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2019 – Second Quarter Review

A Knife's Edge

It is difficult to explain how stocks could be showing double digit returns while bonds are enjoying robust returns at the mid-point of the calendar year. Those two things just don't go hand in hand. If stocks are rising at a fast clip, the prospects for the economy are strong. If bond prices are rising at a strong rate (yields declining), investors are seeing trouble ahead. So, which is it? Red sky at night, sailors delight or red sky in the morning, sailors warning?

The investor can see that the U.S. economy continues to be strong, although beyond its peak. But also, the investor can see economic struggles in Europe and slowing growth in China, and a U.S. – China trade battle that went from hopeful to adversarial overnight at the end of April. In addition, it appears Brexit is heading for the door without a deal. Britain's Prime Minister Johnson and the EU Commission are both claiming to be prepared for a no deal outcome. This is not likely. Brinkmanship is the order of the day. To paraphrase the WSJ on Thursday, 8/15/19, (the day after domestic stock indexes dropped 3%), the low interest rates lead us to contemplate a recession and greater volatility, it leads to a feeling of sitting on **a knife's edge**.

Absent the threat of a trade war and a no-deal Brexit, there simply would be no view of a recession. Asia and Europe are feeling the effects of the trade tariff tit for tat the most. But, in the USA, the consumer is still feeling strong with high employment, growing wages, and no threat of high inflation. It is difficult to confidently know the direction of the world economy, its impact upon the domestic economy, and therefore the direction of stocks and bonds. Mr. Trump's threat of a tariff on the rest of products coming from China deflated the optimism around stocks. The feeling of being on a knife's edge will lead to greater market volatility than what we have become accustomed to in this ten-year bull market.

This is a time to make sure asset class allocations are in balance per your target allocation, seek to take profits on overpriced assets, and seek to lower risk in bonds. DBFM continues to underweight allocation to international stocks. It is also a good time to review the family budget.

Market Data

Through the second quarter, a 100% stock portfolio with 20% invested in international returned 18.18% with dividends reinvested. Intermediate term bonds were up 6.43% (Barclay's Aggregate Bond Index) and short-term bonds were up 2.37% (S&P Short Term Bond – Gov't/Corporate Index).

Growth stocks outgained value stocks in the 1st half of the year by 6.59%. Therefore, value stocks trailed all stocks by 3.3%.

At the second quarter end, price to book value of growth stocks was 7.14. This is 47.8% above the long-term average of 4.83. Price to book value of value stocks was 1.99. This is 2% below the long-term average of 2.03. Valuations for growth stocks and value stocks remain in stark contrast.

Yield Curve Inversion

The U.S. Treasury yield curve is inverted when the 10-year Treasury interest rate is lower than the 3-month Treasury rate. An inversion is often (not always) a predictor of a coming recession within a year or two of the inversion. The curve inverted off and on in June and July, but it has remained inverted all of August to date.

Last week, Janet Yellen (former Federal Reserve Chairperson) stated that the present yield curve inversion is most likely a false reading. Usually, yield curve inversions are driven by Federal Reserve monetary tightening leading the market expectations of interest rate direction. In the present case, the curve was already flatter due to lower expectations for inflation. In addition, the Quantitative Easing (Central Bank buying of longer-term bonds) in the U.S., Europe, and Japan has driven longer term interest rates down. Further, U.S. Treasuries have been the destination of safe-haven money flows. These factors heighten the likelihood that the curve inversion is not pointing to a recession. The jury is still out on this.

Macroeconomics / U.S. Economy

Both the first quarter and second quarter real GDP growth rates, 3.1% and 2.1%, beat expectations. Estimates by business groups, the Federal Reserve and the IMF (International Money Fund) for U.S. GDP growth for 2019 range between 2.3% and 2.1%, while estimates of economic growth for 2020 center around 1.9%.

Eurozone GDP also rose a surprising 1.5% in the first quarter but grew at a slower pace of 1.1% in the second quarter. Japan also surprised with a 2.2% increase in first quarter GDP and 1.8% in the second quarter.

China topped GDP expectations with 6.4% growth as compared to a lowered forecast of 6.3%, but their growth rate slowed to 6.2% in the second quarter. This was their lowest rate of growth in 27 years.

The IMF recently lowered their forecast for worldwide GDP growth from 3.5% to 3.3%.

The impact of the U.S. – China trade negotiations is being felt in business investment numbers as well as Institute of Supply Management readings for manufacturing and services industry. While they remain healthy, they have declined. Numbers above 50 mean growth. Service numbers have gone from 60 to 58 late last year to 55.5 in June and 53.7 in July. Manufacturing numbers have gone from the upper 50s to 51.7 in June and 5l.2 in July.

U.S. retail sales are up 4.64% through July. U.S. personal consumption for goods and services, which account for 67% of the U.S. economy, is up 4.37% from one year ago (2nd quarter end to 2nd quarter end). The U.S. consumer is being supported by continuing strength in employment. Initial claims for unemployment insurance remain at very low levels. This data points to continued growth in employment.

The headline rate of unemployment has ticked up to 3.7% from 3.6% at 1st quarter end. The participation rate is rising, and the underemployment/unemployment rate is declining. Furthermore, the potential for gain in employment has dropped from 3% to 2.5% to date this year. That means more people are rejoining the workforce. The hiring rate in 2018 was 223,000 per month. In 2019, it is 172,000 per month including 224,000 in June.

Productivity rose in the first quarter this year to 3.5% and 2.3% in the 2nd quarter. This compares with 2.4% last year. Wages are growing at 3.1% to 3.2% this year.

With modest wage growth (3%) and below target inflation, it can be safely assumed that maximum employment isn't here yet and there is no present need for the Federal Reserve to raise interest rates. In fact, with the precipitous drop in the 10-year treasury rate from 3.25% last fall to about 1.6% recently, the Federal Reserve will likely have every excuse to reduce the Federal Funds rate towards alignment with the 10-year Treasury rate. It is unlikely that this possible rate reduction will significantly drive economic gain since consumer spending is already at a strong level.

Automotive sales and the housing market have very likely peaked. Automotive sales have been running in the 17 to 17.5 million range for the last three years and are projected to come in at 16.8 million vehicles this year.

Total construction spending is down 2.8% from the peak in May of 2018 at $1.287T from $1.324T, but it is up 0.9% from last year end of $1.276T. According to the National Association of Realtors, the residential home supply is still a low 4.2 months. A six-month supply would be parity for buyers. Surprisingly, average home prices are down 5.25% from the year end peak in 2017, but price and short supply remain hurdles to entry for first time buyers.

Conclusion

All said the economy is still in good shape, but beyond the peak of the economic cycle. Business decision makers are generally on hold for an outcome on U.S. – China trade negotiations and Brexit. Good results would release the animal spirits and a bad outcome or much extended negotiations would continue to slow the world economy.

Of Concern

As stated last quarter, China has a corporate debt problem; the USA, some European countries, and Japan each have a growing national debt issue. At best, if not addressed, it will lead to a "crowding out" effect where government debt crowds out economic growth.

Please feel free to contact us with any questions, or if you would like to schedule an in-person or phone meeting.

Thank you,

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