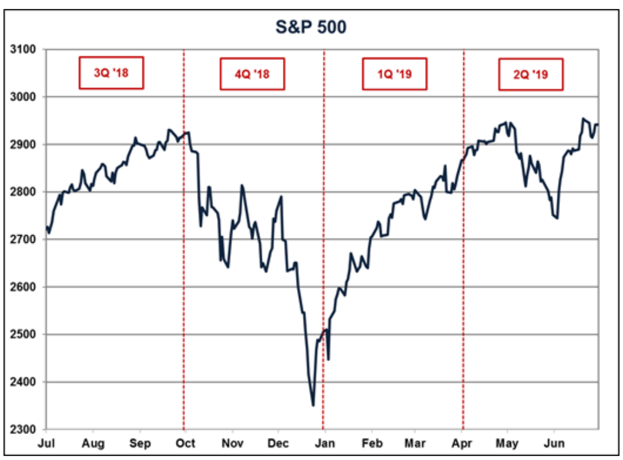
ECONOMIC & MARKET REVIEW

Second Quarter 2019

Following a great first quarter, the S&P 500 continued to power ahead, rising 4.3% for the quarter. Not to be outdone, bonds were up also with the Bloomberg /Barclays aggregate gaining 3.08%. In fact, it was a clean sweep in performance for the quarter as all major market returns – stocks and bonds – were positive. The only international equity market that posted a significant decline was the China A-Shares on the Shenzhen Stock Exchange (SZSE).

Q2 and Year to Date Investment Performance

	Second Quarter	Year to Date
S&P 500	+4.30%	+18.54%
Russell 2000	+2.10%	+16.98%
Barclays Agg.	+3.08%	+6.11%
MSCI EAFE	+3.68%	+14.0%
MSCI EM	+0.61%	+10.58%



Source: Factset Research. As of 6/30/2019

The last six months: "Think that was interesting? Here...hold my beer."

To say that it was an unusual six months doesn't quite cover it. To kick start the New Year, the Federal Reserve reconsidered their opinion that raising rates was the appropriate policy to keep the economy humming only a few weeks after the highly criticized December 2018 rate hike. Based on the Fed's January epiphany, the market reversed course and rallied. Virtually overnight, expectations changed from anticipating several 2019 rate hikes to multiple rate cuts. Meanwhile, President Trump threatened the Mexican, Canadian and Chinese governments with tariffs. For good measure he added the European Union because of their high tariffs on U.S. automobiles vs. our relative low tariffs on Euro area autos. Despite all of the saber rattling and additional tariffs on the Chinese, the S&P 500 had a tremendous start to the year, soaring 18.54% in the first six months.

"What, me worry?"

For those of you old enough to remember Mad magazine's lead character, Alfred E. Neuman and his "What, me worry?" tagline, the mood right now feels somewhat like that with the S&P 500 hitting another record high. While there is much to be encouraged about, I still have a worry list, so let's start with that. Top of mind for me is the negative trending global manufacturing data. The best way to measure this is to review the purchasing managers market indexes. In the U.S., the Institute of Supply Management compiles and releases monthly survey data collected from individuals who are purchasing managers and those who buy raw material and parts to fulfill company product needs. These survey results are a good early indicator of manufacturing activity. The indexes are designed so that any number above or below 50 indicates an expansion or contraction. Taken as a whole, we can get a good sense of the direction of manufacturing around the globe. The U.S. PMI index for June 2019 was 52.1, down from 56.6 in January – weaker, but still in expansion mode. But international results are not as positive. There are 19 countries with PMIs below 50, including Germany, Mexico, Ireland, Italy and Japan. The global PMI is in its longest losing streak of its more than 20-year history.

Tariffs are not the whole story, but they are having a negative impact on general economic conditions.

Manufacturing decline could dampen earnings
The decline in manufacturing forecast by these PMIs will have negative implications for earnings, not for all companies, but perhaps enough to hurt markets in the back half of the year. Globally, the rise in equity markets has come with expanding PE multiples. In the meantime, earnings have been declining, putting markets in a bind. Thankfully, in the U.S. the challenges are not as difficult, but the slowdown in manufacturing ultimately will affect earnings here, as well. Earnings per share growth estimates in the U.S. are 3.6% for the rest of this year and 10.9% for 2020 – which may or may not be too optimistic. At least it is worth considering.

Continued yield curve inversion could be a problem
Another item for the worry list is the $13 trillion in negative yielding foreign sovereign debt. Additionally, in the U.S, the 3-month to 10-year yield curve is inverted, with the 3-month yield at 2.50% and the 10-year yield at 2.00%. The longer this stays inverted – where short-term yields are higher than long-term yields – the more important and worrisome it becomes.

Considering the upside…
Now for the encouraging news. At the top of the list is employment in the U.S. The unemployment rate is at 3.6% and the weekly unemployment claims number is near a 50-year low. Wage growth, while still subdued, is clearly moving up, which means that consumers (who represent about 70% of the GDP) are working and seeing modest wage gains. In addition, confidence surveys show the consumer as positive and upbeat. Along with all other rates, mortgage rates have declined, and a 30-year mortgage can be found for below 4.00%, a boost for home buying. GDP growth for Q1 was a relatively robust 3.1%. Growth will slow as we work through the second half of the year, but from a solid start. Post the 2008 meltdown, financial institutions are in very good shape. Earnings have been good and most importantly for safety reasons, capital positions are hefty, so the country's financial backbone is solid.
Finally, Federal Reserve policy looks to be more neutral to positive for the economy for the remainder of the year. I expect to see a 0.25% rate cut announced on July 31. My concern is that some expect to see a 0.50% cut, so there could be some disappointment if it's "only" 0.25%. Economic data is important for the pace and degree of rate cuts in the offing. Better data means fewer rate cuts while weaker data means more aggressive cuts. Inflation is low and declining. The Federal Reserve has two mandates – a stable labor market and stable inflation. They can check the first box, as employment is a strength of this recovery. However, the Fed has failed to meet its second objective as inflation has consistently been lower than their goal. So, how do you argue that rates should be *cut* when the equity market is at an all-time high, interest rates are low, and consumer confidence is elevated? Answer: Inflation is still below the Fed Reserve target, after 11 years of rate cuts and quantitative easing. They have not been able to hit the inflation target. They have said they would accept a period of higher than target inflation to offset the years of below target inflation. The problem is they have struggled even to get to the target (2% core Personal Consumption Expenditure), which stands at 1.6% year over year.

Equity markets warrant some caution
It seems to me you should have a cautious attitude toward the equity market. Trade issues will continue to grind on growth around the globe. The opportunity for increasing earnings seems unlikely today and weak or declining earnings cannot be totally dismissed. A cautious position regarding equities does not mean wholesale selling. If you are an equity investor, you are by definition a long term investor, don't forget that. Both the economy and risk markets will cycle through stronger and weaker periods. I think we are entering a weaker period that should call for slightly lower equity weighting. I will finish by saying I do not think a recession is near. The Federal Reserve is about to start lowering rates, inflation is not a problem, no bubbles exist like the housing bubble in 2008 and credit spreads are well behaved. The only indicator indicating recession is the inverted yield curve.

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Disclosures

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All data presented is as of last quarter, unless otherwise noted.