Q2 2019
Investment Perspectives

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- **BULL MARKET RAGES ON:** Stocks around the globe posted gains in Q2 as investors shrugged off global trade concerns and cheered supportive rhetoric from central bankers. The US market was a standout performer again, extending its year-to-date outperformance relative to global indices.
- **RATES PLUNGE:** Against the backdrop of stock market exuberance, rate markets continued to tell a more cautionary tale about the health of the global economy. As growth and inflation expectations cooled, yields fell to multi-year lows. Nearly one out of every four dollars of global debt carried a negative yield by the end of the quarter, approaching the all-time highs set in mid-2016.
- **TRADE WAR LINGERS:** President Trump stayed busy roiling trade relationships around the world in Q2. Trump accused China of backtracking on trade negotiations and raised tariffs from 10% to 25% on $200B of Chinese goods in May, followed by threatening to put a 5% tariff on all imports from Mexico unless the country took action on migrant flows and revoking India's special trade status as a developing country.

Market Recap

Despite trade war rhetoric heating up again, risk assets pushed to new highs for the year—and in the case of the S&P 500, a new all-time high. The widely-followed US equity index posted its best start to a year since 1995, gaining 18.5% in the first six months. Investors celebrated dovish comments from central bankers around the world, and stocks continued their rebound after a difficult finish to 2018.

Interest rates moved sharply lower throughout the quarter in response to softening growth and inflation expectations, as well as the specter of central bank easing. The benchmark 10-year Treasury yield finished the first half of the year at 2%; just eight months ago the 10-year yield sat at roughly 3.25%. Falling yields pushed bond prices higher, leading to an equity-like 6.1% total return during 1H 2019 for the Barclays Aggregate Bond Index. Credit rallied alongside higher quality bonds, with the BAML High Yield Master Index advancing 10.1% thus far in 2019.

FIXED INCOME

	USD Total Return (%)	
Index	**Q2 2019**	**YTD**
Barclays 1-10 Yr Muni	1.6%	3.9%
Barclays US Agg. Bond	3.1%	6.1%
BofA/ML HY Master II	2.5%	10.1%

EQUITIES

	USD Total Return (%)	
Index	**Q2 2019**	**YTD**
Russell 3000	4.1%	18.7%
S&P 500	4.3%	18.5%
Russell 2000	2.1%	17.0%
MSCI All Country World	3.6%	16.2%
MSCI EAFE	3.7%	14.0%
MSCI Emerging Mkts	0.6%	10.6%

Source: Bloomberg (Data as of 6/30/2019)

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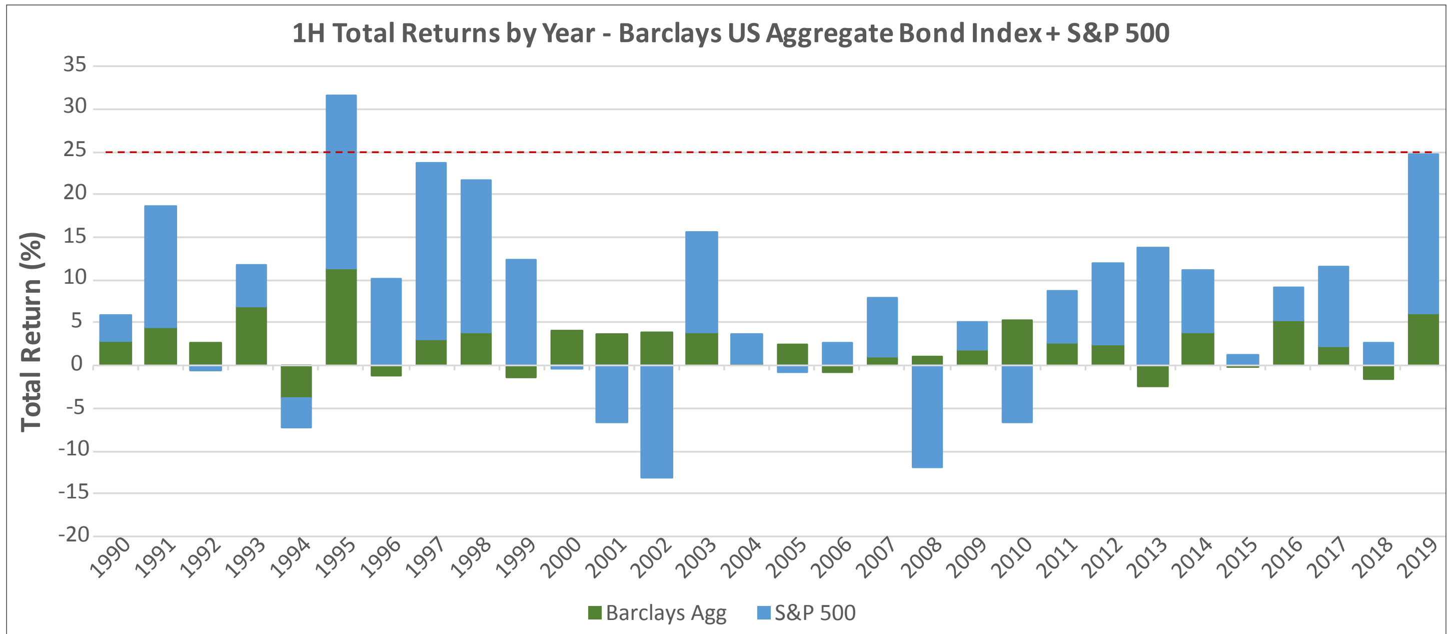
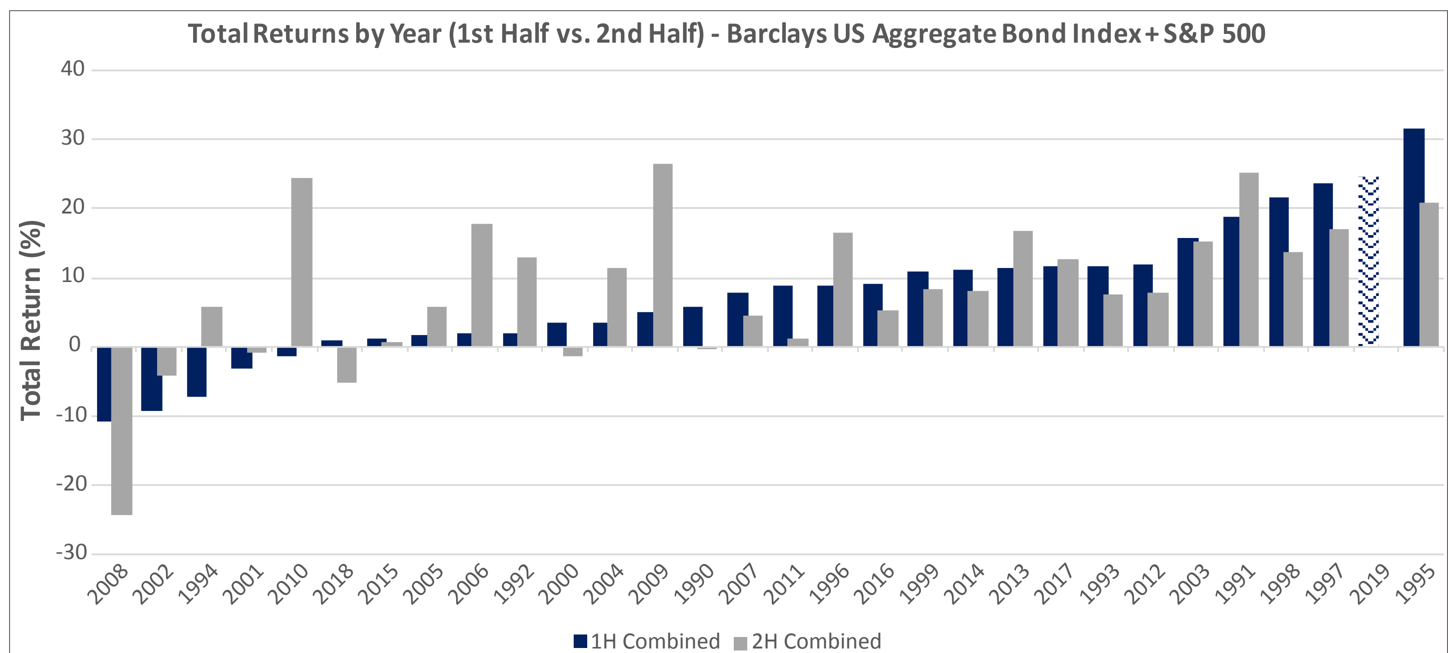
AN EXTRAORDINARY SIX MONTHS

If the near 20% decline for the S&P 500 during Q4 2018 seems like a distant memory at this point, it is for good reason: The first half of 2019 not only produced an extraordinary rally for stocks, but bonds have been equally exceptional in historical terms. To put the year-to-date advance in context, consider that only one year since 1990 (1995) has seen better combined returns for US bonds and stocks (Barclays Aggregate Bond Index + S&P 500) over the first six months. The chart below plots these returns by year; at +24.7%, the start to 2019 more than triples the average advance for the combination of stocks and bonds during the period (+7.8%).



Source: Bloomberg (Data as of 6/30/2019)

Of course, this begs the question "What happened during the second half of the year?" The chart below plots the same combined returns shown above (Barclays Aggregate Bond + S&P 500) in order from worst to best (navy bars) alongside the subsequent 6-month returns (gray bars). If history is any indication, the balance of 2019 may set-up positively for stocks and bonds.



Source: Bloomberg (Data as of 6/30/2019)

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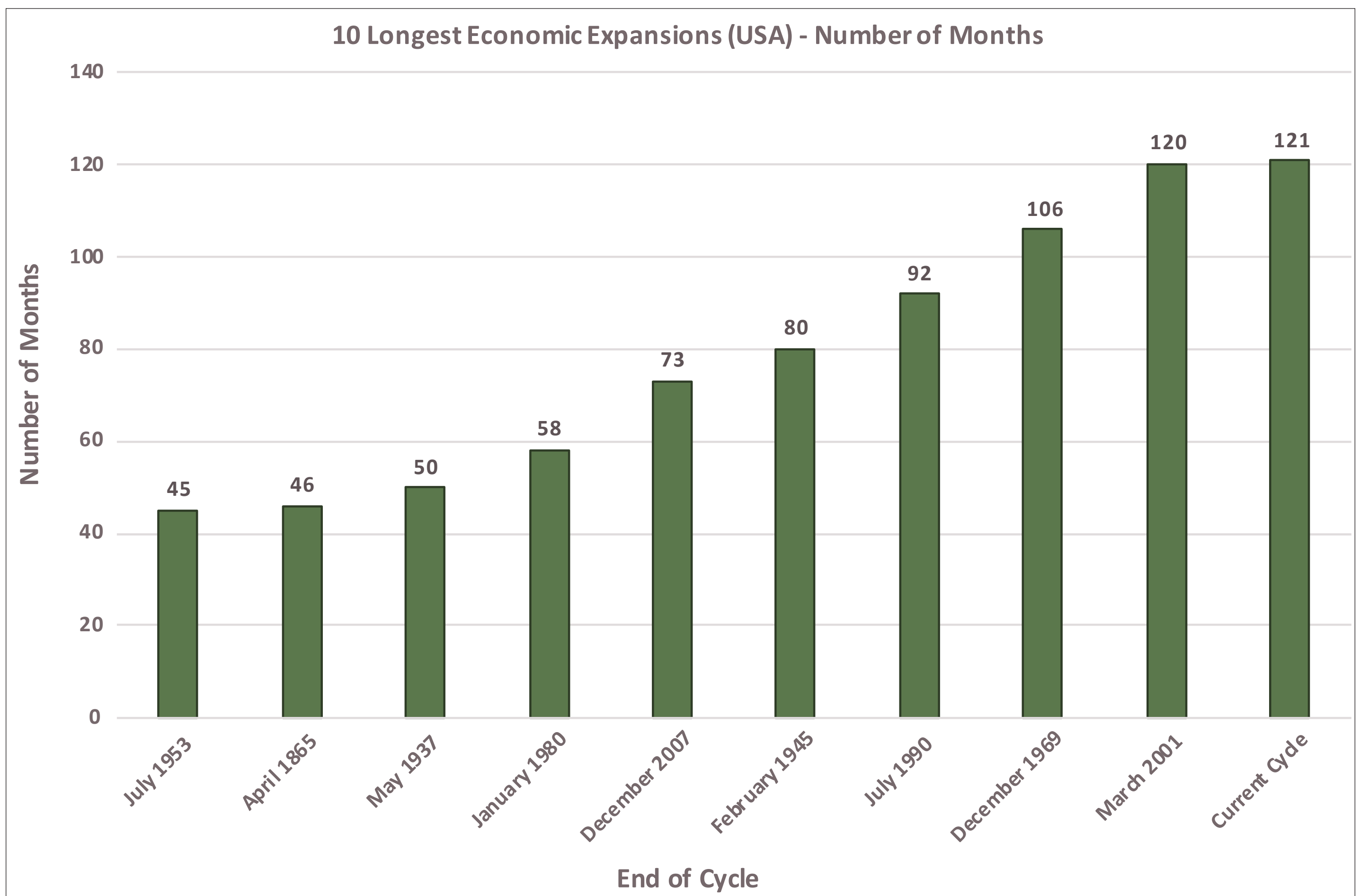
Perhaps more instructive is considering the common theme among the other top performing periods: 1995, 1998, and 1997. In each case the Fed was pursuing a strategy of "insurance" rate cuts—modestly reducing interest rates in an effort to support the economy and extend the cycle. Bonds rallied as yields fell, and stocks celebrated the central bank's more accommodative posture. The analogue to 2019 is clear as Fed Chair Powell's recent comments suggest that the Fed may act to cut rates sooner rather than later.

LONGEST US EXPANSION EVER

While the Fed may not have explicitly outlawed recessions as some commentators have joked, its accommodative policies have helped make the current US business cycle the longest ever recorded according to the National Bureau of Economic Research (NBER). NBER has long been the arbiter of official recession dates, and according to its criteria, the current US expansion has been uninterrupted for 121 months as of June 30, 2019. As you can see on the chart below, this exceeds the prior record of 120 months during the run-up to the dot com collapse in the early 2000s.



Source: National Bureau of Economic Research (Data as of 6/30/2019)

While the record itself makes for a fun bit of trivia, it is the underpinnings of the current expansion that are truly remarkable in a historical context. Interventionist policies from central banks around the world, including aggressive monetary stimulus, appear to be the new norm. As cyclical data has shown signs of slowing and recessionary warnings appear more frequent, central banks appear ready to double down.

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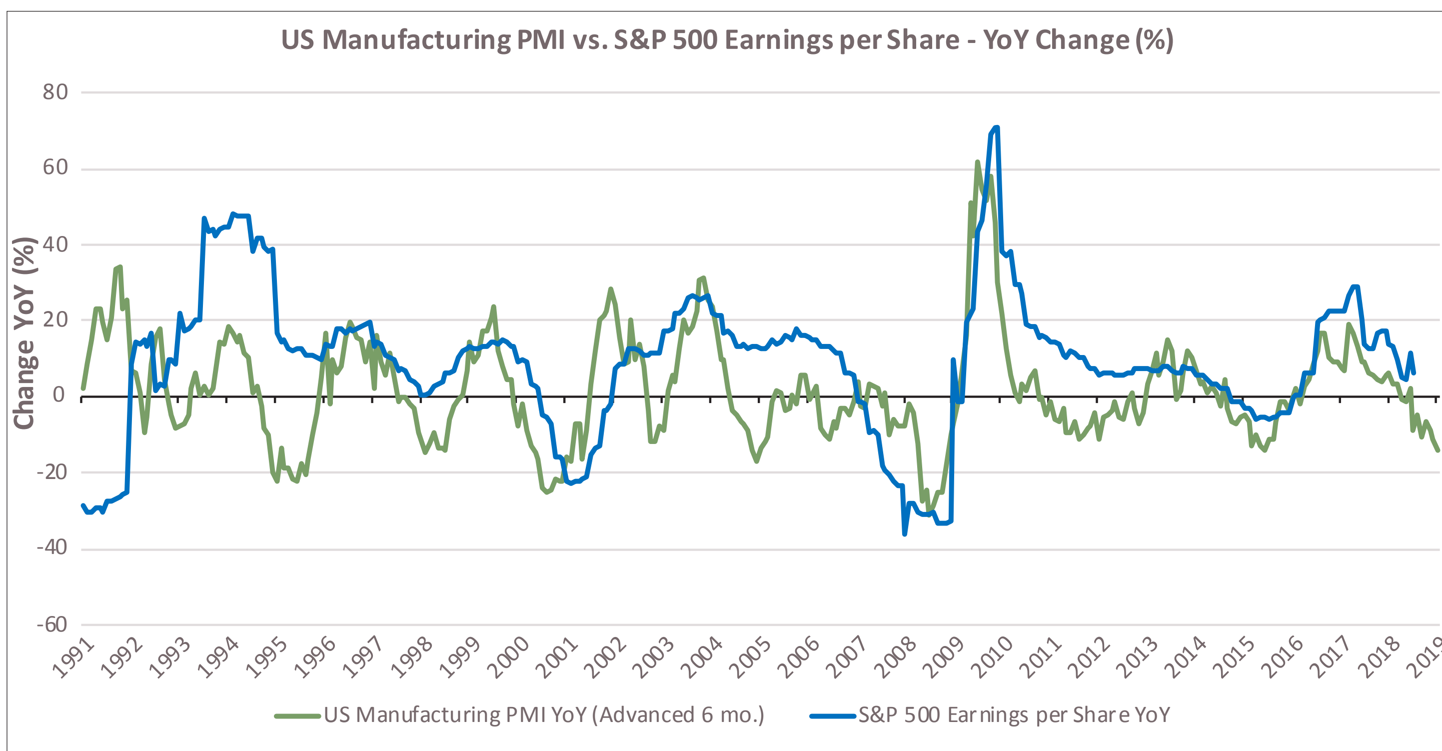
DUELING NARRATIVES

An extended period of stellar performance for stocks and bonds often brings with it a sense of complacency among investors. While equity markets have painted an unequivocally upbeat picture, rates markets continue to suggest that economic weakness likely lies ahead. This year's handsome returns belie the underlying tug-of-war between the two narratives.

Lending credence to the bond market's warnings are a few important signs of cyclical weakness. In particular, a key gauge of US manufacturing health—the Institute for Supply Management's Purchasing Managers' Index (ISM PMI)—is signaling a flagging trend domestically. Why is that important? Consider the chart below that plots the annual change of the S&P 500 earnings per share versus US Manufacturing PMI data advanced by six months. You can see that earnings growth has historically followed the rough contours of the PMI data, and in this case, the PMI data suggest that growth is headed lower.



Source: Bloomberg (Data as of 6/30/2019)

Add to the equation that the JP Morgan Global Manufacturing PMI fell into contraction territory in May and that year-over-year global trade growth has stagnated since Q4 2018. As leading indicators, these metrics would suggest that equity earnings may be headed into a weak patch—despite global central banks' best efforts to cushion any impending decline.

Another divergent narrative is the relative strength of large cap stocks versus small cap stocks. Small cap stocks, as measured by the Russell 2000 Index, remain roughly 10% below their all-time highs set in Q3 2018 in spite of the large cap-oriented S&P 500 hitting fresh highs in Q2 2019. The more economically sensitive small caps are often viewed as a canary in the coal mine for risk assets in general. ●

When Bad Data Is Good News

One of the most confounding elements of markets—to professionals and amateurs alike—can be when stocks drop in the wake of a positive data release. As a specific example, shortly after the end of Q2, the US nonfarm payrolls report was released and showed a gain of 224,000 jobs in June, easily exceeding the consensus estimate of 160,000, per Bloomberg. Despite the upside surprise, stocks initially fell in response to the news.

More generally, an extended stock rally in the face of broadly deteriorating cyclical data—like we have seen in 1H 2019—may seem wildly counterintuitive. Mark Cudmore from Bloomberg Economics recently laid out a useful, two-part framework for thinking about these types of periods in the context of monetary policy. The abridged version is as follows:

Part 1: Is monetary policy appropriate?

- If YES, then…
  - Good data = positive
  - Bad data = negative
- If NO, then…
  - Good data = negative (delays policy response)
  - Bad data = positive (hastens policy response)

Part 2 (post-policy response): Has overall economic outlook improved?

- If YES, then…
  - Good data = positive
  - Bad data = negative
- If NO, then…
  - Good data = modest negative
  - Bad data = very negative (central bank loses credibility)

Consider the story told by the chart on the following page that plots the market's implied probabilities of the three possible outcomes—rate hike, no change, or rate cut—at the July 2019 Fed meeting. For most of 2018, the market was expecting a better than 50/50 chance of a rate hike at the July meeting. As portions of the yield curve began to invert—suggesting that monetary policy had become too restrictive—and economic data began to soften, the market quickly reduced the odds of a rate hike in favor of a "no change" scenario. This was an early indication that market sentiment was shifting toward a belief that Fed policy was no longer appropriate given the macro backdrop.

As Fed Chair Powell adopted a more dovish tone in Q1, the market gradually increased the odds of a rate cut scenario for July. With global economic data failing to demonstrably improve and trade wars raging on, markets sent an unambiguous message to the Fed that it would need to do more than jawbone financial conditions into a more accommodative state. Stocks rallied as the odds of a rate cut increased and economic data continued to underwhelm. Cudmore describes periods like this as having an "asymmetric reaction function"; investors are convinced that the Fed will act in some capacity—despite not knowing the magnitude—so bad news is largely ignored and stocks are bid in anticipation of the Fed's response.

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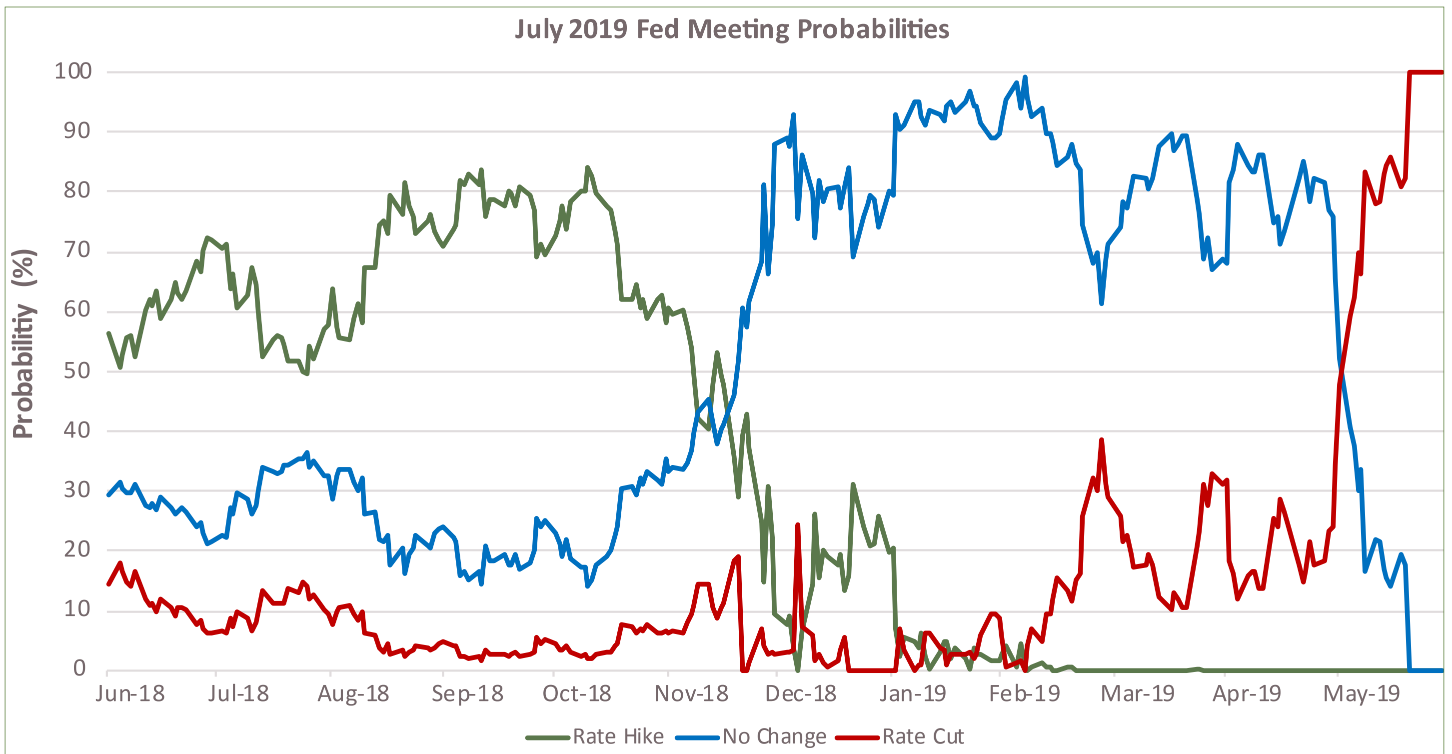


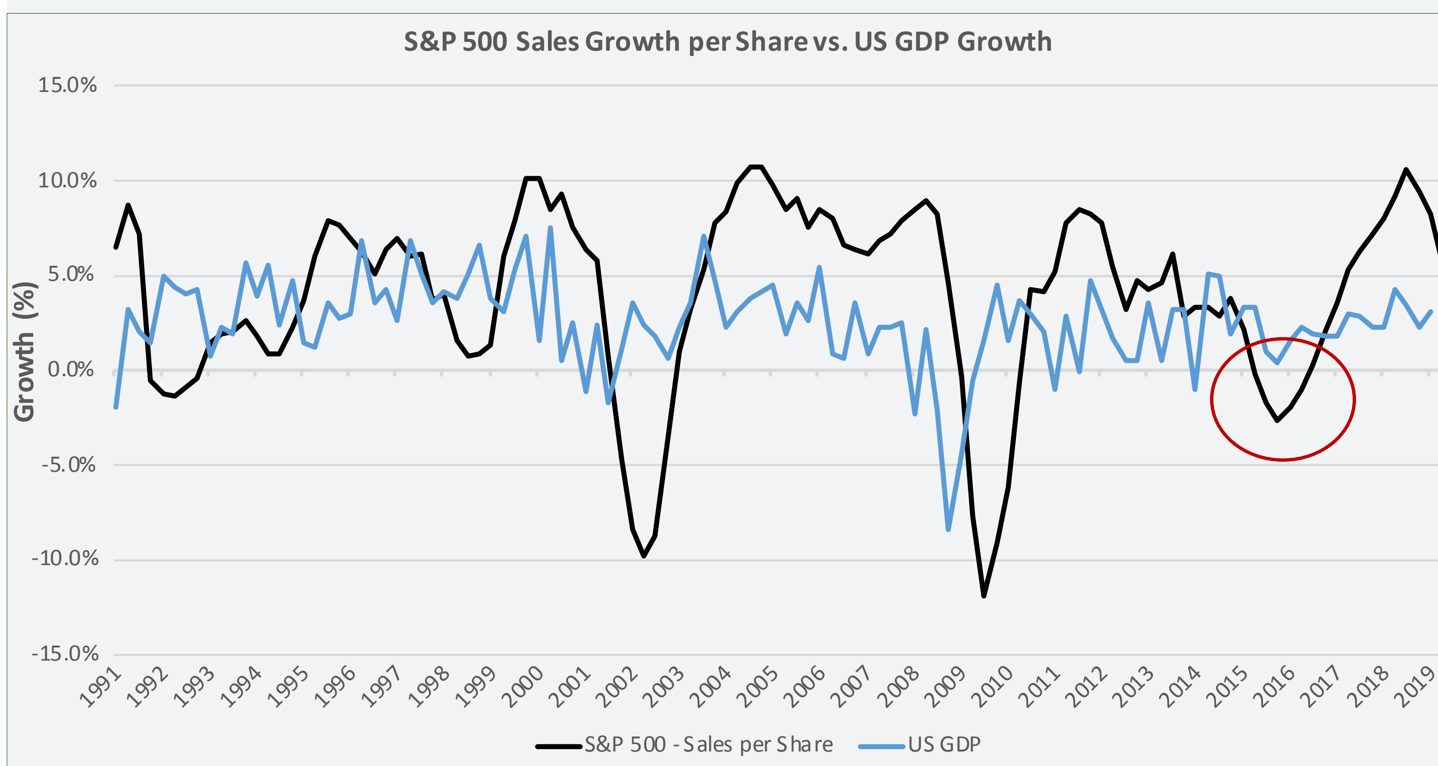
Source: Bloomberg (Data as of 6/30/2019)

Of course, this feedback loop cannot go on forever. The Fed looks set to cut rates in July which should bring its policy stance to a more appropriate position in the eyes of the market. Using Cudmore's heuristic, if the Fed's actions are successful in reigniting the economy, then one would expect good news to be positive again, and bad news to be negative. However, the real risk is that the economy fails to show any signs of life, and the Fed loses credibility with the market. In that instance, the asymmetry flips to the downside—i.e., stocks will have a disproportionate response to negative data versus positive data.

Chart of the Quarter

The Q2 2019 "Chart of the Quarter" could be better described as a thought experiment. In an earlier section, we referenced the National Bureau of Economic Research (NBER) data showing that the current cycle is the longest in US history. We frequently read commentaries that either implicitly or explicitly suggest that the cycle—and the accompanying equity bull market—should be nearing an end on the basis of its length relative to historical cycles. But, what if we told you that the US had already experienced a stealth recession in 2015-2016, and that the business cycle "clock" should have been reset as a result? We cannot claim this as an original argument, but recent talk of the record-breaking expansion makes it worth revisiting.

The chart below plots the S&P 500's sales growth per share (black line) relative to US GDP growth (blue line). Note the red circle around the period in 2015-2016 where sales growth dipped into negative territory for consecutive quarters. While most economists tend to focus on GDP growth as the key criterion for a recession, the three most recent US recessions—early 90s, early 2000s, and the global financial crisis in 2008—were also characterized by periods of revenue contraction for US corporations. For all intents and purposes, this may have been a recession hidden in plain sight.



Source: Bloomberg (Data as of 6/30/2019)

To be sure, revising an arbitrary measure of the business cycle does not change the ongoing trade spats, that portions of the yield curve have inverted, or that stocks are trading at relatively high valuations. But, it would change the increasingly common narrative that the economy is simply "due" for a recession and a commensurate decline in stock prices. (As a related aside, the current S&P 500 bull market that has been called the longest ever twice came within tenths of a percent of being ended via a 20% decline that marks the beginning of a bear market – once in 2011 and again in 2018.)

There is an old saying: "Bull markets don't die of old age." The same could be said for business cycles. But, even if they did, perhaps this cycle and bull market are not as old as people think.●

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