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INVESTMENT COUNSEL

Market Review & Update

SUMMER 2019

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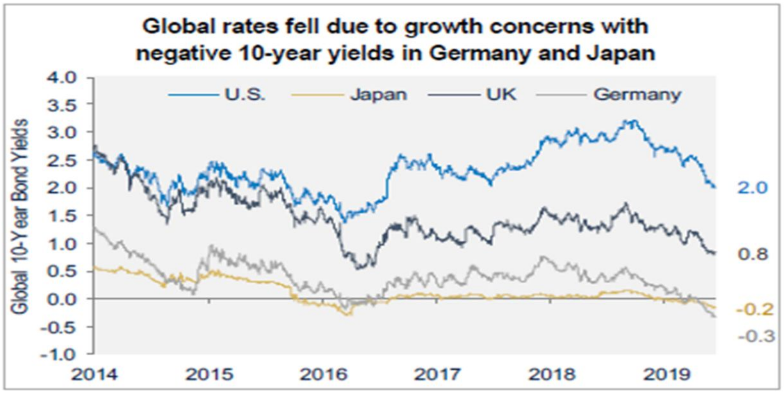
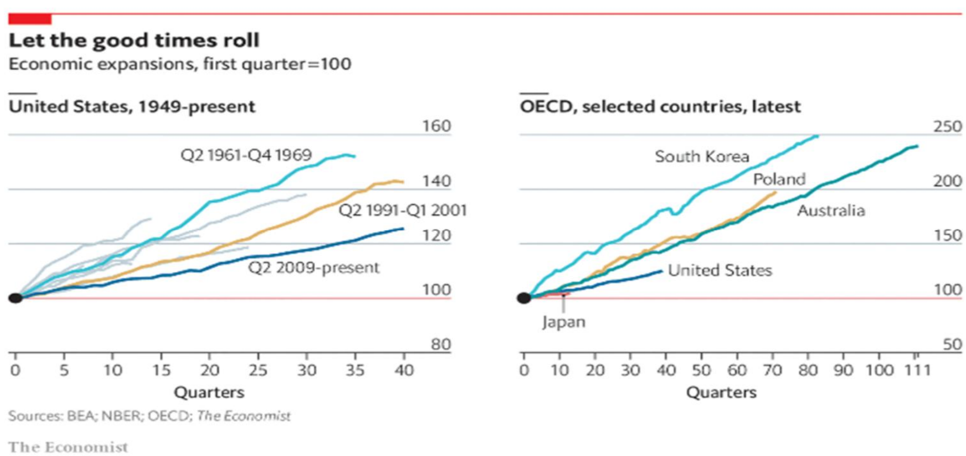
The shock from the financial crisis was so pervasive that fear of a recession and bear market have been present since the beginning of the recovery and bull run in the US equity markets. In this environment the second quarter of 2019 saw US equity markets have their best first half returns since 1997. With yields on bonds providing little competition for investors funds thanks to the Federal Reserve's (near) zero interest rate policy and the gravitational pull of foreign bond yields (chart to right), equities have been providing above-average returns during this recovery.



Source: FactSet. Data as of 6/30/2019.

At this point, Gross Domestic Product, household net worth, and corporate profits are at all-time highs while unemployment is at 50-year lows which is all being reflected in this strong stock market. The current economic expansion has become the longest on record at 121 months old. Starting the 11th year of a recovery it is natural to ask how much longer it can go on. While 40 quarters of expansion is long compared to previous US recoveries, other countries have gone on much longer without a recession interrupting their economic growth (chart below). Australia has gone almost 28 years without a recession while South Korea and Poland have achieved 15 to 20 years of continuous expansion.



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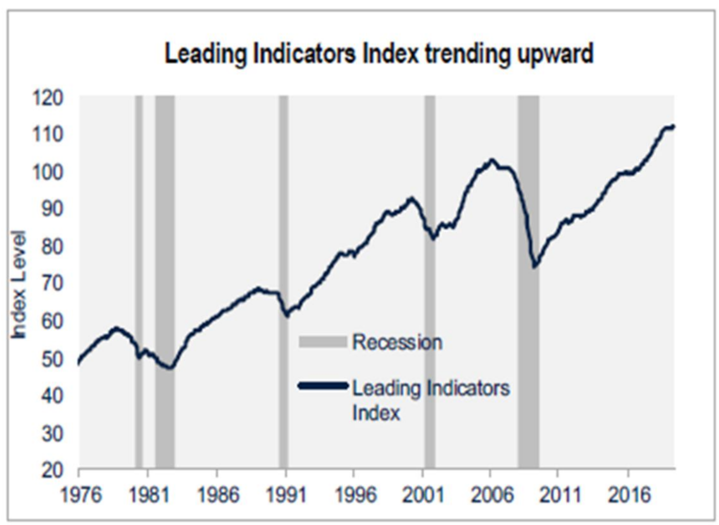
Since the end of 2018, markets have gone from expecting a few rate hikes in 2019 to anticipating rate cuts just six months later all while the economy continues to expand. Two main reasons are speculated for this change in outlook from the Fed. The first is that this would be an "insurance cut" reversing the December hike that helped lead to a pullback in equities in the fourth quarter. This cut is assumed to protect against slowing global growth which some metrics have indicated may be occurring hence the chorus of global central bank's harmonizing their message with the Fed. Even in the US some sectors are still struggling. The US retail sector for instance has seen 7,037 retail stores close year-to-date through June 30, 2019 versus 5,864 store closures during all of 2018.

The other potential reason for the rate cut has to do with inflation. The Fed's target inflation rate of 2% has not been met for any reasonable length of time during this recovery. Federal Reserve board members appear to be open to having the inflation rate run higher than that for a while if they can just get it there. One of the Fed's favored inflation gauges is the Personal Consumption Expenditures (PCE) price index which currently sits around 1.5% on a five year forward basis meaning expectations are low for the next several years. The PCE is a measure of the prices that people living in the United States pay for goods and services. It is also known for capturing inflation (or deflation) across a wide range of consumer expenses and reflects changes in consumer behavior. Inflation is notoriously difficult to measure and in order to more accurately capture different segments of consumers inflation experiences, several different constructs of inflation metrics have been created.

Technological improvements can result in incalculable improvements to society and individuals but the benefits they generate are never captured accurately in traditional inflation statistics. Eastman Kodak, founded in 1880, introduced its first digital single-lens reflex camera in 1991 and it cost about $13,000. It had a maximum resolution of 1.3 megapixels and the digital images it generated were stored in a separate ten-pound hard drive that photographers had to sling over their shoulder. Contrast that with the current iPhone XS which costs around $1,000 and has a front camera with a resolution of 7 megapixels, a rear camera with a resolution of 12 megapixels, and weighs 6.24 ounces. The iPhone and other smart-phone technology enabled developers to create apps like Instagram which was founded in 2010 with just 15 people. Instagram users could take these high resolution digital pictures and immediately share them with friends and family. Less than a year and a half after being founded, Instagram would end up being sold to Facebook for over $1 billion in 2012. Inflation metrics do a very poor job of capturing the dynamics of examples such as this rendering the Fed's job of targeting inflation a difficult task. We will have to wait and see how the Fed reacts to additional data in guiding their decisions on the path of future interest rate decreases or increases.

Equity bull markets and economic expansions don't die of old age, they are typically ended by central banks hiking interest rates with the intention of slowing the economy down from a perceived over-heating. Much will depend on when and how fast the Fed raises rates when it begins tightening again. The Federal Reserve has signaled this quarter though that it is prepared to accommodate the economy's continued growth and has telegraphed a very likely interest rate reduction at the end of July. Most major central banks around the globe have indicated they are going to utilize their own monetary tools to reflate their economies and markets have learned to respect that liquidity. As we go to press the betting is on a 0.25% reduction in the Fed Funds rate. Leading economic indicators do not show any signs of a recession on the near horizon and are still moving upwards (charts below). The economy added 224,000 jobs in June tempering market expectations of a larger rate cut.

Source: FactSet. Data as of 5/31/2019.



Source: QMA, Thomson Reuters Datastream. Data as of 5/31/2019.

Markets should continue to focus on earnings which have tough comparisons to last year's large tax-induced increase in profits but corporate balance sheets are strong and we consumer's have continued spending at a consistent pace supporting the economic expansion. We should begin to get a preview of next year's profit outlook through company earnings announcements for the third quarter which we will be watching closely.

We will talk to you soon...