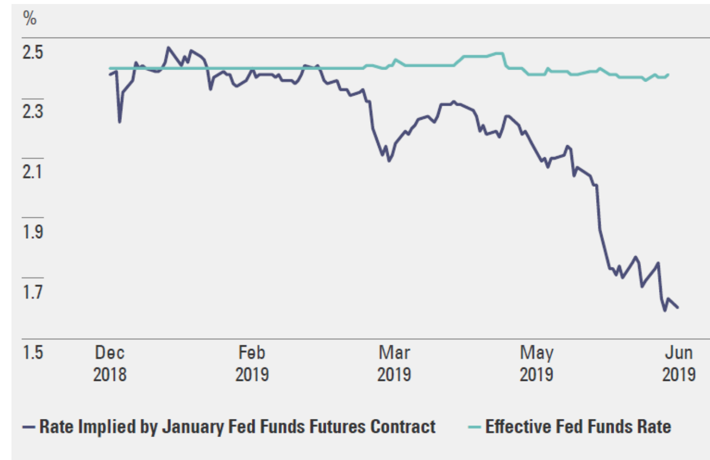
June 30, 2019

The Big Picture and Key Takeaway - *A Fed-Induced Bounce Back*

Traders Increase Bets That Fed Will Cut Rates 3-4 Times This Year



Source: State Street, Bloomberg as of June 24th, 2019

Last month, the markets focused on the downside risks of a protracted trade escalation with China and Mexico. In June, the focus shifted to what the Fed may do to balance the risk of a trade-induced economic slowdown. And the markets got what they wanted. First, the Mexico tariff threat was quietly resolved, for the time being. Next, the Federal Reserve met mid-month and moved a step closer to giving the markets what they want. While the Fed did not lower rates, they foreshadowed their potential intent by dropping the word "patient" from its post-meeting statement, which would allow them to cut rates as soon as July. As the chart above illustrates, the Fed Funds Futures contract expiring in January of 2020, is now implying nearly three to four rate cuts before the end of the year. While the green line represents the actual Fed Funds Rate, which is between 2.25-2.5%, the purple line shows that traders believe the rate will be below 1.70% by next January. Long-story short, the Fed would need to get to work to meet the market's expectation, and they set the stage to do so. Lastly, at the very end of the month at the G-20 meeting, the U.S and China signaled their intent to restart trade talks.

The duo of a more accommodative Fed and improved prospects on trade produced strong returns for stocks, bonds and gold for June. Reminiscent of 2017, and except the month of May, the first half of 2019 has produced strong returns across all asset classes, even as nascent signs of economic slowdown become more prevalent. The trend in several leading economic indicators, such as the average workweek, corporate capital expenditures and the inversion of the yield curve has been worsening. On the positive side, consumer spending appears solid and credit conditions have improved. The economic mixed bag has left the Fed in an interesting position. Take a data-dependent, wait-and-see approach? Or just give the markets what they are clamoring for? It looks like the latter may win out.

It is often said that investors should not "Fight the Fed", but it now seems that the Fed doesn't want to "Fight the Market". The bond market, with significant decreases in long-term yields this year, has made its case that a slowdown could be on its way. The stock market, after the trade-induced losses of May, illustrated its own concern. The Fed now looks to potentially give both markets what they want, in the form of a potential "insurance cut" this summer. If it doesn't, expect more volatility in the second half of the year than we had in the first.

June & YTD Market Performance

Market Returns		Returns (%)	
Index	**Description**	**June**	**YTD 2019**
S&P 500 TR USD	**US - Large Company**	**7.05**	**18.54**
Russell 2000 TR USD	**US - Small Company**	**7.07**	**16.98**
MSCI ACWI Ex USA NR USD	**All International, excluding US**	**6.07**	**13.99**
MSCI EAFE NR USD	**International, excluding Emerging Markets**	**5.97**	**14.50**
MSCI Emerging Markets NR USD	**Emerging Market Stocks**	**6.32**	**10.76**
Bloomberg Barclays US Agg Bond TR USD	**High Quality US Bonds**	**1.26**	**6.11**
ICE BofAML US High Yield TR	**Lower Quality US Bonds**	**2.42**	**10.12**
XAU Gold Spot $/OZ	**Gold**	**7.96**	**9.90**
***Through June 30, 2019 Source: Morningstar, MSCI, Bloomberg**			

Global Stocks

After a dismal month of May for the global stock market, the month of June couldn't have been much better. The S&P 500 delivered one of its best-ever June performances, and did so broadly across sectors. Every sector delivered positive returns, led by basic materials, energy, technology and industrials. For the first 6-months of the year, technology has also prompted U.S. growth stocks to extend their outperformance over value stocks by over 7%. Small stocks kept pace with larger company stocks for the month. International stocks also bounced back nicely in June, but underperformed the U.S. by approximately 1%. A weaker dollar due to lower a lower Federal Funds rate may yet prove to be a tailwind for international holdings, and the degree to which the world's markets move together, has fallen to 20-year low levels according to Charles Schwab – potentially enhancing the benefits of international diversification. Emerging market stocks also recovered in June, although still lag their developed market counterparts internationally.

Bonds

As global interest rates continued to decline, bonds continued to make money in June. For the year, high-quality bonds have increased by over 6%. 10-year Treasury yields dropped by another 0.12% in June and have declined by a whopping 0.68% so far in 2019, reflecting expectations for slower economic growth ahead, hopes for a more "dovish" Fed and a continuing and persistently low inflation picture. Inflation, as measured by the Fed's preferred PCE (personal consumption expenditure) gauge, continue to track well below the 2% target set by the Fed. While high-quality bonds continue to benefit from declining rates, lower quality "high yield" bonds continue to benefit from declining credit spreads, and are up by over 10% so far this year.

The Key Takeaway

Interestingly, we are talking about rate cuts with an unemployment rate at 50-year low levels and a stock market hitting record highs. It's not your traditional setup for an interest rate cut. We can talk about the economic data all we want, because it matters in the real world, and the Fed will always claim that they are economically "data-driven." But, the Fed's U-turn over the past 6-months has laid bare the market's dependency on the Fed, and the Fed's responsiveness to the market. For now, this co-dependent relationship continues to be all that matters. And the market likes what it's getting from the Fed right now. But, should the Fed not meet the markets "accommodative" expectations over time, we would expect volatility to increase and a much less "accommodating" market response than we've seen so far this year.

Important Disclosure Information

This report is provided as information and commentary regarding the market. The views expressed in this report are as of the date of the report, and are subject to change based on market and other conditions. This report contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

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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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