QUARTERLY MARKET UPDATE

July 2019

BROAD MARKET STRENGTH

Name	YTD 2019 Return (%)
S&P 500 TR USD	18.5
Russell 2000 TR USD	17.0
MSCI EAFE	14.0
MSCI Emerging Markets	10.6
Barclays US Aggregate Bond	6.1
Barclays US Credit	9.4
Barclays US Corporate High Yield	9.9

Data Source: Morningstar Direct

So far, 2019 has been a great year for the investment markets. The Standard and Poor's (S&P) 500, which is at an all-time high, is up 18.5% year-to-date, supported by gains in all 11 sectors.

Only one sector, healthcare, which is up 8.1% has not registered a double-digit percentage gain, underscoring the broad-based nature of buying efforts. Investors have not been overly discriminating in their selections.

To add to its impressiveness, these results have materialized in the face of rather notable uncertainty regarding U.S. trade dealings with China, recurrent signs in the economic data that global growth is slowing, and downward revisions to earnings estimates.

What, if any, has been the primary driver of this display? From our perspective, it has been prompted by the prospect of loose monetary policy and the hope it will remain so in months ahead, not just in the U.S. but in other developed countries as well.

Interest Rate Expectations

Evidence to support the market's reliance on an accommodating U.S. Federal Reserve (Fed) is found in the events of May, which saw the S&P 500 decline by 6.6%. Fed Chair Jerome Powell and the Federal Open Market Committee (FOMC) left the impression after the April 30-May 1 meeting that the FOMC was not disposed to cut the target range for the fed funds rate anytime soon.

The Fed chair did not imply that the FOMC would be raising the target range anytime soon either, yet the idea of rates not being lowered was frowned upon by the stock market, which was anxious from a flattening/inverted yield curve and the notion that weakening economic data should prompt the Fed to reverse its December rate hike.

Adding to an already negative temperament, the news that the U.S. would be raising the tariff rate on a $200 billion tranche of imported Chinese goods to 25% from 10% and would be exploring the implementation of a 25% tariff rate on another $300 billion of Chinese imports was announced.

With the tariff situation between U.S. and China remaining unsettled, the administration expanded the tariff conversation to include Mexico in conjunction with immigration issues. This situation with Mexico was ultimately averted, yet real market relief came on June 4 when Fed Chair Powell offered at a conference in Chicago that the Fed will act appropriately not to endanger a continuation of the economic expansion.

The stock market reacted very positively to the news, as it confirmed the existence of dovish-minded tendencies in the Fed's thinking that could result in an interest rate cut happening sooner rather than later.

For good measure, Presidents Trump and Xi later reduced some of the trade deal worries when they said they would hold extended talks at the G-20 Summit at the end of June. The S&P 500 gained 6.9% in June and up 18.5% year-to-date; with the correlation between results and the Fed's inclination to lower rates being strong.

S&P 500 Sectors	YTD 2019 Return (%)
Information Technology	27.1
Consumer Discretionary	21.8
Industrials	21.4
Real Estate	20.4
Communication Services	19.1
S&P 500	18.5
Materials	17.3
Financials	17.2
Consumer Staples	16.2
Utilities	14.7
Energy	13.1
Health Care	8.1

Data Source: Morningstar Direct

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Negative Yields

The Fed has not been the only central bank gathering attention. The European Central Bank (ECB), the Bank of Japan (BOJ), and the Reserve Bank of Australia have also offered the possibility of providing more accommodative monetary policy.

Amazingly, the ECB and the BOJ have espoused policies that include negative rates already and have led to negative-yielding bonds. In fact, it is estimated that there exists approximately $12.5 trillion of bonds globally with negative yields.

It is this dynamic which has had a profound effect in driving down Treasury yields, which are low but relatively high compared to the sovereign bonds of many other developed countries, see Chart 1 below.

The 10-year Treasury yield recently went below 2%, which is its lowest level since late 2016. That's a striking development for many reasons. Typically, low yields exist concurrently with economic pessimism, subdued inflation and growth expectations, culminating in a flight for safety. If fixed income markets forecast these developments, they remain in stark contrast to equity markets at all-time highs led by gains in the cyclical sectors.

In addition to understanding the contribution of relative global yields to the price of Treasuries, the unremarkable level of corporate credit spreads offers reassurance that growth fears might be overblown. Corporate spreads can certainly expand quickly, yet their current reading supports the idea that the inverted yield curve is not predicting a recession so much as it is a function of searching for yield in a low-yield environment, see Chart 2 below.

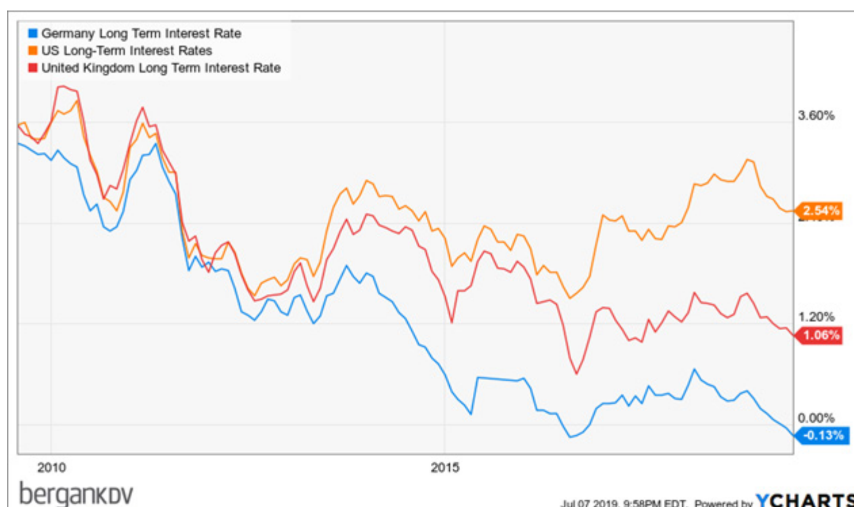

Chart 1 – Treasury Yields

Data Source: YCharts

Chart 2 – U.S . High Yields

Data Source: YCharts

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Watch Sentiment
There do exist certain data trends that confirm the existence of reduced growth; certain manufacturing surveys, business confidence readings, and business investment data detect perceptible changes in strength. The consumer, whose spending accounts for roughly 70% of U.S. Gross Domestic Product (GDP), is supported by productive labor market conditions and is still in solid shape.

However, if business confidence and business spending deteriorate, that could manifest itself in increased jobless claims, ultimately weighing on consumer sentiment and consumer spending. Therefore, consumer-oriented data will be of interest going forward. The enthusiasm for accommodative monetary policy right now rests in the belief that low policy rates may need time to get economic growth and earnings estimates reignited.

If consumer-oriented data begins to disappoint, investors will conclude that monetary policy is not alone enough to facilitate risk-on conditions. The Fed and other central banks cannot afford that conclusion, as it would likely precede an actual recession when faith in monetary policy is most required.

Earnings Growth Required
Global capital markets infer positive intentions from the world's major central banks. Low interest rates have without question supported equity markets. However, the return results we have witnessed would not have been possible without the existence of strong earnings growth and expanding economic activity, as corporate profitability is what ultimately drives equity prices over time.

We are now entering a phase, though, where reduced earnings growth and decelerating economic activity are emerging. Markets have been moving higher, though multiple expansion represents a good portion of the returns. Currently, the S&P 500 trades at 16.6 times forward twelve-month earnings.

That is above the 5-year and 10-year averages of 16.5 and 14.8, respectively, according to FactSet, but it is not an egregious valuation given the level of interest rates. The forward earnings yield of 5.3% is nearly 350 basis points above the risk-free rate, and still appears to hold value, especially when compared to bonds, see Chart 3 below.

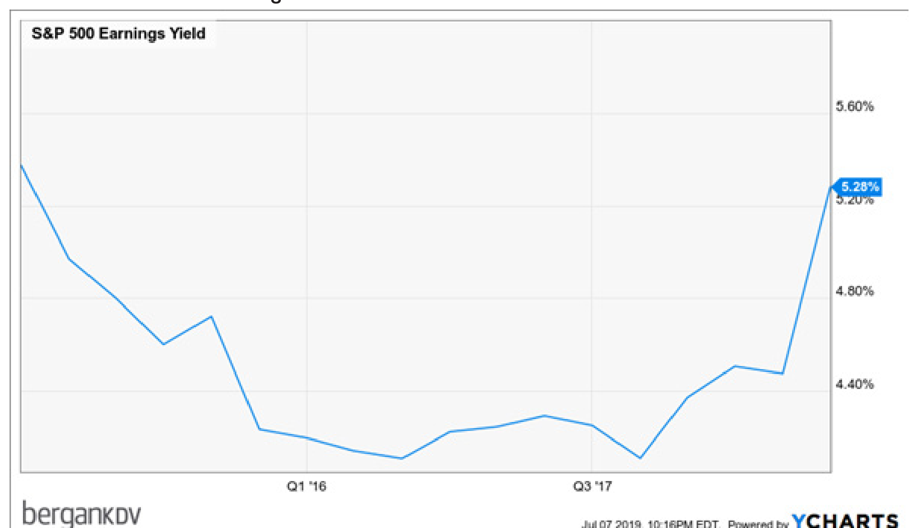
Looking Ahead
The direction of global capital markets will depend on several things. Currently, optimism is being priced in, arguably the most significant factor regarding expectations of continued sympathy, support and effectiveness of the Fed. If that were to change, it wouldn't take long to notice its effects.

Another point of interest will be developments relating to the political landscape. These include the ever-evolving U.S.-China tariff negotiations, uncertainties relating to an increasingly forceful Iran, the budget and debt ceiling negotiations between Congress and the White House, and of course the nascent but increasingly visible 2020 presidential campaign developments.

The stakes involved in the Fed delivering the market's preferred monetary policy environment are not insignificant. The large returns experienced this year have materialized prior to any actual interest rate reductions. In an environment characterized by muted earnings growth and a weakening economic environment, the persistence of low interest rates and the belief that rate cuts are coming can pull future returns forward only so long.

Chart 3 – Earnings Yields

Data Source: YCharts



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