Market & Economic Commentary: Markets Bloom Ahead of Spring

Spring 2019

Josh Mackenzie
Research Analyst
josh.mackenzie@npier.com

Jim Scheinberg CIMA® AIFA ®
Managing Partner
jim.scheinberg@npier.com

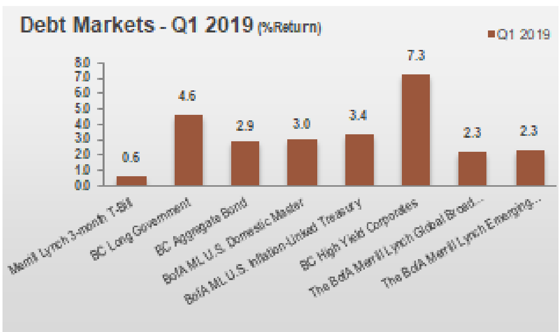
(800) 403-7065
www.npier.com
www.northpiersearch.com

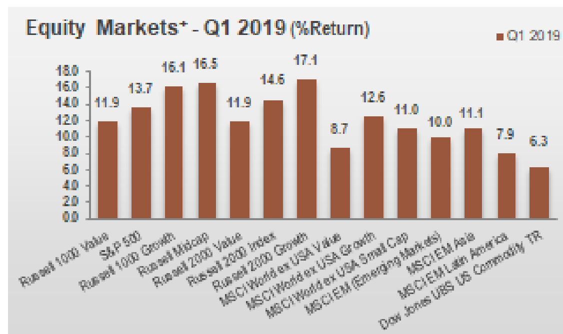
north pier Fiduciary Management

THE NORTH PIER*spective*

Markets Bloom Ahead of Spring

Just as the fear-based instinct of fight or flight is ingrained in all of us for self-preservation, it is also human nature to seek a fresh cause for optimism in the depths of despair. The first quarter of 2019 delivered such cause on the heels of the desperation of the fourth quarter selloff, making it all but a distant memory. As we wrote in our fourth quarter commentary, 2018 was a lousy year all around. We noted that short-term government T-bills were the best performing liquid asset class, as nearly all other major categories were down varying amounts on the year. In 2019, the script has been flipped. Every single asset class that we track posted a positive return for the first quarter. Highlights include the Russell 1000 Growth, whose impressive 16% return outperformed its value counterpart by over four percentage points, a broad-based rally across all credit sectors, and strong performance of emerging market assets (benefiting from a relatively flat U.S. dollar).





How the Markets Fared

Risk assets are on fire thus far in 2019. The spectacular performance of the S&P 500 is a testament to the dramatic flip in sentiment since the Christmas Eve low. When compared to the post-crisis years, the pace of gains in 2019 is evident:

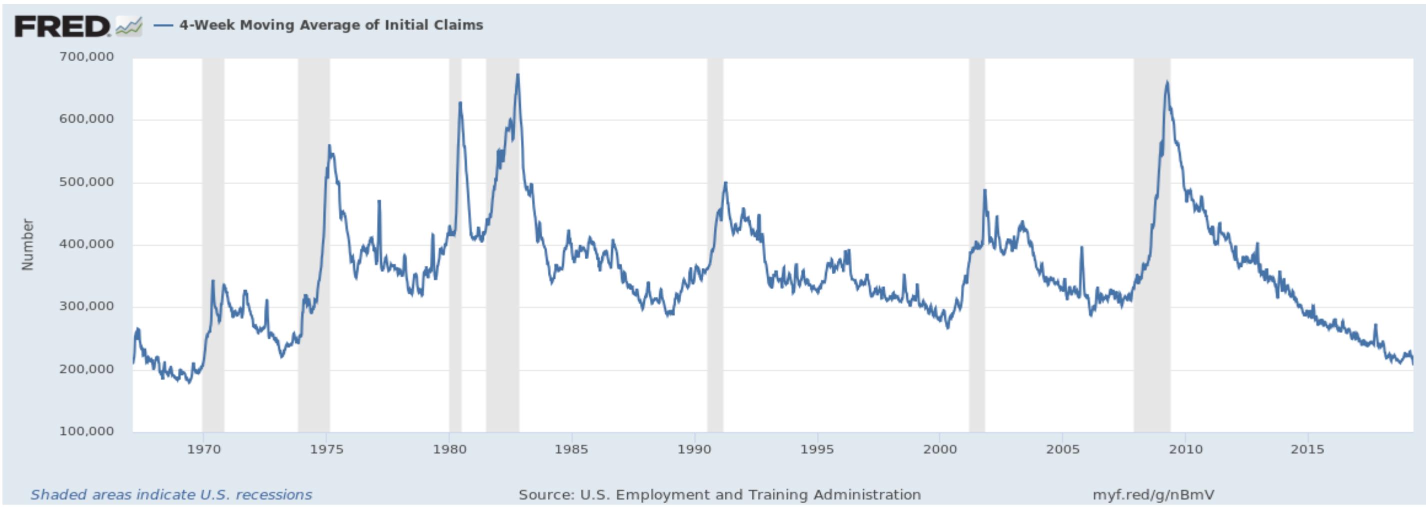
One might ask, what is driving this stellar performance for all risk assets in 2019? Several likely factors are working in conjunction to drive financial markets higher.

The initial rebound from the Christmas Eve lows was likely caused by rebalancing from institutions as well as 'robo-investment' programs in the retail sector. With the sharp declines in equity prices in Q4 averaging nearly 20%, many diversified asset owners found themselves below their policy limits for equity allocation. This led to programmed buying for automated managed accounts programs both from the major Wall Street firms as well as the emerging robo-advisor channel.

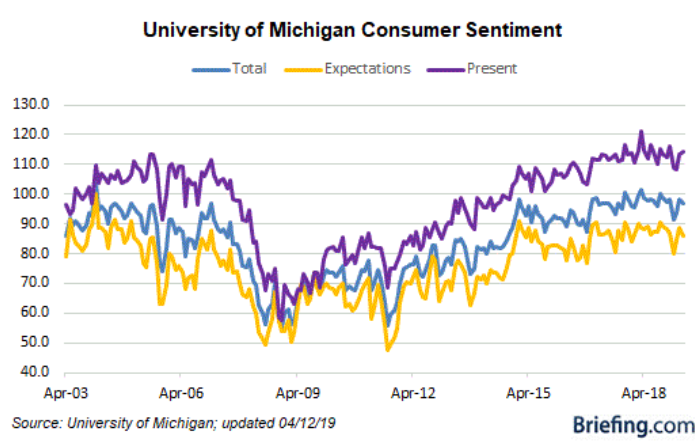
Though not quite as automated, institutions were also quick to add to their diminished equity especially those invested through Outsourced Chief Investment Officers (OCIOs). The institutional trend towards delegating macro-level investment authority to OCIOs[1] sped up this January rebalancing, which would have otherwise taken several weeks/months for committees to gather and act to bring their portfolios back within policy limits.

Unfavorable market action in the fourth quarter of 2018 was predicated on a looming worst-case scenario for 2019. However, as January's rebound began to gather steam, firm economic data steadily rolled out, surprising many cautious pundits to the upside. Since the beginning of the year, the economic data from the two seemingly most important economies in the world, the United States and China, has proven to be meaningfully better than anticipated. Initial Unemployment Claims have dropped to multi-generational lows, and wage growth steadily advanced, highlighting the continued strength of the U.S. labor market:

[1] *Scheinberg, J. (2019, April). Commentary: Record OCIO inflows highlight need for evaluation standards. Pensions & Investments. From* https://www.pionline.com/article/20190402/ONLINE/190409962/commentary-record-ocio-inflows-highlight-need-for-evaluation-standards#>>



Likewise, U.S. consumers continued to remain confident, with sentiment regarding current economic conditions maintaining their rosy viewpoint. Though future expectations readings took a pause after December's market turmoil and a prolonged government shutdown, even those indicators proved resilient, snapping back quickly to optimistic ranges after the stock market began to recover and the shutdown ended.



U.S. consumers were not the only ones to regain their optimism after the markets began to recover in January. U.S. business to business activity continued to show steady momentum as 2019 got underway. The manufacturing Report-on-Business from the Institute of Supply Management (ISM) never showed any indications of an economic slowdown, despite Q4's trepidation. The only blip was a short-lived pullback in New Orders in the January 3rd report. As the sky didn't fall, as was feared in December, New Orders came roaring back in February. The Services side of the ISM report didn't even register a meaningful decline in New Orders in the wake of Q4. Both surveys continue to suggest that the private sector of the U.S. economy is set to grow at a rate in the upper two to three percent range for the coming year.

The U.S. is not the only major factor in expectations for global economic conditions. A healthy China is essential for continued global growth as well. In 2018 the Chinese Communist Party had made deleveraging the economy a priority, tamping down on foreign investment, risky lending and credit growth. While that had the effect of lowering systemic risk, it also put the brakes on economic activity, which was felt in the second half of 2018. Subsequently, Chinese officials have signaled that they will back-off their more restrictive policy goals. Potential tax cuts, removal of red tape, and encouraging lending to smaller private businesses should stabilize growth in 2019, both within China and across the broader Asian emerging market complex. The effects of pro-growth policies have already begun to surface, as Chinese trade data has improved markedly from the depths of 2018's pause.

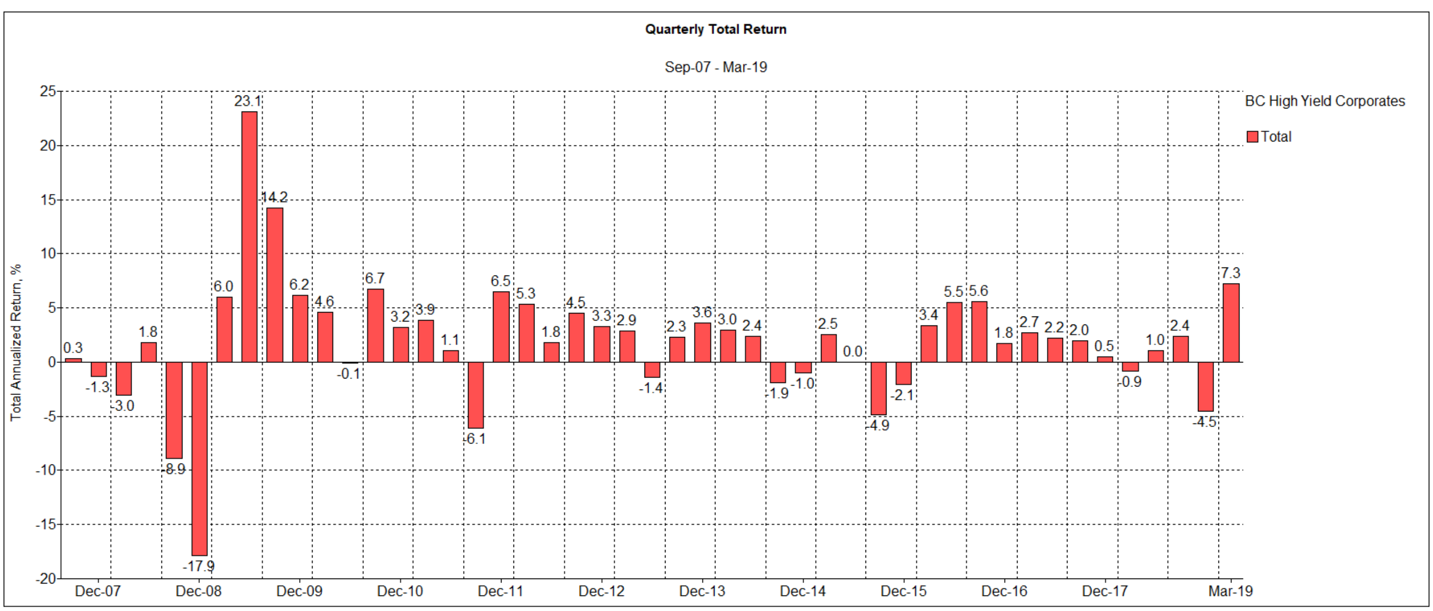
It would also appear that tensions between China and the U.S. have eased since both country's Presidents met at the December G20 summit. Trade had become an increasing point of contention since U.S. market volatility returned in early 2018. Officials on both sides were happy to talk a tough game in the summer and fall of 2018. However, once the realities of pending escalation in tariffs began to challenge affected U.S. manufacturers and multinationals, stock market pessimism gathered steam, political expediency took over. Since the December meeting and subsequent trade-war cease-fire was declared, negotiations seem to progress amicably.

While the exact contents or structure of a lasting trade-deal are unknown at this time, but it is likely that a compromise will be reached. Not only have financial markets been salivating at the prospect of a deal, it is in the political best interests of both administrations to settle this dispute once and for all. As evidenced by the weekly headlines on CNBC and Bloomberg taking some form of: “Stocks rally on trade optimism!”, it is likely that at least some of the upside to trade resolution has already been anticipated by financial markets. Nonetheless, that anticipation has been an important factor driving markets higher in 2019, and could equally be a source of renewed volatility, if talks were to reach an impasse.

Markets haven’t been buoyed by trade policy alone. The Trump administration, for better or worse, has inextricably aligned itself with the future of the stock market. To say this administration is a departure from conventional precedence would be an understatement. The recently announced presidential price target for the Dow Jones Industrial Average is at roughly “5,000-10,000 additional points.” For those keeping track at home, that is approximately a 19%-38% upside from current levels. Putting politics aside, it is safe to say that an administration with such a religious devotion to market performance is probably a net positive for investors in the near term, especially heading into an election year.

The Federal Reserve is also doing its best to avoid a repeat of the fourth quarter’s selloff. The fourth quarter’s concerns about an economic slowdown sent long-term interest rates tumbling from nearly 3¼% to 2½%. Part of that concern was based on a November miscue from the Fed that the Board of Governors was hell-bent on tightening monetary policy, regardless of a potential economic slowdown in 2019. However, Fed Chair Powel cleaned up those concerns in January, and the Fed has moved to a much more dovish stance ever since. After four rate hikes in 2018, it is increasingly likely that the Federal Reserve has finished tightening policy for the foreseeable future. This pivot has helped rates stay low, despite the renewed optimism in the economy and the recovery in equity markets.

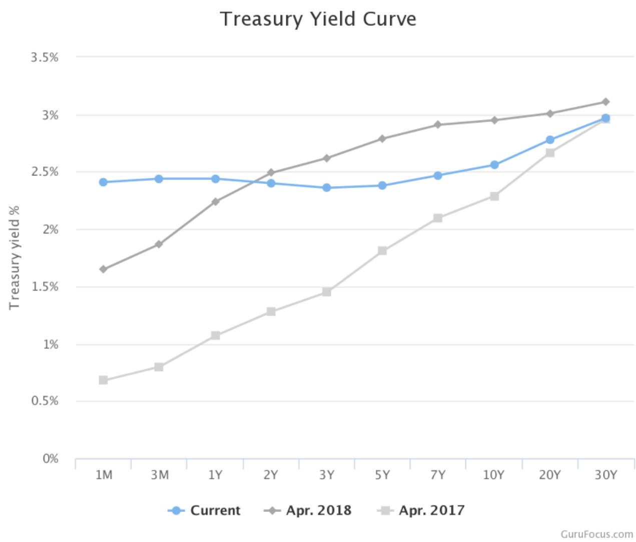
These lower long-term rates are providing continued support to the economy. The housing should be one of the biggest beneficiaries. Affordability should be less of an issue with mortgage rates retreating nearly 75 basis points from their 2018 highs. Cheaper mortgages, improving income growth, and moderated price appreciation should all lead to firming conditions in residential real estate. Declines in interest rates and renewed economic optimism also led to strong performance in the credit markets. High Yield debt had its strongest quarterly performance since emerging from the depths of the financial crisis.



Created with MPI Analytics

Investment grade debt also performed admirably as credit spreads continued to tighten throughout the quarter and intermediate to long-term rates declined.

However, these lower long-term interest rates have resulted in a flatter, and at times, a slightly inverted yield curve. A flat yield curve is often concerning to investors because the shape of the curve is reflective of expectations regarding future growth. A steeper curve is indicative of expectations that growth will be higher in the future than the present. A flat or inverted curve is indicating some degree of the inverse. The following chart illustrates the shape of the curve as it stands today, compared to one and two-year ago periods:



The curvature has been reshaped dramatically over the last two years. Not only has the curve noticeably flattened, but some of the shorter maturity issues have begun to invert. While much ink has been spilled on this topic, it is important not to place too much weight on any single indicator. An inverted yield curve is oft cited as a sign that a recession is near. Though it is factually accurate that inverted yield curves have presaged the last several recessions, the correlation should not be confused with causation. There have been several false positives as well when relying on the curve as a recession indicator, most famously in the mid to late 1990s and the late 1960s. The yield curve as a forecasting tool is best used in conjunction with other indicators to get a fuller picture of where the economy and markets are headed. Quite potentially, it should be taken with a grain of salt at this particular juncture. Historically low global bond rates have made our paltry 2.5% yield on the 10-Year Treasury look incredibly attractive when compared to the near zero returns of Germany and Japan. If global demand is the reason for low longer-term yields, this may very well prove to be another false positive. Especially in the face of so many other optimistic indicators.

PIER*ing* Ahead

There remains the question, where are we headed? All business cycles eventually end in recession, either in GDP, corporate earnings, or often both. Where we are in the current cycle remains open to interpretation. One thing we can say for certain is that this economic expansion is one of the longest in history. If GDP growth continues past July 2019, it will dethrone the 1990s cycle as the longest ever. The adage "bull markets don't die of old age" comes to mind. Getting longer in the tooth is nothing to fret over in and of itself; it is only the complications from getting older, which are highly correlated with the aging process that become problematic. Similarly, as the economic cycle extends, the traditional "complications" should present themselves. Some have already emerged; for example: the cessation of the Federal Reserve's tightening cycle, loosening of credit underwriting standards, and labor market tightness driving up wages. While financial markets can continue to outperform in an economy operating in a late-cycle, high-pressure state, it becomes increasingly important to monitor the incoming data. On that front, so-far-so-good, as year-to-date data has mostly exceeded expectations. By the end of this summer, investors should have a much better idea of where the global economy stands. If stimulus continues to emanate from China and our recent nagging trade frictions fade in the rearview-mirror, it is likely there will be enough gas in the tank for the economy and markets to make yet another push higher, before the side effects of old age really start to kick in. That said, people are living longer than ever… perhaps that will be true of bull markets as well. Time will tell.