AMB Newsletter
3rd Quarter 2019

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Second Quarter 2019 Review

A January Redux? In the fourth quarter of 2018, the Federal Reserve intervened when markets entered a correction, pushing risk assets higher throughout the first quarter of 2019. However, economic data continued to improve throughout the first quarter which once again instilled fear in the markets that the Federal Reserve may not keep their dovish stance. As we entered May, the markets sold off heavily with the S&P 500 dropping 6.35% on economic strength worries. It seems counterintuitive, but good news once again turned into bad news for risk assets. In June, weaker global economic data came to the rescue, giving the Fed and the European Central Bank (ECB) cover to swoop in and indicate monetary stimulus was on the way. This drove assets across the board higher in June turning a down quarter into a solid one.

US equity markets, measured by the S&P 500, finished the quarter up 4.31%. YTD returns for the S&P 500 now stand at 18.54%. Financials led the market higher with a return of 8% for the quarter. This was a major turnaround after being one of the largest laggards in the first quarter. The move was driven by stress test results that will allow higher payouts along with forecasts of a steeper yield curve. Information Technology was the top contributor and was responsible for 129 bps of the upside return. The overall return from the market has been broad based with all 11 sectors trading higher on the year. The only sector down for the quarter was Energy posting a return of -2.83%. Health care lagged once again as it continues to face scrutiny over drug pricing.

International developed equities trailed the US market for the quarter. Our international counterparts posted a combined return measured by the MSCI EAFE of 3.97% which was slightly lower than the S&P 500 for the quarter. For the past year, we have written that international markets may not be as cheap as they appear based on their recent economic slowdown. This has come to fruition as Eurozone economic growth continues to slow, causing us to lower our current expectations of their equity markets going forward. In the first quarter, the Eurozone GDP came in at .4% better than expected but still weak. This put GDP growth at 1.2% year over year which is well below the 2.6% posted in 2017. Future economic growth in the EU has also been downgraded with economists now expecting 1.6% for 2019. We expect that number to be closer to 1%.

Emerging market equities were positive on the quarter but trailed their developed counterparts. Emerging Markets, measured by the MSCI Emerging Markets Index, was up .74% for the quarter bringing its total to 10.78% for the year. This is 800 bps behind the US market. The same factors that plagued Emerging Markets at the end of the year are still in play. As we said last quarter, "We do not expect emerging market strength to occur until we begin to see a real weakness in the US Dollar or growth around the globe starts to show signs of life. For now, we would rather be invested in the US equity markets." We have begun to see some weakness in the dollar as monetary policy has loosened but not enough to make a difference. China's economy continues to slow with the rest of the world; and until we start to see this turn, we believe the US markets are the best place to be.

Second Quarter 2019 Review (continued)

Interest rates continued their downward move during the second quarter as economic hard data continues to disappoint and Central Bank policies continue to become more dovish. In the US during the third quarter of 2018, Federal Reserve president Jerome Powell commented that monetary policy regarding rate hikes and balance sheet reduction was on autopilot. After the equity markets return of -13.52% in the fourth quarter of 2018, the Federal Reserve's tone changed to a more dovish stance. The tone was confirmed once again at the June meeting after a terrible May. The market is now pricing in three rate cuts between now and the first quarter of 2020. The ECB has also taken a more dovish position recently. The ECB president Mario Draghi hinted once again at cutting rates and restarting their bond buying program and stated last month that the ECB was willing to do whatever it took to spur economic growth and increase inflation. This recent dovishness from central banks across the globe has pushed $13 trillion in global debt to a negative yield. As one would expect, fixed income markets have done well with most government bond indices posting returns above 5%.

3rd Quarter Outlook

Economy (Global)

When we think of the current global economic situation, one word comes to mind and that is uncertainty. This uncertainty is mostly driven by ongoing trade disputes between the US and other global powers. However, even with this uncertainty, our prediction from the beginning of the year still holds true, "Slowdowns in the second half of the year in China, Japan and the Eurozone definitely spiked concerns of an impending global recession. This fear was wide ranging and could be seen in markets across the globe. For 2019, even with the recent global weakness, we expect the global expansion to continue, led by US growth." So far, our assessment has been precise. US growth surprised to the upside in the first quarter posting GDP of 3.1%. The Eurozone beat expectations at 1.2%, Japan posted a better than expected 2.2%, and China also exceeded expectations at 6.4%. Despite ongoing concerns, the global expansion has continued.

Even though we expect US economic growth to continue, we are now entering our tenth year of this expansion. With the most recent data, we have seen our belief realized that we are in the late stages of the current cycle. As previously discussed, we expect to see slowing growth throughout the year. We are beginning to see some warning signs, but our key indicators remain stable. Financial conditions remain stable and inflation has remained subdued as confirmed in the recent PCE releases. We still believe the earliest we will see a US recession is the summer of 2020.

Inflationary pressures will remain our focal point with our main indicator from those releases being wage growth. With 70% of the US economy comprised of consumer spending, this metric is our favorite for obvious reasons. If we begin to see upward pressure from wages, our outlook will change. As it currently stands, the majority of World Central banks are easing as inflation has waned once again, giving them the leeway to loosen financial conditions further.

In our view, the main focus for the Global Economy should remain on China as it has contributed approximately one-third to global growth over the past eight years. Starting in 2018, China's slowing growth has been a drag on the global growth story which was brought on by increased trade conflicts with the US and tighter domestic policy. Both issues appear to be improving. Trade negotiations seem to be progressing between the two global economic powers after talks seemed to fall through in the second quarter, and financial conditions are easing as the PBOC injects liquidity into their financial institutions. We believe trade talks will progress as we get closer to 2020 due to the US's impending 2020 presidential election as trade spats hindering growth will not look flattering.

Economy Global (continued)

Central Bank monetary policy will continue to play a role in our economic projections as their role in the global economies continues to expand. Their actions have a direct impact on the money supply which can either promote or hamper growth. Going into the year, we thought that the US Federal Reserve would hike rates twice which is half the number of times the market expected at the end of the third quarter 2018. We were right on our call of the Fed being easier than the market expected, but the Fed went even further and now does not expect any rate hikes in 2019. Instead of rate hikes, the market is now pricing in three rate cuts between now and the end of the first quarter of 2020. The ECB has also taken a more dovish stance with Draghi giving his “whatever it takes speech” once again. To say Central Banks have done an about-face over the last seven months would be an understatement. Going forward, we believe the Fed will continue its “wait and see” approach to try and gauge the actual health of financial conditions; and if it seems conditions are deteriorating, they will act by cutting rates.

Politics will continue to put our economic projections in flux. It is impossible to put a number on uncertainty and the ongoing ripple effects of increased or decreased tensions. Geopolitical turmoil will continue to hang over the market in 2019, but we believe there is a light at the end of the tunnel which would be a welcome sign by economies around the globe.

US Equity Market

Equity markets had another strong quarter returning 4.31%. For the year, the market, as measured by the S&P 500, is up 18.54%. This move has been driven exclusively by multiple expansion due to the Federal Reserve’s dovish stance. With the market now expecting two rate cuts in 2019, interest rate expectations have fallen which lowers discount rates and pushes price multiples higher. In our view, for this rally to continue, we need earnings to pick up in the second half. Yes, the Federal Reserve has put a floor in, but earnings expectations are currently capping the upside.

Our positive themes from the first half of the year remain intact. We believe the global expansion will continue throughout 2019; but as we said, we expect this growth to moderate. Monetary Policy has moved from a headwind to a tailwind in the last six months. We believe the easier financial conditions will put a floor under equity valuations. Resolving trade negotiations could be the biggest tailwind for equities going forward.

While there are positives, there are still headwinds. Valuations remain extended and slowing earnings remain an issue. However, we have seen earnings expectations pick up over the past few weeks which is a positive. We will also pay close attention to profit margins. With the latest CPI report, we have begun to see inflation pressures from tariffs. Core CPI just posted 2.1%, above the mandate of 2%. As cost pressures increase, profit margins may begin to be impacted. This metric will be our main focus point this earnings season.

We continue to believe the bull market is intact; however, there is room for caution. Trade spats and other crosscurrents continue to put earnings expectation and global growth in flux. With these ongoing issues, we believe quality companies with strong balance sheets and free cash flow are where we need to be positioned. The US equity market continues to be more attractive than the rest of the world. It’s true that Europe trades at a cheaper valuation. The reasons for this are plentiful, and we believe those suppressed valuations will continue as the Eurozone continues to slog along. We remain negative on emerging markets as well. Until the trade is resolved, EM countries are going to struggle. The UK looks attractive; but with the current overhang of BREXIT, we don’t recommend putting money there. When looking around the globe, US large cap equities remain our top pick.

Going into the second half of 2019, we believe the market will trade higher, but upside will be capped as returns have already reached a yearly level. Positive drivers to sustain this move are needed. These include looser financial conditions from the Fed, which have already started, and progress or resolution to the trade negotiations would go a long way to helping ease economic slowdown worries.

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US Fixed Income

Just six months ago, we were on the path to interest rate normalcy as the Central Banks from the US and EU were amid a tightening cycle. Since then, however, we have done a 180 and are back to monetary easing on a global scale. Interest rates around the globe have continued their downward trajectory throughout the second quarter which was driven by Global Central Bank policy. These policies have suppressed rates at historic lows. Global negative yields now stand at $13 trillion. That number is absolutely astonishing and unsustainable.

The US interest rate curve remains inverted out to ten years, but credit has remained stable. One would expect credit spreads to be blowing out wider if the yield curve was predicting that a recession was imminent, but this still is not the case. High yield has held together well after the dip it took in the fourth quarter of last year. We have been keeping an eye on coverage ratios, and they remain strong even with slowing revenue growth. Signals from the fixed income market remain mixed, and we will be watching for any deterioration in spreads.

Our views have not changed since December. We still believe it is a good time to move out of lower credit and into high quality credits. As we have seen, credit markets flashed warning signs at the end of the fourth quarter and now the yield curve and economic data are flashing yellow. With the massive amount of corporate debt on the books, a major economic downturn could turn ugly quickly. With this in mind, being in higher quality names is prudent. Another major factor is liquidity. If we get into a credit crunch, high yield markets could seize up. We still like the belly of the curve, but we are moving our duration target from overweight to neutral. The long end remains unattractive as one is not being rewarded for the increased interest rate risk that would be taken.

As always, investors should remember why we invest in fixed income. It is not the growth engine of portfolios, yet it brings stability and predictability. When using a buy and hold strategy, interest rate movements are irrelevant as we are investing for a stream of cash flows and the safety of principal (which will be repaid upon maturity as long as the bond is credit worthy). Fixed income provides diversification and stability to an inherently more volatile equity portfolio, and we feel it should play a part in every portfolio in some facet.

Conclusion

The first half of the year has been very strong. US equity markets are hitting new all-time highs while fixed income markets have provided their strongest returns in recent memory. This move has come on the expectations of looser financial conditions from Central Banks around the globe. The two most recent examples come from the US Federal Reserve and the European Central Bank. The Federal Reserve is now expected to cut rates three times in the next nine months while also stopping their balance sheet runoff in September. The European Central Bank has once again proclaimed its “whatever it takes” mantra to try and spur economic growth and inflation through interest rate cuts and bond buying. These monetary policy moves have spurred a rally in asset prices across the spectrum. Going forward, our outlook for equity markets remains favorable but our expectations have been tempered due to the rally in the first half of the year. We have also moved our duration exposure from overweight to neutral due to the massive rally in rates. As always, we will be keeping a close eye on economic, geopolitical and fundamental data; and if perceived risk begins to rise, we will act to position accordingly. Thank you for the opportunity to help you achieve your financial goals.

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