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OUTLOOKS

June 2019

ECONOMIC OUTLOOK

Summary

The global economy has been gradually cooling over the last 12 months, with the United States outpacing our foreign trading partners. Tax cuts, lowered regulatory barriers and a general, pro-business attitude from the administration has buoyed consumer and business confidence. The cumulative impact of these policies has powered the stock market higher, incentivized business investment and encouraged a more risk-on sentiment among retail and institutional investors.

These hard fought gains are being eroded by the same administration who is actively calling out perceived and legitimate trade violators around the globe. The on-going trade war with China is beginning to spill over to all aspects of the world economy, with weak growth getting softer and steady growth trending lower. There are valid reasons for the administration to engage in these economic scrimmages, but none of them includes faster GDP growth and increased certainty. This game of trade "Chicken" is being played out in the bond market with market rates down by over 1% since December, with no rate cuts.

The May ISM Manufacturing Index fell from 52.8% to 52.1%, the lowest since 2016. Although the numbers portend positive growth over the near term, the trend is down and when coupled with very soft readings in other industrialized nations, is a clear headwind for the U.S. More broadly, the Eurozone, UK and China figures are in contraction territory and much of Southeast Asia is close behind.

There is time to reduce trade tensions and avoid an unnecessary economic downturn, but some level of stability will be required by the fall, in order to avoid a big slowdown in GDP leading up to the 2020 presidential election.

Positives

Initial claims for unemployment insurance remain near 40-year lows

Consumer confidence near recent highs and close to best levels since early 2000's

Second revision to Q1 2019 GDP came in at 3.1%, 3.0% was expected

Negatives

ISM Manufacturing Index hits lowest level in 31 months, but expanding

Durable goods orders miss expectations in April, March revised lower

Pending home sales dropped 1.5%, 0.5% was expected

Expanding Possibilities

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EQUITY OUTLOOK

Summary

After an exceptional start this year, equity markets finally began to tire of the lingering trade disputes with China. The S&P 500 lost momentum falling 6.4% in May but still stands 10.7% higher for the year. Trade negotiations have seemingly broken down in recent weeks, causing global markets to worry that an ultimate resolution may not be seen for an extended period.

The weakness in equity markets throughout May was widespread across equity style, size and geography. Growth and value stocks experienced similar losses with the Russell 1000 Growth Index falling 6.3% and the Russell 1000 Value dropping 6.4%. The Russell Mid-Cap Index and Russell 2000 Index (small-cap) declined 6.1% and 7.8%, respectively, during the month. International stocks, which had been underperforming their U.S. peers to start the year, declined as well. The developed MSCI EAFE Index dipped 4.7% and the MSCI Emerging Markets Index lost 4.7%.

Energy was the worst performing economic sector within the S&P 500, sinking 11.1% as crude oil prices tumbled in response to the possibility a prolonged trade dispute would lead to a global slowdown, reducing the demand for oil. The information technology sector down 8.7% was the second worst performer. With interest rates falling significantly in May, the rate sensitive utility and real estate sectors were the best performers. Utilities declined just 0.8% while real estate managed to eke out a gain of 1.5%.

Over the past few months, we have cautioned equity investors to expect volatility given the magnitude of the gains to start the year in addition to the numerous geopolitical uncertainties. From a positive standpoint, the recent dip in stock prices has caused equity valuations to look more attractive, and the corporate earnings backdrop still looks favorable particularly in the U.S. In spite of these encouraging considerations, we still expect markets to be fairly choppy throughout the summer as markets continue to digest the cross current influences.

Positives

- Accommodative Federal Reserve now more likely to cut rates
- Any progress on trade resolutions would surprise to the upside

Negatives

- Lingering trade conflict would continue to be a concern
- Global economic slowdown back in play
- Investor sentiment overly optimistic

Unknown

- Brexit path and impact

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OUTLOOKS

June 2019

FIXED INCOME OUTLOOK

Summary

Trade negotiations and tariffs dominated the financial news wires in May. The first real sign of trouble brewing was in early May when President Trump tweeted that tariff levels would ramp up on nearly all goods imported from China after negotiations faltered. China then retaliated with tariff increases on U.S. imports and late in the month announced restrictions on rare earth exports, which are vital in the manufacturing of many high-tech devices. Then late in the month, Trump announced applying tariffs on all Mexican imports unless they are more active in curtailing the flow of immigrants to our southern border. As investors scrambled to assess the trade war impact, global economic data rolled in softer with manufacturing data particularly weak.

As investors worried about slowing global trade and supply chain disruptions, they sold riskier assets such as equities and high-yield bonds and aggressively bought U.S. Treasury bonds. Yields plunged by about 35 basis points across the entire curve. The 2-year note closed the month at 1.92% while the 10-year and 30-year bonds ended at 2.13% and 2.57%, respectively. Yields are now more than a full 1% lower than they were in November of 2018. According to the Fed Funds futures market, investors now believe that there is a 95% chance of a rate cut before year end, up from a 68% probability in early May.

While yields were falling and the stock market swooning, the Fed appeared oblivious to the events making headlines. In early May, Chairman Jerome Powell said he saw no reason to shift rates higher or lower and that the first quarter's low inflation rate was "transitory". Inflation has been below the Fed's 2% target for the majority of the recovery since the financial crisis and recession ended in 2009 but the Fed still considers it "transitory." It is our opinion that the Fed continues to fight a battle that does not exist and their inflation models cannot keep up with the realities of the current economy. To the market, it is apparent that policy has become restrictive and that the Fed should be easing the overnight rate by the September meeting of the Federal Open Market Committee. We concur with the message the market is sending. Many Fed presidents and governors are coming around as well.

Positives

- Fed will likely lower the overnight rate before the end of the year
- Core inflation remains below target
- German 10-year yields hit new historic lows of -0.20%

Negatives

- Drop in yields already reflect one or two cuts in the overnight rate so unlikely to fall much further
- Economy of European Union rebounds enough in Q1 to avoid a technical recession

Unknown

- Disruptions to worldwide GDP caused by trade war with China and bilateral tariffs
- Denuclearization negotiations with North Korea and Iran

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