans, which have declined about 15% since the end of May.) The global market disruptions we are currently seeing, primarily in Emerging Markets and China, are more likely tied to the strength of the dollar, and economic weakness in Europe and China.

Early in Q2, US Treasury yields moved higher in this environment of strong growth and rising inflation. In late April, the 10-year US Treasury yield pierced the 3% level for the first time since December 2012. Then in May, the 10-year reached a seven-year high of 3.11%. However, yields moderated for the balance of the quarter, closing at 2.86%. The Barclays Aggregate Index returned -0.2% in the quarter, and is down 1.6% YTD.

After a small negative return in Q1, the S&P 500 resumed its upward march in Q2. For the quarter, the S&P 500 was up 3.4%; YTD, the index is up 2.6%. Technology (7.1%), Consumer Discretionary (8.2%), and Energy (13.5%) stocks were the primary drivers in Q2. Technology continued to lead the market, accounting for about one-half of the S&P's total return in Q2. On the other hand, Financial (-3.2%) and Industrial (-3.2%) stocks were the laggards. The Small Cap Russell 2000 index hit a new all-time high in June. Investors have flocked to small cap stocks as a safe haven from "trade war" fears. The revenues of smaller US companies come primarily from US-based customers, insulating their operations from international tariffs. The Russell 2000 returned 7.8% in Q2.

It's important to point out that the powerful stock market rally we're witnessing is extremely narrow, largely driven by the performance of a handful of very large market cap stocks. The so-called FANG+ stocks, Facebook, Apple, Amazon, Netflix, Microsoft, and Google, have pushed the S&P 500 up 2.7% since November 2017. The remaining 494 S&P stocks are DOWN 0.4% over that time. The six FANG+ stocks account for nearly $4 trillion in market value, which is larger than the British stock market, the 5th largest in the world!

While the US economy is firing on all cylinders, the rest of the world is most certainly NOT. Beginning in February, many European economies showed signs of dramatic slowing. In addition, a more hawkish Fed, higher US rates and a stronger US Dollar combined to put a great deal of strain on Emerging Market economies. Many of these countries have US Dollar denominated debt to service, and better growth prospects in the US causes capital flight from these emerging economies, weakening their domestic currencies. Finally, slowing growth in China and trade war fears have caused both the Chinese stock market and currency to plummet. Chinese stocks are down 20% from their 2018 high water mark.

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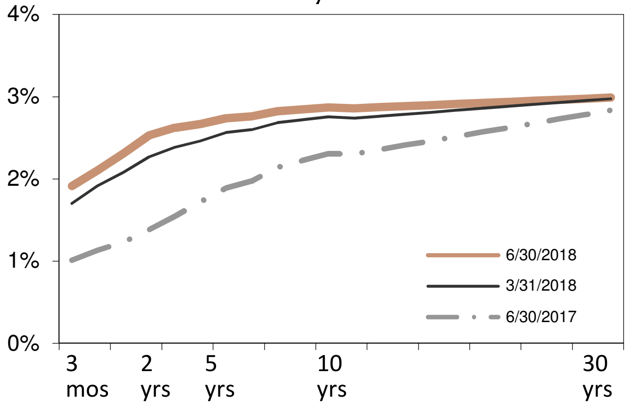
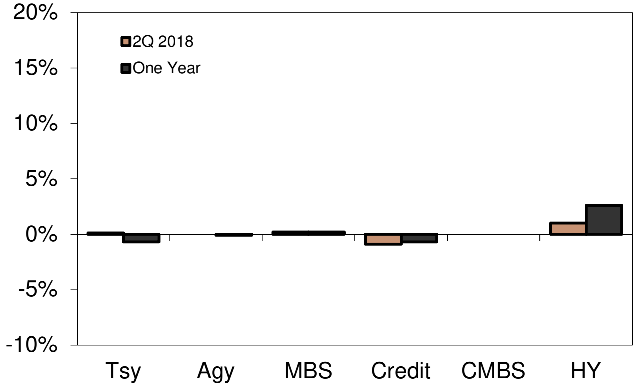
US Treasury Yield Curves



Sector Index Returns



As the Fed has raised the federal funds rate six times in 18 months, we've witnessed a pronounced flattening of the yield curve. As recently as February, the yield of the 30-year US Treasury bond was 1.1% greater than that of 2-year Treasury note. That difference has narrowed to less than 0.4% today. Curve flattening is common during a Fed rate hike cycle as the Fed raises short-term rates, slowing the economy, which in turn dampens long-term rates which are primarily influenced by inflation expectations. If the curve were to invert (short rates higher than long rates), that would be an ominous sign as every recession of the past 60 years has been preceded by an inverted yield curve. The Fed must strike a delicate balance between keeping inflation in check, while not tipping the economy into recession.

Surprisingly, despite US economic strength and percolating inflation, longer term US rates have barely risen. Remember, long-term rates are determined largely by expectations for economic growth and inflation. We believe the biggest variable keeping a lid on long-term US interest rates is Europe. The EU economies have slumped badly since early this year. With China also faltering, investors have questioned the ability of the US economy to power along on its own, especially given the increasing hawkishness of the Fed. If Europe were to find its economic footing (and there are preliminary signs that this is occurring), we would expect to see long-term US rates move higher. The European Central Bank (ECB) has been slowly withdrawing the massive stimulus programs put in place in response to the Great Recession. Bianco Research has published some interesting data showing a very high correlation between US 10-year rates and expectations for ECB interest rate hikes. Currently, markets are expecting the ECB to begin raising rates in December 2019. However, we think it's possible that ECB could decide to move sooner, perhaps as early as next summer, in response to better EU growth prospects. If that's the case, US rates would likely move higher, and US stocks could benefit from a resurgent Europe.