2Q 2019
Market Commentary

Here's the answer: "Trade Uncertainty!" What are the questions?

1. What triggered businesses to delay capital spending plans?
2. Why has world trade growth declined?
3. What has caused commodity prices to weaken?
4. In considering reversing course on interest rate policy by lowering the Fed Funds rate, what does the Federal Reserve Board hope to offset?

It's all about the massive uncertainty created by the trade battles the U.S. has undertaken, particularly the trade war with China. The outlook seemed positive leading up to the May meeting between U.S. and Chinese negotiators, but when China backed out of key deal points, recession fears grew once more and the stock market plunged again in May.

These fears contributed to the bond market's expectations that the Fed would be forced to come to the rescue by reversing course and actually cutting rates or halting quantitative tightening (QT). With Fed Funds right around 2.5%, by the end of the quarter, the bond market had pushed the yield curve down from its modest inversion to steeply inverted with -80 basis point spread between Fed Funds and the 1.71% yield on the 3-year Treasury note. As of June 30th, the bond market was already discounting the expectation that the Fed will cut rates by 50 basis points during its July meeting. The entire curve rallied in the 2nd quarter, and by quarter end, the Fed Funds rate stood just below the 2.53% rate on the 30-year Treasury bond—stunning!

The stock market rallied back to new highs in June on the prospect of the Fed reversing course, with lower anticipated discount rates boosting stock prices and price/earnings ratios. Yet, there is little evidence, either in the U.S. or around the developed world, that pushing interest rates down (and deeply negative for some countries) boosts economic growth beyond housing and autos. Furthermore, if the temporary reduction in trade tensions coming out of the recent G20 meeting at which Xi and Trump agreed to restart negotiations actually leads to a permanent deal, won't economic growth reaccelerate as the playing field for corporate decisions becomes clear? The answer is "yes," and if such an outcome were to occur, the call for rate cuts may come to an end. Although a return to higher interest rates may hurt some high growth and bond-substitute stocks, a return to sustained economic growth could have a salutary impact on stocks overall and the opposite impact on bonds.

If instead the Fed pushes down rates in response to external pressures or real economic deterioration, this would likely stop being good for stocks as earnings plunge in a recession. While we generally view the former as being more than twice as likely as the latter recession scenario, if the debilitating impact of the trade war wears on, a real recession cannot be discounted as a possibility.

Trade fears would diminish, however, if the Trump administration is successful in getting the House and Senate to approve the USMCA (US/Mexico/Canada Agreement) by year end. The longer it takes the U.S. and China to reach an agreement, the more likely the Chinese become willing to wait for the conclusion of the 2020 presidential election with the possibility that a different administration emerges with fewer demands. And guess what? The presidential election season is already upon us, adding federal government policy uncertainty to today's trade uncertainty. So uncertainty remains, with news reports and election polls likely triggering periods of market volatility.

The stock market's gain this year (up 18.5% for the S&P 500) has to be taken in the context of its 13.5% plunge in the 4th quarter of 2018. The return to GDP growth in the 2.0-2.5% range could still lead to high single digit returns for stocks over the next couple of years. If this outlook were to come to pass, stocks less sensitive to higher interest rates are likely to perform better compared to the growth stocks and bond substitutes that have lead much of the market's move higher in 2019.