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OUTLOOKS

July 2019

ECONOMIC OUTLOOK

Summary

The U.S. economy just surpassed the longest economic expansion in modern history, clocking in at 121 consecutive months. That exceeds the 120-month expansion from 1991 to 2001. Having crossed that important milestone, we may need some rate cuts by the Fed to keep the economy on an upward path, albeit a slowing one. As noted in last month's Monthly Outlook, the American economy is outperforming many of its developed nation peers but the global economy is clearly decelerating.

On July 1, 2019, the worldwide Purchasing Managers Index recorded a sub 50.0 reading (49.8) indicating a contracting global manufacturing rate of business. The U.S. is still positive at 51.7 but is weakening with the rest of the world. However, some of our underlying details were weak too, as new orders printed at 50.0 and order backlogs were below 50.0 for the second consecutive month. Europe is struggling as well, with the German Ifo Business Climate Index at the lowest level since November 2014.

It is important to note that the U.S. is primarily a service based economy (around 85% of GDP), so we are not in recession and should be able to avoid one. Clearly, a worldwide easing cycle has begun with the Fed likely joining the party this month with a 0.25% drop in the Funds Rate. Many of the developed and developing economy central bankers have already lowered rates, with indications of more to follow. Trade war threats, supply chain uncertainties and a 2020 U.S. election have business leaders in a cautious mode. With forward-looking inflation measures softening and the Fed seemingly determined to avoid a recession, we should expect a boost from monetary policy this year in order to keep the expansion alive and kicking.

Positives

Existing home sales came in at 5.34 million units (annualized) compared to 5.21 million last month

Durable goods orders (excluding transportation) came in at 0.3% last month, 0.1% was expected

Third revision to Q1 2019 GDP came in at 3.1%, 3.2% was expected but a good number nonetheless

Negatives

New home sales disappointed at 626,000 units (annualized) down from 679,000 last month

Consumer Confidence Index dropped to 121.5 last month, 131 was expected

ISM Manufacturing Index hits lowest level in 32 months but expanding

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OUTLOOKS

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EQUITY OUTLOOK

Summary

Global stock indexes rallied in June recovering losses from a rough May in which stocks dealt with fresh concerns about trade relations. The S&P 500 climbed 7.1% hitting new highs following the 6.4% loss the previous month. The index has returned 18.5% at the halfway point of the year, marking its best start in over 20 years. An anticipated cut in the Fed Funds Rate by the Federal Open Market Committee also helped stocks.

Tariffs and trade remain primary focuses for equity markets at home and abroad. While there is still much work to be done on this front, markets were relieved that talks between China and the Trump administration will resume following the unexpected breakdown in late May. Both developed international and emerging equity markets responded positively as well. The MSCI EAFE Index gained 5.9% and the MSCI Emerging Index rose 6.2%.

A strong rally in gold, oil and other commodities helped buoy basic materials, up 11.6% and energy, up 9.4% to the pole positions in June. Communication services and utilities, while still up nicely, were the worst performing sectors adding 4.8% and 3.2% respectively during the month.

Given lower interest rates and the strong probability that the Fed will begin to cut rates between now and year-end, current valuation levels may be much more reasonable than they appear and could rise higher. Since most other major asset classes look relatively unattractive, stocks are once again locked into the "There is no alternative" (TINA) trade. Equity indexes are likely to continue the march higher until something more significant knocks them off course.

Positives

Accommodative Federal Reserve now more likely to cut rates

Expectations for a near-term trade resolution are low, progress would surprise to the upside

Negatives

Global economic slowdown

Investor sentiment overly optimistic

Unknown

Brexit path and impact

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OUTLOOKS

July 2019

FIXED INCOME OUTLOOK

Summary

The rally in fixed income markets continued in June with yields falling and credit spreads narrowing. Early in the month, Federal Reserve Chairman Powell finally acknowledged that he is receptive to a rate cut. After pivoting from a tightening forecast to one that is "data dependent" way back in March, we wonder what finally convinced the head central banker of the world's largest economy that it was time to consider actually lowering the overnight lending rate. It might have been the chorus of softening economic data including manufacturing data, housing sales and employment. It might have been the uncertainty created by the trade conflicts with our major trading partners; it could have been the weakening data abroad that has sent the other central bankers of the world to expand accommodative policies that pushed up prices and sent about $13 trillion of bonds into negative yields (yes, you pay more than you get back). After missing on their inflation target for the majority of the past 10 years, maybe it was another 20 basis points (bps) plunge in forward looking inflation forecasts.

Whatever the reason, the Fed now appears to be listening to the message the market is sending. At one point, the market was pricing in a nearly equal chance of a 50 bps cut but that expectation evaporated with the rebound in June payroll growth. We think the market has a right to expect 25 bps at the end of July and another 25 bps in September or October, with a further chance of a third cut by year's end. The yield on the 10-year Treasury note dropped below 2% when the market began looking for a 50 bps cut this month but it has rebounded a bit. While we have been hopeful that yields could move a bit higher, we now are less optimistic and believe that current levels make sense relative to global rates and the likely path of our own overnight rates. With no recession on the horizon and increasing confidence that the Fed will not purposely kill the historically long economic expansion, investment-grade credit spreads seem attractive to us at an average of 120 bps of incremental yield.

Positives

- Fed on board with a July cut in the overnight rate, with more before year's end
- Decline in inflation expectations as global growth slows
- German 10-year yields hit new historic lows of -0.40%

Negatives

- Yields already likely reflect part of future rate cuts
- Trade disruption could cause temporary inflation spike

Unknown

- Disruptions to worldwide GDP caused by trade war with China and bilateral tariffs
- Denuclearization negotiations with North Korea and Iran

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