Market Outlook

April 2019

A Market of Contradictions

The market sold off sharply in the second half of 2018 amidst a strong economy. It has rallied back with equal fervor in the first quarter as economic momentum has slowed. Technology stocks have snapped back nicely while the financial sector continues to underperform. FedEx recently issued a disappointing earnings outlook, but the railroad stocks continue to perform well. We are pleased that the year has gotten off to such a strong start on balance though we are left to sort out a number of contradictions within a market that hovers at roughly the same level as it did in the first quarter a year ago. Stock market investors are placing more bullish bets on a dovish shift in Fed policy and expectations for a positive resolution to the trade negotiations between the U.S. and China. At the same time, the yield curve has flattened which suggests that bond investors think inflation will remain low and growth will slow over the next 12-18 months. How should investors position portfolios in an environment where so many mixed messages have presented themselves?

The flattening of the yield curve in recent weeks has been a headline grabber because this typically leads recessions. Historically, demand ramps up during expansions, followed by higher prices for input materials, and higher labor costs. This typically feeds itself for a period of time until prices become destabilizing and the Fed comes in to raise interest rates to slowdown the pace of demand to a more sustainable level. As the Fed raises short term rates, the yield curve flattens usually leading economic slowdowns by several months. The bond market is not wrong as inflationary pressures have been slow to build even with unprecedented monetary stimulus by central banks across the globe. There is a sluggish quality to the global economy that we don't expect to see this far along in the cycle. Inflation has stayed low due to more emphasis on stock buybacks than capital investment, aging population demographics holding back consumer spending, and the U.S. economy shifting away from manufacturing to some degree. This structural shift to a more technology and service based economy has had an impact on how long it takes for inflationary pressures to build as the economy expands. If corporate profits can grow for longer periods of time without being impacted by rising inflation, then stocks can continue to generate attractive returns. High tech and service companies tend to have higher margins and use capital more efficiently than their old economy counterparts which in large part explains why investors continue to put money to work in the U.S. stock market.

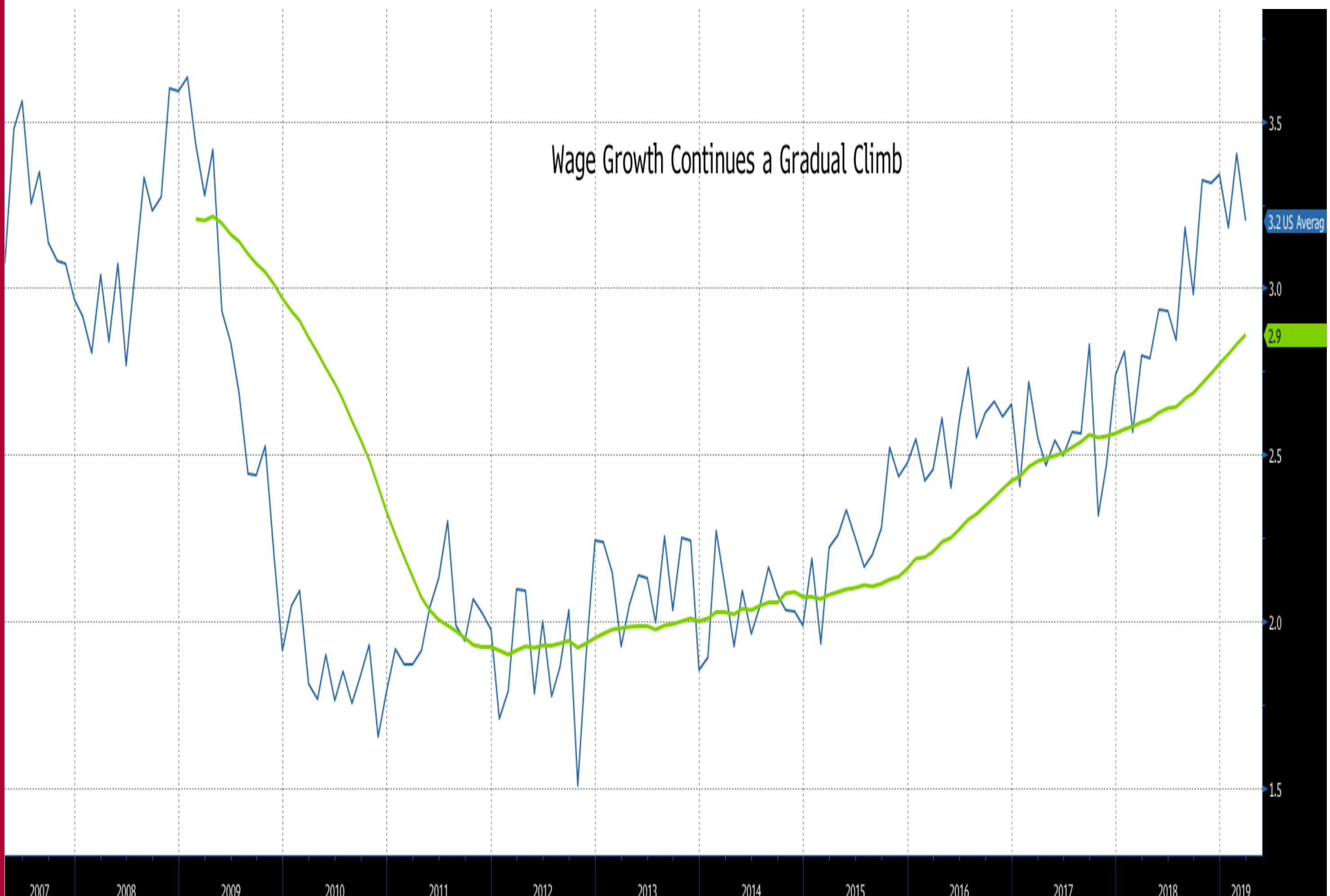
We continue to see evidence of demand in tight labor markets as average hourly earnings on a year over year basis have moved up into the 3-3.5% range and initial jobless claims have dipped below the 200,000 level for the first time in many years. This is one reason that money continues to flow into stocks. Another reason is that economies in Europe and Asia are noticeably weaker so we are seeing a flow of funds from these markets into the U.S. which continues to give prices an upward bias. It is difficult to sustain a bear market in stocks with these two factors underpinning the demand for risky assets in the marketplace.

At the same time, because there is evidence that inflationary pressures may start to slow, we've now reached a point where the Fed has backed away from further rate hikes as it worries that weakness overseas and an uncertain trade policy could begin to retard growth. This policy change has been applauded by the market for the moment because the economy is still growing at a modest pace, but the implication of the policy shift is that wage inflation may slow down on its own without further Fed tightening. Should this occur, there would be concerns about the sustainability of the bounce back in stocks. Negative interest rates in Europe and Japan have brought foreign investors into higher yielding U.S. credit markets pushing the dollar higher and flattening the yield curve. These are two areas of concern that we will be watching in the weeks and months ahead. Further dollar strength would make U.S. goods more expensive overseas and would present headwinds for corporate earnings. A flatter yield curve makes lending less profitable than most bankers would prefer and it is difficult to sustain a bull market in a challenging banking environment. This explains the lack of participation from the financial sector in the rally back from the lows seen back in December.

We are left to continue on in a late cycle bull with some uncertainty looking further out, but a reasonable situation for the time being. It is a time for patience as opposed to taking aggressive positions in portfolios as volatility in the market has increased due to shifts in expectations for Fed policy direction. The presence of high volume algorithmic traders has had a tendency to exaggerate volatility in the short term at times, especially around economic releases and political events. This was certainly true during the fourth quarter correction last year. As a result, we need to be careful not to overreact in the absence of clear fundamental evidence that the economy is shifting trend on a longer term basis. Rather, our focus continues to be on the weight of fundamental evidence that defines longer term market opportunities as opposed to the short term impact of the so called "algos."

—Charlie Mathews, CFA

Change in Average Hourly Earnings
Year over Year



Treasury Curve Flattening vs Six Months Ago