Quarterly Commentary: Q2 2019

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Equities:

Performance across individual companies and sectors was a bit choppy during the second quarter as investors wrestled with the shroud of uncertainty created by the tenuous trade relationship between the United States and China. Nevertheless, the U.S. equity market (as measured by the S&P 500) rode a strong June rally to new all-time highs, with optimism being fueled by rising confidence that central banks will provide the juice needed to stave off a global economic slowdown. That sentiment was felt worldwide, with international equities in both developed and emerging markets taking advantage of strong June rallies to end the quarter in positive territory.

At present, equity markets are painting a very positive picture of the future; one where central banks can continue to keep the current expansion on target even as it faces its stiffest competition yet in the form of slowing global trade, declining manufacturing activity, and rising geopolitical tensions. Whether that optimism will prove justified remains to be seen, but one only needs to go back to the 1990s to find an example where equity markets extended the rally for an additional five years after the final Fed rate hike.

Bonds:

With equity markets playing the role of Pollyanna, bonds are casting a far more pessimistic tone. Treasury rates continued their precipitous decline throughout the second quarter, with the yield on the 10 Year Note falling to its lowest level since 2017. The futures market is now pricing in more than 100 bps (1%) of rate cuts by the end of 2020. For reference, this would mean the complete reversal of four previous rate increases. Of course, when interest rates decline, bond prices rise, meaning that bonds joined equities in generating healthy returns for investors during the first half of the year.

Whether explicitly part of the policy agenda or not, the Federal Reserve has at the very least, shown that it is keenly aware of market expectations and sensitive to bouts of market volatility that may have been caused by its actions. There have been multiple examples over the past several months of Fed representatives providing what might be construed as strategically timed comments that seemed to help sooth markets during bouts of volatility. Thus, current market expectations may have wedged the Fed between a rock and a hard place, where it risks disappointing markets and tightening lending conditions if it keeps interest rates above what the market is calling for. While we continue to believe that the fundamentals of the economy remain strong enough that a recession is not on the near-term horizon, the Fed may ultimately conclude that with inflation still in check, a preventative "insurance cut" (as it has come to be referred to in financial circles) may be its best course of action for keeping the economic expansion on the path of least resistance.

Outlook:

With equities and bonds seemingly at odds with one another, there are some interesting and challenging implications for portfolio construction. In the current backdrop, the only way that both the stock and bond markets can be proven right is if the bond market has correctly predicted that the Fed's concern over economic growth will push it into an aggressive mode of monetary easing (i.e. significant rate cuts), and that this monetary easing will be impactful enough to enable equities to charge onward. There is little in the last 10 years of economic history to suggest that this isn't a plausible scenario (central bank intervention in the United States has been quite effective since the financial crisis), but the next several months will go a long way in helping us learn whether the bull can be tamed. At this point in time, we remain cautiously optimistic and continue to recommend a balanced, neutral approach to portfolio positioning.

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