Basis Points – April 2, 2019 – 1Q19 Review

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Stay in Your Seat

You cannot enjoy witnessing unthinkable events without committing to stay at the game in both good times and bad.

I attended a Dallas Stars hockey game many years ago that I will never forget. The Stars matched up against the Boston Bruins on Oct. 14, 1995, at the old fan-friendly Reunion Arena in Dallas. It was a Saturday afternoon game, early in the hockey season, and the 89-degree high temperature that day caused it to feel more like summer than mid-autumn. The Stars, however, were cold that day, and trailed the Bruins 5-3 with only a minute left in the game. Statistically at that moment, the Bruins had a 99.9% chance of winning the game, with such a large lead and only a small bit of time left. Most hometown fans were resigned to their team's fate and had left the building already or were filing to the exits.

That is when the fun began. The Stars' Kevin Hatcher scored a rebound goal with 48 seconds left, to pull the Stars back to a 5-4 deficit. The Stars then pulled their goalie to add another offensive player, and Mike Modano tied the game at 5-5 with 15 seconds left. The game appeared headed for overtime until a blind pass in the offensive zone deflected off Stars' center Guy Carbonneau into the net with less than 4 seconds left. Game over. The goal capped off a highly improbable 6-5 win for Dallas, with three goals in the final 50 seconds of the game. For the hearty souls who stayed in their seats and kept the faith, they were treated to one of the greatest comeback victories in NHL history, and could forever brag that they were there to see it. Those who gave up and left the arena found no joy that day.

The stock market certainly made a similar comeback in the first quarter of 2019, off the depths of despair from an awful December and fourth quarter of 2018. Equities, bonds and commodities all saw their lowest prices on Dec. 24, a holiday-shortened but no less brutal day for the financial markets, a day that saw the S&P 500 lose 2.7% in just three hours of trading. The S&P closed that day down 19.8% off its recent high, and crude oil closed at $42.50 per barrel, a loss of 44% in just three months. Investor sentiment was understandably both dour and at near-panic as folks opened their presents on Christmas Day.

That is when the fun began, for the investors who kept faith and remained in their seats. The S&P 500 notched its highest gains in a quarter since 2009 and enjoyed its best first quarter performance since 1998. The first quarter of 2019 saw a global equity and fixed income rally across all sectors and most asset classes, which was as broad in scope as the losses were in the fourth quarter of 2018. The S&P 500 saw gains of 13.6% in the quarter, while global developed stocks rose 12.3% and Emerging Market stocks rose 9.9%. All sectors in the S&P 500 showed strong gains, with a 7.0% gain for the weakest sector, the Health Care group, to the 19.8% gains for the strongest performing Technology sector.

The Fed's Call on the Field

Many factors contributed to the rebound in the financial markets in the first quarter, but no factor was as important as the turnaround in the stance of the Fed with regard to the path of interest rate increases. During 2018, the Fed reiterated its rate increase plan of four rate hikes in 2018 and three scheduled for 2019. The financial markets clearly concluded in the fourth quarter that the Fed was tone-deaf to the fragility of the current economic expansion and was raising rates far too rapidly. As the year ended, the Fed finally gave the financial market investors indications that it understood the market's concerns, and publicly stated that in the future the Fed would be patient, gradual and data dependent with its decisions on future rate increases. This rapid change in stance by the Fed certainly underpinned the rapid change in sentiment in the financial markets and was the chief reason for the large rally off the lows of 2018. The Fed is clearly now on the sidelines as we finish the first quarter, and the Fed Funds futures are now pricing in a strong chance of a rate cut sometime later this year. Notwithstanding the futures market, the Fed is on hold and will need to see a clear and demonstrable change in economic outlook to either raise or cut rates from current levels.

The Yield Curve – the New Market Worry: In late March, the yield on the 3-month government T-bill, at 2.46%, eclipsed the yield on the 10-year government bond, at 2.36%. This “yield curve inversion” is a rare occurrence, and in the past has been a sign of a coming recession. Yield curve inversions are unusual because they indicate that investors are willing to earn less interest income on money they invest, preferring to lock in longer maturities rather than enjoy higher yields in the short term.

This preference has historically indicated that investors believe the economy is slowing rapidly, which will lead to the Fed cutting short-term rates sharply. Anticipating a cut in short-term rates, bond buyers prefer to lock in an acceptable yield for a longer period. The inversion of the yield curve has been a somewhat reliable precursor to an eventual recession, but the record is not perfect and typically a recession follows the inversion over the next 12 to 18 months. There is strong debate regarding what, if anything, the inversion is telling the market about the economy. Some investors have discounted news of the inversion, as the economy is strong, unemployment is low, consumer and business confidence are high and worker wages are rising.

The market stance on the odds on a change in the level of short-term rates this year has changed considerably over the last three months, and we end this quarter with the Fed Fund futures market discounting an 83% chance of a rate cut in 2019. The Fed may be stubborn, however, as they recently raised rates at the mid-December meeting, and deciding to lower rates in the near-term would reflect badly on the Fed and its ability to read market conditions. The Fed is an independent body and should be above all criticism, but we are all human. Admitting this “mistake” may take a serious and materially negative change in economic conditions to justify.

One specific metric in the inversion debate that market bulls point to is spreads in the corporate bond and high yield market. If the economy was in fact slowing at an alarming rate, this concern would be reflected in the health of the corporate bond market. However, spreads are still currently very low, indicating that corporate and high yield bond buyers are not yet worried about the credit health of the underlying issuers. Bond investor worries about the creditworthiness of companies would certainly be reflected in higher bond yields. In general, equities are priced on hope and bonds are priced on truth, but the nerdy hall-monitors of the capital structure do not appear to be worried just yet. The yield curve last inverted in 2007, but at that time high yield spreads had widened considerably, presaging the 2008-09 recession and financial crisis. We are not currently seeing any signs of a similar dislocation in the high yield market, however.

Six Factors — Where Are We Now?

The Fed: The Fed is clearly on hold for rate increases in 2019, so Fed policy is on the market's side this year. Economic factors will need to drastically change for the Fed to move rates in either direction this year.

The Economy: At the end of the first quarter of 2019, the U.S. economy is still in very good shape. The Fed sees GDP growth of 2.1% this year, which is a slower rate of growth than 2018 but still solid.

Unemployment: The jobless rate remains at generational lows, and more workers are re-entering the job market after a considerable time away and taking jobs, which should mute wage growth somewhat.

Wage Growth: Worker wages are increasing at a very healthy 3% rate, which leads to increases in consumers' disposable income which is good for the economy. Wage growth in the past has not harmed corporate profit growth until the gains hit 4% annually, as that inflation increases pressure on business costs that may lead to economic slowdown. We are far from that detrimental wage growth rate now, however.

Inflation: The inflation rate also remains low and manageable at 1.9%, about on track with the Fed's 2% inflation target. The Fed sees the inflation rate remaining at this level in both 2019 and 2020. Inflation is clearly under control and not a factor.

Trade War: At quarter's end, the trade talks involving the U.S. and China continued with no clear end in sight, although frequent positive comments trickle out from the White House. It is in both countries' best interest to sign a deal and declare victory, as China's economy has slowed markedly due to the tariffs enacted thus far, and the White House does not want to enter an important election year with a domestic economy slowed by tariffs, so a completed deal could be announced in the second quarter.

At any point in an economic cycle, there are usually many disparate opinions on where the economy and financial markets stand, and these diametrically opposed versions of the future are acutely different as we ended the first quarter. There are two versions of the future for the coming year:

Glass Half Full: Although earnings growth will be slower this year, GDP growth of 2.1% is still a very solid rate of growth after nine years of economic recovery. Wages are growing but that is very positive for the consumer and the growth is at a very manageable rate. Unemployment is low, consumer and business confidence are high and lower tax rates will continue to boost consumer spending. Corporate and high yield bond spreads remain very tight, indicating that investor worries about corporate health are still benign. Inflation is low and under the watchful eye of the Fed. Mortgage rate have fallen with the overall decline in the yield curve, and housing activity has rebounded. Capital spending will be strong this year with higher corporate profits and more cash repatriation from overseas. Although we are in the 10th year of economic recovery, GDP growth over this decade has been low and sluggish, so it may last longer than in previous cycles.

Glass Half Empty: The yield curve has inverted, indicating financial market investor worries about an impending economic slowdown with a resulting recession. An inverted yield curve has been a very dependable historical barometer of a coming recession and should always be heeded. Student loan debt has ballooned and housing costs are high, especially in large cities, affecting younger generations' plans to buy a house, spend on discretionary items and plan for their financial future. A slowdown in global economic growth, particularly in Europe, will be imported into the U.S., which will, in turn, lead to a severe domestic economic slowdown. The tax reform package did not put the spoils of lower tax rates in the right hands, and low-income and middle-class consumers have seen little benefit. The economy is in the 10th year of a recovery, so we are due for an economic slowdown and recession. Equity valuations are high and not appropriately priced for the coming economic slowdown. Any benefit from a completed trade deal between the U.S. and China is already priced into the stock market, given the sharp rebound in the first quarter.

Whether an investor sees the current economic environment as a glass half-full or half-empty, the vast differences of opinions in the market are normal and are what makes markets tick. The S&P 500 lost 13.5% in the fourth quarter of 2018 and gained 13.6% in the first quarter of 2019. If long-term investors had not seen any financial news in the last six months, they would have themselves saved a lot of short-term angst and worry. As long-term stewards of our clients' investment funds and wealth plans, we will always stay in our seats to benefit our clients in both good times and bad.