August 12, 2019

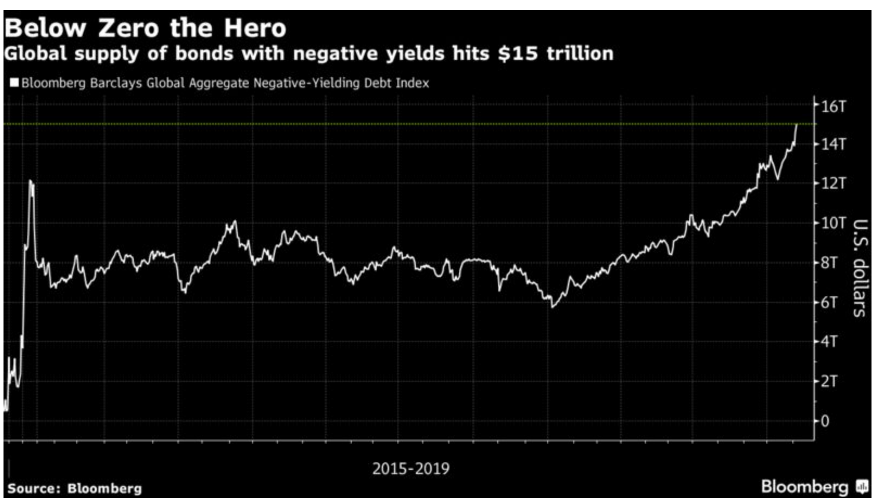
The Big Picture and Key Takeaway - July 2019

While July is usually notable for the fireworks that occur at the beginning of the month, from the market's perspective, most of July was quite calm. But the fireworks did arrive at the very end of the month, and have continued well into August. As we've mentioned previously, 2019 has been defined by the volleying back and forth between two major forces - Federal Reserve policy and trade talks between the U.S. and China. For most of the year, the news has seemed supportive on both fronts. Outside of a hiccup in May on trade concerns, the Fed's "shifting towards a rate cut" stance in June prompted the stock market to claw back all of May's losses and then some, leading to new record highs for the U.S. indices in July. All was good, until July 31st.

When the Fed met on July 31st, the expectation was that the Fed would deliver a 0.25% interest rate cut – which it did. But in setting forward guidance for future policy, the Fed indicated that the cut should not be viewed as one in a string of cuts. It was an insurance cut for the time being, no more or less. The stock market immediately sold-off, as it wanted more assurance that rates would continue to move lower. Jerome Powell did not provide that – yet, of course.

On the trade front, the news was also disappointing. While U.S. and Chinese trade negotiators met in Shanghai at the end of July, little of note was accomplished as they determined to revisit discussions in early September. A "can" seemingly kicked just a bit further down the road. The delay wasn't such a big deal, until the White House announced the potential imposition of another 10% tariff to be applied on another $300 billion of Chinese goods. China responded by devaluing its currency to make its products more competitive. The U.S. reacted again by labeling China a currency manipulator, something the U.S. has been careful not to do in the past.

In contrast to the trade optimism of months ago, the recent trade war rhetoric and actions have been digging the hole deeper, with real economic impact, and neither side is showing any inclination to blink. With an already slowing global economy, these developments have been unwelcome. As a result, riskier assets like stocks have sold-off in early August, while safe-haven assets like high-quality bonds and gold have been the beneficiaries.



Since the disappointing guidance by the Fed, and the negative tone of U.S.-Chinese trade talks, interest rates have plummeted to levels that most thought we might not see again – at least not this soon. Global central banks are again leading a race to the bottom on interest rates, as more than $15 trillion of international assets now provide investors with negative yields (see chart)! Also, the U.S. bond market is telling a recessionary tale, or at least pricing in much more easing by the Fed than even the Fed indicated it would provide a mere week or so ago.

Will the Fed give the markets what it wants? It's likely, because in recent years, the Fed has *always* given the market what it wants. According to Charles Schwab, since the end of the financial crisis in 2009, the Fed has met 80 times. In every instance, the Fed delivered precisely what was expected as priced in by the markets. The markets are indeed the "tail" that now wags the Fed "dog." Will more easing be enough to hold things together? We bet we'll find out.

July & YTD Market Performance

Market Returns		Returns (%)	
Index	Description	July	YTD 2019
S&P 500 TR USD	US - Large Company	1.44	20.24
Russell 2000 TR USD	US - Small Company	0.58	17.66
MSCI ACWI Ex USA NR USD	All International, excluding US	-1.21	12.22
MSCI EAFE NR USD	International, excluding Emerging Markets	-1.27	12.58
MSCI Emerging Markets NR USD	Emerging Market Stocks	-1.22	9.23
Bloomberg Barclays US Agg Bond TR USD	High Quality US Bonds	0.22	6.35
ICE BofAML US High Yield TR	Lower Quality US Bonds	0.51	10.72
XAU Gold Spot $/OZ	Gold	0.30	10.23
*Through July 31, 2019 Source: Morningstar, MSCI, Bloomberg			

Global Stocks

While stocks meandered quietly for most of July, they ended the month off the record highs hit earlier in the month. While U.S. stocks managed to eke out small gains, adding to already substantial gains for the year, international stocks gave back some gains for the month. Most of the differential between U.S. and international stock performance was attributable to the U.S. dollar strengthening relative to a basket of foreign currencies. Emerging market stocks lagged slightly compared to their developed counterparts, likely impacted by slower trade volumes in 2019. Within the U.S. markets, large-company stocks fared better than smaller companies, while growth-oriented names continued to outpace cheaper value names. Among individual sectors, communication services and technology led the way, followed closely by consumer staples and financials. The energy, healthcare, material and utility sectors all lost ground in July, but remain in positive territory for the year so far. As earnings growth for the stock market has slowed down as expected, investors will pay close heed to the resilience of corporate earnings, or lack thereof, in the months to come.

Bonds

Bonds continued to benefit from a decline in interest rates across all maturity levels. The 10-year Treasury bond yield dropped another 0.14% in July and has now declined by well over 1% from where rates were 12-months ago. As rates fall, high-quality bond prices go up, and all major bond market sectors have produced positive returns for the month and the year. If you go back 12-months, the Barclays US Aggregate Bond index has outpaced the global stock market as defined by the MSCI All Country World Index by over 10%, as of August 6th. Both investment-grade and high yield corporate bonds led the way in July, as credit spreads continued to grind lower. As the 30-year Treasury bond is near a record low yield level, and the yield curve inverts in places, investors and markets will be paying close attention to signals the bond market may be sending about the economy and the potential for an economic slowdown.

The Key Takeaway

We've been in a low rate world for 10-years, and now rates all around the world can hardly be lower. It seems that when low yields aren't quite enough, the only answer is that they need to decline further. Pair that with trillion-dollar a year fiscal deficits and spending projected by the U.S. government, and one has to wonder why we are not worried about overheating growth and inflation, as opposed to the opposite. But here we are. If the trade war escalates, we would be concerned about the real economic fallout and subsequent market adjustment. If it somehow resolves peacefully, after rate cuts are forced lower by the markets, the good times of 2019 may continue to roll. Maybe that's the plan after all.

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Index and Category Definitions

The S&P 500 Index** is a capitalization-weighted index of 500 U.S. stocks.* ***Russell 2000 TR USD** is a market cap weighted index* The Russell 2000 measuring the performance of approximately 2,000 smallest-cap American companies ***The MSCI All Country World ex-USA Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI All Country World ex-USA Index consists of 22 developed and 24 emerging market country indices.* ***The MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada.* ***The MSCI Emerging Markets (EM) Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of 24 emerging markets countries.* ***Bloomberg Barclays U.S. Aggregate Bond Index** is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.* ***ICE BofAML U.S. High Yield Index** is an unmanaged index of below-investment grade U.S. corporate bonds.* ***XZU Gold Spot $/Oz** reflects the exchange rate of **Gold** against the US dollar **index

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