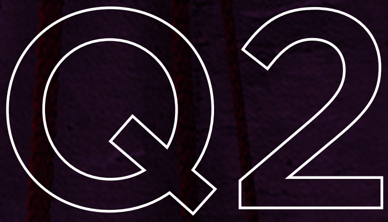

Q2 2019 REVIEW

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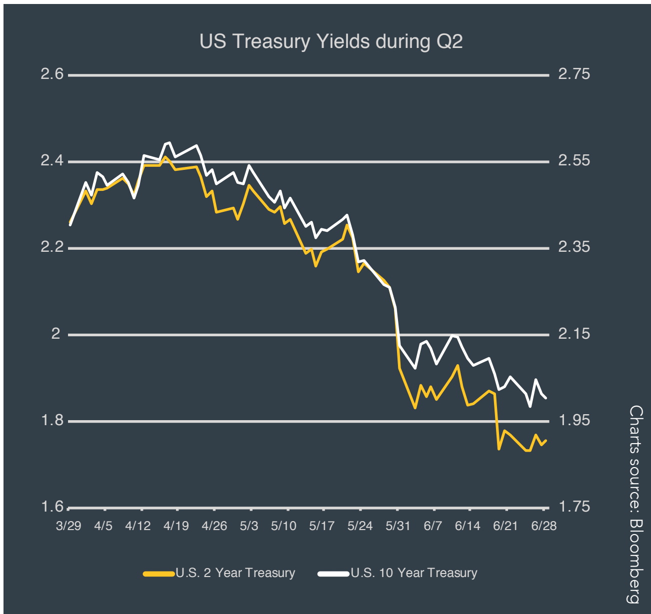
MARKET NOTES

THE STORY WAS INTEREST RATES

The story of the quarter was the story of interest rates and the U.S. Federal Reserve. In a little more than six months, the market has gone from expecting the Fed to lift rates to anticipating a minimum of one—and possibly as many as three—rate cuts this year.

Much of the economic data was mixed throughout 2Q, not surprising given all the cross-winds. The quarter started on an up note, with the S&P 500 climbing more than 2% on positive news out of China and a strong U.S. jobs report. The major issues that have continued to bedevil global markets – China trade and Brexit – were around then, too, but there was a higher level of optimism that something would be resolved, at least with China. The yield on the 2-year Treasury stood at 2.33% on May 3; for the 10-year Treasury, that number was 2.53%.



Charts source: Bloomberg

EARNINGS BETTER THAN EXPECTED

Second quarter earnings were better than expected with many companies exceeding (previously lowered) analyst expectations. Unemployment reached a near 50-year low while wages demonstrated modest growth, providing support for the consumer to continue to spend. Towards the end of April, the S&P 500 was on course for the best four-month start to the year in more than three decades.

But, even as the markets were rising, data in the U.S. and elsewhere were starting to show some signs of weakness, suggesting that the failure to solve the China – U.S. trade conundrum was beginning to filter through to the real world. The month of May saw stocks retreat, with the S&P 500 down around 6% on the month. At the same time, 1Q GDP came in well above estimates, up 3.2% compared to expectations of around 2.3%.

Inflation, as measured by Personal Consumption Expenditures (PCE), stayed well below the Fed's 2.0% target, at 1.6% in May, supporting the Fed's then "watch and wait" position on interest rates. The big news for the month was the unravelling of the trade talks with China, with new tariffs announced by President Trump in a weekend tweet. Threats escalated on both sides, and markets were rattled; though, in the U.S., at least, the economic fundamentals remained relatively strong. Homebuilder sentiment rose to a seven-month high. Housing starts climbed more than expected, and consumer sentiment, as measured by the University of Michigan survey, rose to the highest level in 15 years; however, retail sales were weak, based on slowing demand for autos.

Earnings season ended on a positive note, as earnings for the S&P 500 climbed 1.8% in 1Q, well ahead of the -3.0% that was projected. Nonetheless, U.S. equity markets remained unsettled, declining for four weeks in a row through the end of May.

BOND YIELDS FALL

Treasuries generally rallied in the face of all this uncertainty; bond yields fell, and the yield curve inverted again. The Fed was given something more to think about in late May when President Trump unexpectedly threatened to levy tariffs on Mexico in a weekend tweet. Unusually, this had less to do with economics than with immigration policy, and it threatened to severely disrupt markets and billions of dollars in cross-border trade.

On June 4th, Federal Reserve Chairman Powell gave a speech indicating that the Fed was closely monitoring the impact of trade on the economy and would be willing to "act as appropriate" on rates. The stock market responded positively to his remarks, climbing more than 2% on the day. Ultimately, the Mexico situation was resolved, at least temporarily, allowing President Trump to declare victory. The trade policy uncertainty lingered, however.

Heading into the second half of June, the U.S. economy continued to soldier on; though, both manufacturing activity and job growth showed signs of slowing. Retail sales were strong, however, suggesting that consumers were still prepared to spend. The Atlanta Fed marked up its GDP Now predictions for the second quarter in mid-month, from 1.4% growth to 2.1%.

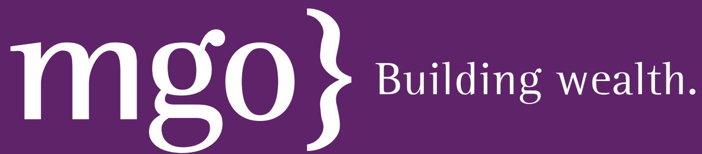
But the Fed and its fellow Central Banks around the world continued to be the story. As of mid-June, investors were assigning an 83% chance that a cut in Fed Funds was in the offing at the September Fed meeting. The European Central Bank suggested that it, too, was prepared to cut rates. For its part, the Bank of England cut its Q2 growth forecast for Britain's economy to zero and kept rates steady.

MARKETS RALLY

Heading into the end of the second quarter, some uncertainty had begun to materialize regarding the G20 meeting between President Trump and President Xi. But on June 18th, President Trump tweeted that the two leaders had agreed to an "extended" conversation at the conference. Markets rallied strongly on the news. The following day, the Fed announced that it would leave rates unchanged, but showed a definite bias towards cutting rates later in the year if needed. They removed the word "patient" from their statement, in reference to rate policy. Following this, markets continued to head higher, even as the yield on the 10-year Treasury fell below 2.0% for the first time since 2016.

Stocks closed out June up 17% year to date, as measured by the S&P 500—the best first half in 22 years. For the second quarter, the S&P 500 was up 3.8%. Other data continued to be mixed. New home sales fell in June, and consumer confidence dropped to its lowest level since September 2017 as the uncertain resolution to the trade conflicts continued to take a toll. But the trade situation took a turn for the better at month's end as Presidents Trump and Xi, meeting at the G20, agreed to resume trade talks and the U.S. lifted restrictions on China's Huawei.

The economic expansion, now the longest, if not the strongest, on record, looks set to continue.



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