Market Commentary

June 30, 2019

Well, somebody is going to be wrong. In early July, the S&P 500 set a new all-time high, signaling that the US economy is firing on all cylinders and corporate earnings are sturdy. Meanwhile, the bond market had a tantrum (in the form of falling interest rates and an inverted yield curve), demanding that the Fed cut rates to avert a recession. If the stock market is correct, bond yields will eventually move higher and the curve will steepen. If bond traders prove to be more prescient, a recession is likely and stocks will take it on the chin.

While stocks and bonds appear to have different opinions on the state of the economy, there is one thing that both markets agree on: the Fed will cut the federal funds rate at the next FOMC meeting in late July. This is likely to mark the beginning of an easing cycle that will, based on current market pricing, drop the funds rate by nearly 1% over the next year. Many are wondering, with stocks near all-time highs and the unemployment rate near 50-year lows, why are interest rates so low and why is the Fed about to embark on an easing cycle? It's a good question, and we'll touch on that in a moment.

In April, stocks moved higher, building on the strong Q1 equity rally. Through April, the S&P was up over 18% YTD. However, the stock market's hot streak screeched to a halt in May as the trade wars heated up. In addition to the on-going trade dispute with China, the US threatened to slap tariffs on Mexican imports if Mexico failed to halt the flow of migrants to the US. The markets did not appreciate this development, and stocks were hammered. However, dovish Fed-speak fueled a powerful rally in June, erasing all of May's losses and propelling the S&P 500 to a new all-time high in July. The S&P 500 was up 4.3% in Q2 and 18.5% YTD.

In Q2, Growth stocks (4.6%) again outperformed Value (3.8%). Small Cap stocks had a rough quarter (2.1%), trailing their Large Cap brethren (4.3%) by a wide margin. Financials (8.0%), Materials (6.3%) and Technology (6.1%) were the clear winners in Q2. Only one S&P 500 sector had a negative return in Q2: Energy (-2.8%), due to declining crude oil and natural gas prices. Among International equities, Emerging Markets (0.6%) badly lagged both Developed International Markets (3.7%) and US domestic stocks in Q2.

The 10-year US Treasury, after flirting with the 2.6% yield level in April, plummeted for the balance of the quarter, ending Q2 at 2.0%. This massive rally led to the highest first half return for the Barclays Aggregate since 1995. The Aggregate was up 3.1% in Q2 and 6.1% YTD. A bond rally of this magnitude is typically associated with economic weakness, but the US economy has been quite strong, leaving many market watchers scratching their heads. We believe the answer for the low level of US bond yields and the Fed's dovish turn can be found across the pond, in Europe and Japan.

In June, outgoing ECB president Mario Draghi surprised investors when he announced the possibility of further interest rate cuts and the resumption of its quantitative easing program of bond purchases. Only six months ago Draghi had ended bond purchases, proclaiming that Europe had turned the corner, avoiding recession and was on the path to sustainable growth. But this rosy assessment was soon proven false. Given the fragile economic state of some EU member countries, the ECB must do everything in their power to avert a recession which could push some countries into an economic death spiral. Interest rates across Europe plummeted on this news, causing the amount of global debt with negative yields to soar past the $13 trillion mark!

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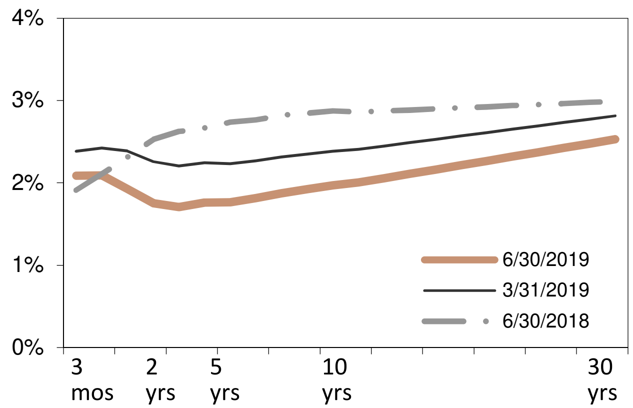
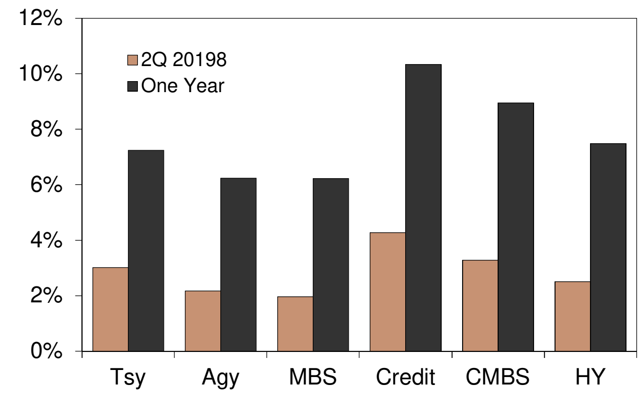
US Treasury Yield Curves



Sector Index Returns



We must remind ourselves that the US is part of a global economy, and in many ways, the Federal Reserve is the world's central bank. Fed monetary policy decisions have enormous implications across the globe. Currently, the US federal funds rate is at 2.5%, a low rate by US historical standards. However, 2.5% is higher than the yields on 99% of all foreign government debt in the world! The federal funds rate is clearly at an extreme level relative to the rest of the world. That is why the US Treasury yield curve is inverted and why the Fed has to cut rates. Jim Bianco, a well-known market strategist, has a rule-of-thumb regarding Fed interest rate moves: "The Fed decides when to hike (rates) and drags the markets along kicking and screaming. The markets decide when to cut (rates) and drag the Fed along kicking and screaming." The latter scenario is certainly playing out now. World interest rate markets are forcing the Fed's hand, demanding interest rate cuts, and more stimulative monetary policy is on the way.

With world central banks once again unanimous in their desire for stimulative policy, look for the monetary spigots to be turned wide open and for financial assets to benefit. "Don't fight the Fed" is sage advice in this climate, and, despite their lofty valuations, stocks are likely to be well bid. In our fixed income portfolios, we continue to tactically adjust portfolio durations to take advantage of anticipated interest rate changes. Currently, our client portfolios have average maturities slightly longer than their respective benchmarks. We continue to believe that the US economy is on solid footing, but interest rates should remain low in the near term due to loose Fed policy. However, long-term rates are likely to drift higher later in 2019 as inflation pressures build. Given the massive rally in risky assets, we do not believe investors are receiving adequate compensation for holding lower-rated corporate bonds. Thus, we are underweight exposure to BBB-rated bonds, the lowest rated debt in the investment grade credit sector.