Monthly Update

June 2019

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What the S&P 500 lost in May (down 6.6%), it got back almost all of it in June (up 6.9%)[1]. The main catalyst for the rebound was the hope, and eventual confirmation, that the Federal Reserve will likely reduce the fed funds rate at their end of July meeting and possibly follow with more by year end. While this is in response to slowing economic growth, a negative, the markets see it from a glass half full perspective, anticipating that it will help stem, and hopefully reverse, the slowdown. This slowdown, which is a global phenomenon, is predominantly in the manufacturing sector, as global growth has moderated and trade uncertainties overhang business confidence.

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On the topic of trade uncertainties, Trump and Xi met at the end of June at the G20 Summit in Osaka, Japan and departed agreeing to resume negotiations. In the meantime, the feared implementation of an additional tariff on the remaining $300b worth of goods we import from China was placed on hold, which also helped brighten the mood. Trump also gave China's telecom giant, Huawei, a life line by allowing it to purchase some US tech products that don't threaten national security. Where this goes from here, of course, remains to be seen but the last batch of tariffs will stick around for now and could further impact global economic activity. Positively in June, the administration came to an immigration control agreement with Mexico and we didn't see any tariffs placed on Mexican imports.

If the global bond market could send a message about the economic outlook, it would be less optimistic than the message that record highs in the stock market is sending. The US 10 year treasury ended June at a yield of 2.00% vs the beginning of the month yield at 2.13%[2]. That 2% level is the lowest since November 2016[3]. Also dragging down global bond yields was the hint from the head of the European Central Bank, Mario Draghi, that they are considering cutting interest rates even deeper below zero. The German 10 year yield went further below zero to -.33%, from -.20% at the end of May[4].

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Taking a step back, the S&P 500 ended June just 2% higher than where it was in January 2018. We can view the stock market from this index as being in a large trading range over the past 17 months, after an impressive 2017 that rode the coattails of the corporate tax cut euphoria[5].

1. – 5. Bloomberg

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We can call this action digestion, after that performance, as we try to figure out the direction of the US economy, interest rates and trade. As for the US economy, the length of this expansion as of July is now the longest on record[6].

The Global Economy

After a good 3.1% GDP performance for the US economy in Q1, growth is expected to slow to 1.5% in Q2 according to the Atlanta Fed and 1.3% with the NY Fed's estimate[7]. Averaging the two quarters together we'll have first half growth of around 2.25%, which is similar to the 10 year trend, but a moderation from the 3% growth seen in 2018[8]. The economies of China, the rest of Asia and Europe are slowing as well, mostly due to the slippage in global trade trends, but the domestic and services side of their economies are doing better. The World Bank estimates 2019 global growth at just 2.6%[9].

Resolution of the trade dispute with China will go a long way in alleviating a lot of stress points in global manufacturing and supply chain disruptions that the trade spat is causing. We are hopeful that both sides can find common ground, but compromise is needed and the timing is highly uncertain as to any resolution.

The Yield Curve

We've talked about the yield curve as a gauge of how the bond market views the pace of economic activity and the recent inversion in parts of it cannot be ignored. This is because every recession since WWII has been preceded by an inversion. But importantly, not every inversion was followed by a recession, and we of course, hope that is the case again. The spread between the 3 month Treasury bill and the 10 year Treasury note was inverted the entire month of June and a signal we are watching very closely[10].

Earnings

The next big focus for the markets is Q2 earnings season, which begins in earnest in the 3rd week of July. The consensus estimate is for zero growth versus the same quarter in 2018[11]. Some of this is certainly the very tough comparison compared to the robust growth seen last year, but there is also an impact from moderating revenue growth and a dip in corporate profit margins.

6. National Bureau of Economic Research
7. Atlanta Fed, NY Fed
8. Bloomberg
9. World Bank
10. – 11. Bloomberg

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Most importantly with earnings season is the messaging we'll get from Corporate America and how they are maneuvering through the more challenging global economic environment. We believe those companies with more of a domestic focus to have less of an earnings impact from trade than those multinationals with substantial exposure overseas.

Commodity Prices

Last month I talked about the sharp moves in oil, copper, corn and soybeans. In June, most commodity prices, these included, traded in a tight range. What stood out, however, was the price of gold as it rallied 8% in response to expectations of aggressive Fed easing, a weaker dollar, falling real rates, and moderating economic activity[12]. The front month gold futures contract ended the month at $1,413.70 per ounce. For perspective, it topped out at about $1900 in September 2011 and bottomed in December 2015 at around $1,050[13].

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Conclusion

All year, it has seemed that the market's main focus was more on what the Fed was going to do with rates and how the US/China trade talks were going, rather than the old school analysis of markets, based on economic data and corporate fundamentals. That certainly was the case again in June. Maybe in July focus will shift back to the fundamentals during what will be an important earnings season. The bond market is already pricing in an almost certain chance of a July rate cut and we now wait for a hoped for trade agreement that will take time to consummate, if at all.

I'm going to repeat here my last paragraph of the May letter because I feel it's still an appropriate way of managing in the current times. When the news flow is dizzying, investing with a short term horizon can be very difficult, if not impossible, which is why we do not do it for our clients. We take a long-term view and maneuver through current events in a diversified fashion. Sometimes the road is smooth and sometimes it gets bumpy, but either way, a prudently constructed portfolio that addresses the liquidity needs and investment objectives of our clients means that it typically doesn't matter.

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Please never hesitate to reach out at any time with questions or for any discussion on the economy or markets.

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