Monthly Update

April 2019

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The stock market train kept rolling on in April with an impressive 3.9% gain for the S&P 500, bringing the year-to-date increase to 17.5%, not including dividends[1]. The technology and consumer discretionary sectors continued to lead the way, as they have for most of this bull market[2]. Optimism that the Federal Reserve is not just done with its current rate hike cycle, but that it may even cut rates by year-end, has been the main catalyst for the stock market rally, just as it has been all year. Another key factor was the announced economic stimulus plan that came from China, which has helped to stabilize recent data points and has given hope that the slowdown we've seen in global trade figures this year will rebound. That, in turn, helped to lift US Treasury yields by 10 basis points in April to 2.50%, from 2.40% at the end of the first quarter[3].

This 2.50% level, however, is well below the 3.25% yield we saw last November[4]. This reflects a rather wide discrepancy between the message of the stock market, which is expressing optimism about economic growth and an earnings rebound, and the concern the bond market has shown with global economic growth, which has moderated.

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The Stock Market

The rally in the S&P 500 in April, which followed the gains experienced in the first quarter, drove the index to a record high, exceeding the previous peak seen in September 2018, which at the time surpassed the previous high in January 2018[5]. Stretching the January 2018 high thru April 2019 only has the S&P 500 higher by a total of 2.5% (not including dividends) as we, of course, had to digest the fourth quarter sell off[6]. I keep referring to the S&P 500 because other areas of the market have yet to recapture their 2018 highs. The Russell 2000, for example, is still about 10% below[7] its peak.

After this amazing start to the year, where again, we are seeing new highs for many large capitalization stocks after a difficult fourth quarter, it now begs the question of; what is next? The direction of the economic data and pace of earnings growth in coming quarters will help to guide us in determining where we go from here. Who will be right in accurately discounting the coming six months, bonds or stocks?

1. – 7. Bloomberg

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International markets have also had a great year so far as they are also benefiting from the same hopes that U.S. investors are focused on, that of a rebound in economic activity, a US/China trade deal and a friendlier Federal Reserve. The "iShares MSCI Global Stock Index ex U.S." rallied 2.8% in April, which brings the year to date gain to 13.4%[8]. Overseas markets, particularly in Europe and Asia, have lagged the U.S. significantly in this bull market and we believe there is time for catch up in performance with international valuations still very attractive.

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The Global Economy

The U.S. economy put on an impressive performance in the first quarter with a 3.2% GDP growth rate[9]. As I examined these results, I noticed that growth was more mixed. The 3.2% GDP growth rate was helped most by a build in inventories, government spending, and a rise in exports and drop in imports. Personal spending, the largest chunk of GDP, and business investment, saw a slower rate of gain[10]. Thus, we should average out the growth rate for both Q1 and Q2 to better gauge the state of the US economy. For the full year, I expect a growth rate of between 2.0% and 2.5%.

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There has been more notable slowing in overseas economies. China's economy continues to downshift and that has had a spillover effect on other Asian nations and in Europe, particularly Germany. China is Germany's largest trading partner and Germany's economy is estimated to grow less than 1% in 2019[11].

The Fed and Interest Rates

While this is an April commentary, I'm going to include the Federal Reserve news on May 1st, as they met for a regularly scheduled meeting. As stated earlier, markets have been under the belief that not only has the Fed ended its rate hike cycle, the fed funds futures market priced in a likely chance that they will end up cutting interest rates at some point before year-end. The reason for that has been the latest slowdown in the pace of gains in the Fed's preferred inflation gauge, the Personal Consumption Expenditures inflation index. In his press conference on May 1st, Chairman Jay Powell put that idea to rest and expressed his belief that the recent fall in inflation will be transitory and the Fed was not looking at cutting rates any time soon. This was the catalyst for the May 1st equity selloff and we'll see if the 'Fed trade' is now about take a breather, or not.

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9. Bloomberg
10. Bureau of Labor Statistics
11. Bloomberg

In response to the softness in economic data this year, seen mostly from foreign countries, there has been a sharp decline in global bond yields. With optimism that the Chinese economy is beginning to stabilize in response to recently announced fiscal stimulus, bond yields did rise in April. The German 10 year yield went from -.07% in March to +.013% at the end of April[12]. The Japanese 10 year yield remained negative in April, but less so by 4 basis points[13]. I do have to say that it's still very strange to be writing a minus sign in front of a bond yield. The US 10 year yield rose 10 basis points to 2.50%, but still remains well below the 3.25% level it saw last fall[14].

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Corporate Earnings

We are currently in the midst of a flood of corporate earnings announcements. From what's been seen so far earnings are coming in slightly better than expected. Historically, about 70% of companies exceed earnings estimates, as most companies intentionally lower the bar so that they can more easily beat the estimate. As of this writing, about 75% of companies are beating forecasts[15]. For the first quarter as a whole, earnings per share are estimated to be unchanged to slightly down, versus last year. Keep in mind though that comparisons are very difficult, as last year benefited from a one-time lift from the lower corporate tax rate that resulted from President Trump's 2017 tax cut.

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Of note, we are now seeing a fall in corporate profit margins, as profits are now rising slower than revenue growth. Some of this though is positive for workers, as wages are growing at a quicker pace, which is typically the biggest cost for businesses. Corporate profit margins and labor costs are highly correlated.

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Conclusion

This great start to the year has certainly helped client portfolios recover nicely from last year's late selloff. It then begs the question of 'what now'? We're not here to make any profound predictions, but I hope this letter helps you understand the different cross currents that we are continuously monitoring. Markets rarely move for a long time in a straight line, so it would not surprise us if the amazing gains experienced year-to-date take a breather and recharge in the coming months.

Either way, we always make sure to have a plan for your capital in terms of meeting liquidity needs, being appropriately positioned, and understanding that opportunities always abound.

12. – 15. Bloomberg

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