

NAVIGATING CROSS CURRENTS

THE ECONOMY CONTINUED TO SHOW STRENGTH DURING THE SECOND QUARTER OF 2019

However, the markets exhibited more volatility as concerns about trade, growth, and the Federal Reserve (Fed) took center stage.

Gross Domestic Product (GDP) growth for the first quarter of 2019 came in at 3.1 percent, significantly better than the estimate of 2.3 percent and the fourth quarter of 2018 at 2.2 percent. However, this 3.1 percent is temporarily elevated due to higher-than-normal inventory flows that stemmed from trade concerns. Corporate earnings growth for the first quarter 2019 was fairly flat. While this is a significant decline from the double digit positive growth in 2018, those higher rates were harder to maintain after the initial benefit of the fiscal tax stimulus. The consumer remains strong and unemployment remains low around 3.7 percent. Some business forecasting surveys, including the Institute of Supply Management (ISM) surveys, have started to decline, but overall business activity is moderate. We believe it likely the overall slower-but-moderate pace of economic growth continues throughout 2019 and into 2020.

The Fed raised rates four times during 2018. They initially indicated they would raise interest rates twice in 2019, but then put the increases on “pause” due to mixed economic signals. In June they shifted position again and indicated they would do whatever it took to support the continued economic expansion. They stated there are uncertainties in the U.S. economic outlook, including some “cross currents” between trade developments and growth. As a result, they are now indicating a more accommodative posture. Both the Fed and the financial markets are digesting the effects of the more conciliatory tone of recent trade talks. The financial markets, as measured by Fed futures, now project a high probability of 2 interest rate cuts in 2019, with one occurring at the July meeting of the Fed Open Market Committee. Interest rate cuts may be premature, but at this point the Fed has limited other options.

Both the fixed income and equity markets showed strong performance for the 2nd quarter of 2019. Risks include increased trade tensions, slowing global growth, and geopolitical uncertainties.

Fixed Income Market Update

VOLATILITY RETURNS

Volatility ruled the day within the fixed income markets during the second quarter. Some volatility was created by external market factors such as trade negotiations and political disruptions (e.g. Brexit). However, a growing source of volatility for investors is the ongoing debate regarding if/when the U.S. Federal Reserve (Fed) and other global central banks will begin to cut interest rates later this year. The timing and magnitude of any cuts could have wide ranging implications for fixed income investors.

OVER THE PAST FEW MONTHS, INTEREST RATES EXPERIENCED THEIR HIGHEST LEVELS OF VOLATILITY IN NEARLY 3 YEARS.

The market factor most impacted by volatility over the past quarter was interest rates which experienced their highest levels of volatility in nearly three years. Interest rates, as measured by the 10 year U.S Treasury Note, declined significantly over the quarter and ended at 2.01 percent, which was 0.40 percent lower than where it ended the previous quarter and over 0.68 percent lower from the beginning of the year. Short term interest rates declined even further as the market began pricing in more potential future rate cuts by the Fed.

Declining interest rates resulted in strong absolute performance for most fixed income sectors during the quarter. The Bloomberg Barclays Aggregate index (Agg), a broad measure of the investment grade U.S. bond market, rose by 3.08 percent for the second quarter and is up over 6 percent year-to-date. A return of 6 percent for the Agg has only been exceeded twice in the last ten calendar years.

A few major fixed income sectors, such as corporate and municipal bonds, managed to outperform similar duration U.S. Treasuries for the quarter while other sectors such as mortgage-backed securities and agency bonds underperformed due to their heightened sensitivity to interest rate volatility. Within the corporate sector, lower quality and longer duration slightly outperformed higher quality and shorter duration segments of the sector.

In the coming months and quarters the fixed income markets will be heavily influenced by the direction and timing of interest rate moves. Those rate changes will be dictated by the path of economic activity and by the Fed and other global central banks. Miles Capital forecasts slower growth ahead for the U.S. This type of environment could cause the Fed to cut rates 1-2 times over the remainder of 2019. However, barring any major shocks from external market factors, we may see less volatility in the second half of the year.

EQUITY - DESPITE STUMBLES, MARKET KEEPS CLIMBING

U.S. equities continued to rally in the second quarter after a stellar first quarter. The S&P 500 increased 4.30 percent for the quarter. Combined with the first quarter, which was the best quarter in almost a decade, 2019 has had the best start to the year since 1997.

All sectors were positive except for energy, with financials, materials, and information technology leading the way. Other laggards were the defensive sectors (health care, real estate, consumer staples), but even these still posted gains for the quarter.

It may sound like a broken record at this point, but the second quarter saw continued volatility that has accompanied the stock market since October. Most of the market gains came in April when investors optimistically believed that the U.S. and China were close to reaching an accord on trade. That optimism disappeared in May as the U.S. and China ramped up rhetoric and threatened higher tariffs. The S&P 500 then recovered from May upon its best June since 1955 on hopes that the Federal Reserve (Fed) will soon cut interest rates in an effort to maintain economic growth.

The commentary calling a potential slowdown in the economy has increased due to mixed data reports and the first quarter earnings results, which reported the first year-over-year decline since 2016. However, expectations are for corporate earnings to remain low in the second quarter, then strengthen throughout the remainder of the year. We do not believe a prolonged earnings recession or significant economic deterioration in 2019 is likely.

China trade negotiations and the Fed remained the primary focus for market participants. There were other significant headlines throughout the quarter, such as strife between the U.S. and Iran or the potential for additional tariffs with Mexico, but these were largely shrugged off. We expect these two topics to remain the focus for much of the markets going forward.