Bank of New Hampshire
WEALTH MANAGEMENT

Private Banking

Quarterly Review
July 2019
Higher Highs and A Fed Shift

Market/Economic Update

It is always good news when we see the stock market move to higher highs as it did heading into the end of the June quarter. The S&P 500 rose +4.30% for the quarter driven by expectations that President Trump will reach a trade agreement that defuses trade tensions with China and that the Federal Reserve will lower the Fed Funds target in the second half of the year. If we were to look at just stock market performance in isolation, we might conclude that the economy was growing smartly, that inflation was on an uptick and the Fed was in tightening mode. The present environment is more complex because the global economy is slowing across the board at the moment while there have been other structural factors that have supported stock prices in the U.S. We see this in declining purchasing managers activity in many countries which provides insight into how companies view demand going forward. The consensus in this regard is that global demand is slowing which has resulted in mediocre performance from foreign stocks relative to U.S. holdings and an inflow of foreign money into our stock market from investors that are seeking better growth prospects. This coupled with record levels of stock buybacks have been vital in pushing domestic stocks to higher ground.

However, the bond market is telling us a very different story about the state of the economy as the yield curve has inverted to form a "belly" in the two to eight year segment and credit spreads on high yield bonds have begun to show signs of widening. Both of these are indicators that investors expect the economy to weaken over the next six to twelve months which is out of sync with a stock market that is moving to higher highs. The yield curve tells us that expectations for future inflation are low which means that investors do not believe that growth will be strong enough to support higher prices. This presents a sharp contrast to what we have seen in the equity market. It is a challenging time for investment managers when markets are out of sync as they are now because it suggests uncertainty around the primary trend. This makes it riskier to look for value from the tactical asset allocation in portfolios. Rather, it is a time to be fairly neutral with regard to allocation and to emphasize high quality stocks that can continue to produce consistent earnings growth going forward amidst the uncertainty.

—Charlie Mathews, CFA

Equity Markets

The S&P 500 closed out the second quarter up 19.56% on a year to date basis while the Nasdaq gained 22.74%, both very respectable tallies. The path to these returns was somewhat volatile with the S&P moving consistently higher through April into early May when the S&P 500 hit a new high of 2,945 on May 3rd. to be followed by a decline of close to 200 points by the beginning of June. By June 20th a new high was set at 2,954 and since then the S&P has reached yet another new high in early July. The Russell 2000 Small Cap Index is up a tidy 17.91% though international stocks have lagged a bit with the MSCI-EAFE Index rising 15.03% year to date and the MSCI Emerging Markets up a more modest +11.06%. The upside move early in the quarter was driven by solid earnings growth and continued focus on the economy continuing to grow, albeit at a slower pace. In May, the trade war with China came back into the headlines and a slowing global economy was front and center as investors determined what effect the global slowdown might have on the U.S. Economy. By the end of May, there was talk of Federal Reserve interest rate cuts and China was willing to once again take up trade talks.

We anticipate this volatility to continue as the trade war continues on with skirmish after skirmish but no real agreement being decided. The focus will remain on the Fed and the economy, and now as another quarter has come to a close another earnings season is upon us that will help determine the health of the longest bull market in history. As my father used to say, “All good things must come to an end.” In this case, it may be a while before we see the end of this bull market cycle.

—Robert Magan, CFA

Credit Markets

The key story in the bond market is that inflation expectations are nil in much of the developed world as evidenced by negative interest rates in Japan and across Europe. This has brought inflows from foreign investors seeking more yield from the U.S. government market which has pushed ten year yields to the low end of the 2-2.5% range that we have seen during the first half of the year. Falling rates don’t speak well for the global economy, but have produced bond returns that have been above most predictions as the BBG Aggregate Index has risen 6.11% year to date. The shift to an easing bias in the Fed minutes indicates that a rate cut is on the horizon and has been the major focus for investors in recent weeks. Our analysis of historical returns for six and twelve month periods following initial rate cuts suggests that a bias toward higher quality and slightly longer than benchmark duration should produce competitive performance in bond portfolios in the coming months.

We heard one Wall Street analyst refer to the yield environment as “slim pickings” this week and this is likely to continue to be the case for a while. As a result, our focus in structuring portfolios is to minimize risk in the event of a downturn and to take care to be positioned so that the bond side will add some needed insulation for the riskier assets in portfolios should the global slowdown arrive on U.S. shores.

—Dona Murray