Monthly Update

July 2019

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My initial July client update was going to be rather typical with the main drivers of the markets being the Fed and corporate earnings. The S&P 500 ended the month of July up 1.3% and the 10 yr yield closed at 2.02% vs 2% at the end of June[1]. The Fed cut rates at the end of the month, as widely anticipated, and corporate earnings are beating estimates by the usual rate of about 70%, with growth around zero versus the 2nd quarter of 2018[2]. What turned everything upside down however was the August 1st tweet from the President which threatened a 10% tariff on the remaining $300b of goods we import from China that hasn't yet been tariffed. The date of implementation is scheduled for September 1st. [3]

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This news came just a few days after the US Trade Representative Robert Lighthizer and Treasury Secretary Steve Mnuchin met their Chinese counterparts in Shanghai, so it definitely took markets by surprise. Also, this last batch of tariffed goods are consumer products which means both businesses and consumers will now feel the impact.

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The market's response was rather sudden, as the S&P 500 from August 1st thru August 5th fell by 4.5% and the US 10 yr Treasury yield dropped to 1.71% from 2.02%[4]. Oil fell to almost $54.50 from $58.60 and copper was lower at $2.54 per pound from $2.66 per pound, two very economically cyclical commodities[5]. The US dollar reaction was mixed as it rallied vs the Chinese yuan, as it went through the highly focused level of 7 to the dollar, but fell against the euro and the yen[6].

This escalation comes in the context of a global economy that has been seeing slowing growth, particularly in trade and manufacturing, and that helps to explain why the Federal Reserve lowered interest rates by 25 basis points to a range of 2-2.25% on the last day of July[7]. The Federal Reserve however also disappointed markets as they hinted that this would not necessarily be the beginning of a rate cut cycle, but rather a "mid cycle adjustment" according to Fed Chairman Jay Powell[8]. Markets were disappointed as they were pricing in multiple rate cuts.

1. Bloomberg
2. Bloomberg
3. Twitter
4. Bloomberg
5. Bloomberg
6. Bloomberg
7. Bloomberg
8. Federal Reserve

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That immediately changed in the days following the trade news and now the markets expect the Fed to respond to the trade driven economic worries with more rate cuts. This begs the question of whether the rate cuts will be able to offset the impact on the economy from the tariffs and the collateral impact.

The Global Economy

As stated, the global economy has been slowing as the pace of trade has been moderating all year, which in turn has hurt manufacturing. What has been trade related and what is a byproduct of the economic slowdown in China is tough to say, but we can point fingers at both. China's weaker economy has impacted its trading partners in Asia and Europe, particularly Germany. US manufacturing has also not been immune, and that, in turn, has started to impact the services side.

At the end of July the US government said the US economy grew by 2.1% in the 2nd quarter, which while a slowdown from the 3.1% pace in Q1, still results in a good first half average of 2.6%[9]. The US consumer carried the day and along with an increase in government spending helped to offset the negative overseas impact on trade, manufacturing and the influence on capital spending[10].

Earnings

As of this writing about 80% of S&P 500 companies have reported Q2 earnings and about 70% are exceeding bottom line expectations[11]. That is the typical beat rate and earnings are expected to be about flat year over year, but with the help of stock buybacks the earnings per share gain is expected to be around 3%[12]. The earnings comparison from last year is tough due to the one time impact of the corporate income tax cut, in terms of setting a new bar, but we are beginning to see a moderation in corporate profit margins in part due to higher wages being paid to employees. Revenue growth is coming in at a growth rate of about 2% with half of the companies reporting beating estimates[13].

Stocks

For perspective, 2019 has been a good year for stocks, even after the early August selloff, but it also is no higher than it was in January 2018, as we continue to digest the solid gains of 2017 and absorb the impact of the trade fight, slowing economic growth and the change in policy by the Fed as they begin to cut interest.

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

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Because of a decline in earnings expectations this year, much of the increase in stock prices has been due to P/E multiple expansion and that has all been due to the help of the policy shift of the Fed to easier money. From here, stocks will most likely be driven by where growth and earnings.

Bonds

Bond yields across the world have collapsed further. The US 10 year yield has fallen to the lowest level since October 2016[14]. The German 10 yr bund yield has dropped to -.54%, an astonishing yield and its yield curve is below zero all the way to 30 years[15]. Yields out to 10 years are also negative in France, Sweden, the Netherlands, Switzerland, Austria, Finland, Slovakia, Belgium, Slovenia, Latvia and Japan[16]. The dollar amount of global bonds trading with a yield below zero is now up to $15 Trillion, which is about 25% of all global sovereign and corporate bonds[17]. We are certainly not in Kansas anymore. The hunt for yield in this context has truly become extraordinary.

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Currencies

The other news of early August was the announcement that the US Treasury was officially declaring China a currency manipulator. This is the Treasury's way of saying that China artificially sets its currency rather than having the market set the level. This is more noise than substance, as all countries in some way manipulate their currencies, but it does raise further tensions with the Chinese. The euro heavy dollar index, where the yuan is not a component remains in a multi-month trading range[18].

Conclusion

The main bullish factor that has helped markets this year began with the Fed shift in January from one of a central bank that was looking to tighten policy to one that is now easing. That, in turn, has eased financial conditions and helped to lift price multiples across a variety of asset classes. It is likely that the boost from this has mostly run its course for now as the Fed has made it clear that a rate cutting cycle is not set in stone.

Of course, what is throwing a wrench in the Fed's plans is the concern over the economic impact of the trade fight, with a global economy that was slowing anyway. Does the Fed try to offset this via more rate cuts or do they realize that they don't have the tools to manage "global developments" that are influencing growth?[19] That is a key question as we look towards the back half of 2019.

14. – 18. Bloomberg
19. Federal Reserve

As it's been a wild news flow year (isn't it always in some way?) I'm going to continue to repeat what I've stated in previous monthly updates. When the news flow is dizzying, investing with a short term horizon can be very challenging, 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 and are always looking to take advantage of opportunities that markets present.

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

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