Review & Outlook – 2Q 2019

The second quarter of 2019 was signified by a lot of ups and downs and ended higher than where it started – which is pretty much the story of the last twelve months, only on a smaller scale. The S&P 500 had a nice 4.1% gain in April, followed by a sudden 6.4% drop in May (which felt like more), followed by a strong snap-back of almost 7% in June. The net result for the last three months was a 4.3% return for the S&P 500, a 3.2% return for foreign developed markets stocks, and just a 0.5% return for emerging markets stocks.

S&P 500

Source: Strategas Research Partners

With the news cycle becoming shorter and shorter, and President Trump's avid use of Twitter, the market is acting like a dog in a yard full of squirrels, jumping back and forth with every headline. This quarter, China trade and the Federal Reserve seemed to dominate the market headlines, as the brinksmanship between Trump and Xi waxed and waned – with the market following suit. The Fed continues to hem and haw about the possibility of rate cut(s) – which seemed like a farfetched possibility even 12 months ago. Compounding these issues is the election cycle, which has shifted one more gear higher with the first round of Democratic presidential debates.

With all that said, the U.S. economy is still doing "okay," and "okay" is pretty darn good, considering how long this expansion has lasted. Unemployment remains below 4%, and real wage growth has been (finally) ticking up. While corporate capital expenditure expectations have moderated, consumer spending growth remains in positive territory. The flat/inverted yield curve remains a source of concern, although, a) it depends on which parts of the curve you measure; and b) inverted yield curves can tell many different stories about the economy and have had several "false alarms" over the years. Overall, the leading economic indicators remain firmly in positive territory.

While we avoid gazing into crystal balls to predict market movements, there are some key drivers and risks present within the economy that could impact markets over the next 12-24 months:

1. Consumer spending – Consumer spending is approximately 70% of the total economy, and the spending rate is still healthy with unemployment at multi-decade lows. More jobs = more money in people's pockets to spend. While there are questions about the supposed quality of the jobs out there, it's hard to dispute that 3.9% unemployment is anything but an economic positive.

2. Business investment – Corporate capital expenditures do not have the same direct effect on the economy as consumer spending, but they can be a useful indicator of corporate confidence in future earnings growth. Capex has moderated in the wake of the US/China trade spat, so an uptick here would be a positive factor (and vice versa).

3. The Fed – Love them or hate them, Jerome Powell and the Federal Reserve Open Market Committee control much of the short-term swings in the market. They are in a bit of a pickle right now, given the presence of conflicting data. While unemployment is at multi-decade lows (which would normally push up inflation), headline inflation is still very benign, and the economy is just "okay," with GDP growth clinging to the 2%-3% range.

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4. Trade/Brexit/geopolitics – All of these issues are interrelated and mainly affect the global economy. Since we invest a portion of our client's funds into international stocks, this is relevant. A decisive trade resolution with China will most likely take much longer than expected, as a) China's leaders are masters at playing the "long game," and b) China has more to lose than the U.S. Ironically, a long stalemate could be a positive for the markets, as companies slowly adapt to the new status quo and shift around supply chains to compensate. The Brexit deadline has been extended to Halloween. However, Britain currently has a lame duck Prime Minister and no consensus or agreement on how to exit the E.U. While Brexit would have more of an impact on Europe than the U.S., Europe is a huge trading partner and a large cog of the world economy that has been very sluggish lately. A messy Brexit could push Europe into recession.

Of course, all of this must be evaluated in the context of valuation: how much you are currently getting paid to invest in each asset class. The charts below convert the valuation of three different asset classes (stocks, bonds, real estate) into a common measure – the price to earnings (P/E) ratio. While stocks certainly aren't cheap at 18x earnings, they compare favorably to residential real estate at a 21 P/E (as measured by price to annual rental income) or Treasury bonds at a 50 P/E (the inverse of the yield). While the comparison is imperfect – Treasury bond interest is guaranteed by the government, while stock dividends aren't guaranteed by anybody – it helps to put valuation in perspective, especially when a talking head on CNBC starts yelling about a "stock bubble."

Many readers find these reviews and outlooks frustrating, because there are few definitive statements. And we get it, we really do. The problem with investing in long-dated assets like stocks is that their prices discount decades worth of future events. This goes against every human instinct that has been cultivated over tens of thousands of years. If a human saw a tiger 5,000 years ago, he wouldn't convene a committee meeting debating the long-term trends of the tiger/mammoth populations and the merits of flint vs. stone spearpoints. He would either fight, run, or become a tasty meal for the tiger. News reports, talking heads, and Trump tweets are all like ghostly tigers and mammoths – scary, yet enticing – which continuously triggers the fight-or-flight instinct for decisions which need to be much more long-term in nature. This instinct ultimately leads to overtrading, selling low, buying high, and generally disappointing performance.

So, in the face of this sensory overload, what should an investor do? The answer is simple, not easy. Stay true to your investment policy statement. This document is your long-term guide through the jungle and is designed to work across investment and economic cycles and allows you to tune out the daily noise by diversifying across different asset classes. If your investment policy says to maintain a 60% stocks/40% bonds allocation, and stocks are at 67% and bonds 33%, then you should probably sell some stocks and buy some bonds, regardless of what you hear on CNBC. If you are below target at 55% stocks, then maybe buy stocks and sell bonds. Buying stocks when they are going down (or selling when they go up) goes against every instinct we have as humans, but a written policy short-circuits those instincts and frees your mind to fight real "tigers" and hunt real "mammoths."