07/24/19

Quarter in Review

The Markets

Q2 was an interesting quarter, equity markets in May gave up all their April gains and more when the Sino-US trade deal (or removal of tariffs) collapsed in early May. Even though no deal was reached in June, the meeting between the presidents of the US and China at the G-20 seemed to reverse the losses of May ending up about where we left off at the end of April. **Large and Mid-cap value sectors ended up over 3% with Small-caps up just over 1%.** Developed nation stocks were up over 1% as well, but emerging market stocks were up only about 60 bps. The big winner this quarter was Long Term Bonds, with investors realizing the Fed was not going to raise rates anytime soon but rather more than likely will cut instead, **Long Term bonds rallied over 6%, with medium term bonds up 3% and short term up about 2%**. Surprisingly TIPS were up close to 3% (over 6% for the year) while inflation has remained muted at best and part of the reason the Fed is going to cut at the end of this month. To me, despite the US TIPS market being over 20 years old, this shows the desire for US Treasuries when the world markets are printing negative yields, not inflation concerns which is what they should be used for! High Yield bonds printed a 2.5% return while World Bonds were up over 3% for the quarter and 5% for the year. Real estate was up about 1.3% for the quarter but it remains one of the best assets classes this year at over 17% YTD. Commodities have been all over the place this year helped by oil's steady gains and Iran disrupting traffic through the strait of Hormuz as sanctions start to bite. But commodities were down over 5% for the quarter leaving the asset class up only 4% for the year.

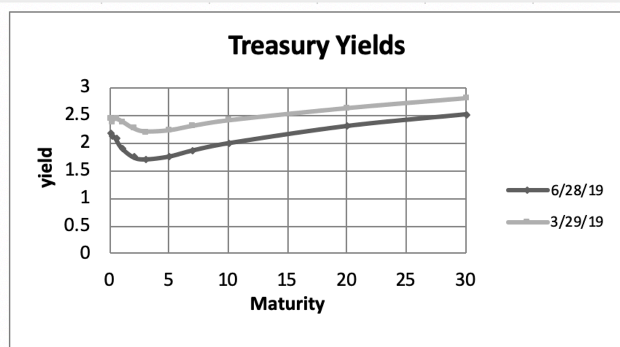
In domestic news, the Attorney General's summary and redacted version of Special Counsel Robert Mueller's final report was released to congress and to the general public. No charges were brought against the president however several people in congress have continued to pursue all legal avenues against the president even at the potential cost of their political careers. Many have called for and brought impeachment proceedings to the floor of the house of representatives all to be rebuffed by the speaker, a seasoned politician that remembers the result of the last impeachment. Meanwhile the White House removed the waivers that allowed countries to buy Iranian crude without facing US sanctions, turning up the heat on Iran as it continues to enrich Uranium. In the middle of May a Jury awarded $2 Billion in damages against Monsanto (Bayer AG is the parent company) regarding the company's Roundup weed killer product. Also during the quarter, India's developing nation status was removed, which before had allowed over 200 goods to be exported tax free. There were several IPOs this quarter with Uber being the most watched as the unlucky timing of its offering coincided with the US China trade deal falling through. United Technology agreed to buy Raytheon in an all stock deal, whose combined sales are now $74 billion in aerospace and defense products. Lastly all 18 money center banks passed their Federal Reserve stress tests at the end of June.

Internationally, things have become much more stressful from an economic and geopolitical standpoint. In early April, Theresa May asked the EU for an extension to the Brexit deadline which they responded with an October 31st, 2019 date. Several days later, the White House proposed new tariffs on imports from the EU, in response to the bloc's continued subsidies of Airbus. The EU is definitely slowing down, and tariffs will not help, as Soc Gen shed 1600 positions and the DB and Commerzbank merger (which fell through) would have meant shedding another 40,000. Theresa May, after a tumultuous at best tenure, said she would step down in June as the leader of the conservative party. Boris Johnson will replace her having won the leadership position over Jeremy Hunt. He has stated he could shut the government down during the end of October to force the UK to leave with or without a deal. In other European news, Fiat Chrysler withdrew its offer to combine with Renault, siting unfavorable political conditions in France for a merger.
Julian Assange finally wore out his 7-year welcome at the Ecuadorian embassy in London and was immediately arrested. In the beginning of May, Juan Guaido's attempt to overthrow the Venezuelan government failed before it got started as the military sided with Maduro. The US sent a carrier strike group and bomber force to the Middle East to send Iran a message, which they responded by enriching uranium beyond the 2015 agreement which the US left over a year ago, by attacking two Saudi Arabian oil tankers and by shooting down a US drone in their airspace. The larger news in May was the collapse of the US-China trade talks and a 25% tariff on $200 billion of Chinese imports. This sent global equity markets south and rallied long term bonds. The focus in June was on the protests in Hong Kong (at one point 2 million strong) of the extradition bill which would allow Hong Kong to send people to mainland China, into a justice system found to be opaque on its best days. Although the bill has been tabled, it has not been removed, and the threat of China sending troops into Hong Kong spurred visions of Tiananmen protests in 1989.

Interest Rates

As of the April write up, the Fed had put on hold its plans to increase rates, but during the second quarter that moved to an even more dovish stance as the trade talks between the US and China disintegrated. The street now expects the Fed to cut at least 25 bps at the end of the July with some thinking 50 bps. But recent economic data like the June job report may rein in a larger decrease in the funds rate. The Fed is concerned on two fronts now, inflation and global trade. Industrial production, both home and abroad, is slowing and estimates for Q3 and Q4 GDP numbers are sub 2% at best. The only bright spot it seems is the American consumer, whose balance sheet is much better, and income is increasing, who is seemingly keeping the economy from slumping into a recession. The yield curve this quarter made an almost completely parallel shift, coming in about 50 bps from the 1 year to the 10 year. The front and back ends of the curve came in only at about 25 bps each. China is now holding the least amount of Treasuries in two years. The Fed's balance sheet at $3.8 Trillion is unlikely to get smaller. The reduction of $669 Billion which started in 2018 is far short of the original target to let $ 2 Trillion to roll off.

Years	6/28/19	3/29/19	Difference
0.08	2.18	2.43	-0.25
0.24	2.12	2.4	-0.28
0.5	2.09	2.44	-0.35
1	1.92	2.4	-0.48
2	1.75	2.27	-0.52
3	1.71	2.21	-0.5
5	1.76	2.23	-0.47
7	1.87	2.31	-0.44
10	2	2.41	-0.41
20	2.31	2.63	-0.32
30	2.52	2.81	-0.29



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage has continued to drop over the quarter from 4.06% to 3.73%. 15-year conforming balance moved down from 3.57% to 3.16%. The Mortgage Bankers Association information as of 07/17/19 showed the 30-year conforming balance FRM down from is 4.46% with .44 points in April to 4.12% to .37 in points. Jumbos loans were barely down to 4.01% with .28 pts from 4.07% with .21 pts. 15-year conforming balance FRMs were also down from 3.87% with .44 points to 3.48 with .32 in points. Mortgages have continued their decline from Q1, and this should help the housing market.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 111.5 for June 2019 (revised 111.7 for March 2019). Although the index has declined slightly in June, it has essentially stood still for the past 9 months. The issue however is that only 6 of the 10 components are adding positively to the index, whereas in March it was 8 of the 10. Looking closer at those data points that were negative, claims is a volatile number and is still at a multi-year low. ISM new orders, which also detracted from the index, is a bit of a concern as since January it has been close to zero, and for each of the past three months it was negative. This coincides with a well-known slowdown in the manufacturing sector of our economy. Building permits, an estimate made by the Conference Board, show the preliminary number is down, while the housing market has showed signs of a slowdown. Lastly the interest rate spread between the 10-year treasury and the federal funds rate went negative in the end of May and has stayed that way through June. Unless there is a 50-bps cut to the funds rate, this will stay this way for a while. This LEI report isn't bad but isn't good either. This could be the first warning signs and I will continue to watch it closely.

Jobs

At the time of this write up, **nonfarm payrolls** posted an **increase of 224,000 jobs for June** (consensus was 160k). This was a large rebound from the 72k in May that spooked the markets and the Fed. Last year the average monthly gain in payrolls was about 223k, but in 2019 the average has been about 172k. This is definitely enough to keep the unemployment rate steady. It now stands at 3.7%, just under its twelve-month average. The median duration of unemployment is at 9.6 months, up from 8.9 (the lowest it has been since the start of the expansion. Aggregate weekly hours worked is at its highest level since 2006, while temporary help services were just off their December high, but like the LEI numbers holding steady. Watch this number for early warning signs. The civilian labor force participation rate hasn't really moved since the beginning of 2016, stuck around 62.9. The 4-week moving average of unemployment claims was right around 222k, about where it was in May of last year. We haven't seen it climb north of 234k since January of 2018. The ISM survey number for June was 54.5, right at the three- and six-month averages, still in positive territory, but not reflecting the BLS survey of almost flat manufacturing employment for 2019. This job report, like Q1, didn't show signs of an imminent recession, more of a status quo, but with forward GDP estimates that are sub 2% this can't be sustained.

Industrial production

Q2 Industrial production was negative again, this time down only -0.08%. But Q1 was revised much lower, down -0.78% vs. the -0.33% from my previous write up. And with CPI positive (albeit weak) that designates the prior two quarters as recession periods. Unlike 2015, we are not seeing the month after month negative IP. But with some other indicators starting to slow down as well, this definitely gives me some cautionary signals. Utilities had a very bad June, as cooler than average temperatures tempered air conditioning usage. What buoyed the index was a large, nearly 3% increase for motor vehicles sales for the month. If that didn't happen, we would have probably been down about 10 to 20 bps for the month. Over the past twelve months IP was up 1.3%, while capacity utilization was up 2.1%, but it is still off its long run average of closer to 4%. Manufacturing jobs are still well off from their pre-recession numbers, close to 900k less jobs, and nowhere near the 19.5mm jobs of the late 1970s (we currently have about 12.9mm). Our country has been on a multi decade decline in manufacturing, and industrial production slowdowns have been synonymous with our recessions. Although they are an important gauge for the economy, they need to be taken in concert with other numbers.

Housing

New home sales came out today at 646k per year, slightly above the long run average. But the real story was the revisions to the prior three months, removing 55k homes over three revisions. **Existing homes sales declined for**

the month (-1.68%) and year over year (-0.74%). The National Association of Realtors' chief economist was confused that sales are down, given the recent trends in mortgage rates coupled with low unemployment and increases in wages. The truth though is that the inventory that is out there (albeit only 4 months' worth) is undesirable at the price point. Even a decade after the recession, people are still warry of home ownership and the true cost of owning a large liability, and the ramification of another economic downturn. There are also demographic changes to our country and the mobility of the work force to consider. These too weigh on the purchase of new homes. As of April, the S&P CoreLogic Case-Shiller 20 City Composite was up 0.81% for the month, 1.66% for prior 3 months, and 2.54% for the last twelve months. Substantially lower than the prior 10-year average of 4.47%. Even with mortgage rates lower, I don't see a surprise rally in either home prices, home ownership or sales for the remainder of the year.

The Consumer

The **Conference Board's consumer confidence index stood at 121.5 as of June 2019.** The index has been very volatile this year, far from the October 2018 high, spawned by concerns for trade, the labor market and future business prospects. The **University of Michigan's Consumer Sentiment June number was 98.2.** Although not dramatically different from March's number, the volatility is matching that of the Conference Board. The consumer's importance in the GDP number makes this type of volatility concerning. If the consumer doesn't feel good about their future prospects they will hold off on durable purchases until later. With that said, it doesn't explain the large increase in Auto purchases this past month. Both of the indexes still stand at relatively high levels though, and the pull backs don't seem to be a trend - more a reaction to current events.

Personal income and outlays expanded again in the first two months of Q2 and year over year. Personal income was up over 4%, disposable income up 3.9%, and **Real Personal Income less Transfers was up 1.92%** since May 2018. However, we see that a decent portion of the personal income was made up from social security transfers increases. The savings rate is now at a 6.1% annual rate, far from the 2.2% rate in 2005 but also far below the 8.8% long run average since 1959. With the savings rate going lower, the borrowing amount continues to climb, with the total consumer credit increasing at 5.19% with revolving and non-revolving credit up 4.54% and 5.42% respectively.

Inflation

As of June, **CPI was up 1.66% and PCE was up 1.52%** as of the end of May, over the past twelve months. PCE has been right near 1.5% for the past three months and will probably be lower in June. This has now turned the Fed into full on insurance mode and we should see a cut in the federal funds rate as of the end of July. They have achieved their full employment target but have not been able to keep inflation at or above their target since Q4 of 2018.

Both May and June saw the CPI index up only 0.1% on a monthly basis, with core goods up the same in May but jumping 0.3% in June. For the quarter, energy was flat, rising in April and falling again in June. Food was almost the opposite and was up 0.2% for the quarter. Whereas unadjusted headline inflation was up only 1.6 since June 2018, core was up 2.1% over the same time period. Shelter, Medical Care, and Transportation services were up 3.5%, 2.8% and 0.9% for the year ending June 2019. Whereas Apparel and Medical care commodities were both down over 1%. Headline inflation is definitely off, but core seems to be doing well, so although the economy is slowing a bit, I don't really think that the Fed easing will do much more than juice stock and bonds yields over the short term.

In Closing

We are now **120 months** into an economic expansion making it the longest expansion since the National Bureau of Economic research start keeping track of them in June 1857! This expansion has been anything from typical, with GDP annual growth rates peaking at 3.81%, low unemployment rates not seen since 1969, and unemployment claim levels not seen since the early 1970s. The recovery for home prices and security prices has exceeded the Feds indirect goals, and now that we are starting to show signs of a slowdown, the Fed is trying to come in for a soft landing if not prevent a recession. The **yield curve had another parallel shift downward**, 25 bps in the front and back and almost 50 bps in the belly. The two/ten-year spread moved back out to 25 bps from the 14 bps it was in March, but the ten-year yield at the end of June was only 2.00%. The **LEI has been constant for the past nine months**, but the components that keep it positive have been more volatile. The jobs reports as well have had wider month to month swings, unemployment duration has started to rise a bit, but temporary service is still on the rise. Unemployment is at a 50-year low, but manufacturing employment is definitely off. **Industrial production was negative for the second consecutive quarter**, but not as bad as 2015. Manufacturing looks to be stalling both here and globally. New home sales saw a rebound this month but that was after downward revisions to the prior three months. Existing homes sales look like the decline has stopped but are pretty flat even with mortgage rates falling over the past 6 months. Consumer sentiment dropped in June showing the anxiety over US/Sino trade issues, and expectations for jobs going forward. But the balance sheets remained strong, savings rates held just over 6% annually, and consumer credit continued to expand.

As of this write up, I believe the chance of a recession is still below 20%. The above economic data isn't showing signs of a major pull back, just that we are in the latter stages of this expansion. We must remember that the US is a very insular economy and that our exports don't make up the bulk of GDP, thus we can ride out a global slow down. With that said, the Fed's decision to loosen is a bit concerning and I adjusted the duration longer to take advantage of this as I don't believe they will raise rates anytime soon. However, the long duration trade looks to be a bit crowded right now, and if the Fed doesn't cut, I will look to exit quickly back into intermediate duration bonds. On the other hand, if the Fed does end up cutting 50 bps in a couple of days then I will not only be looking to exit

long duration if the yield curve parallel shifts again but will start to watch for signs when to exit some equity positions. This is a very tricky time in the investment space, as exiting too soon at the end of the cycle will make you miss a decent amount of returns, but not exiting soon enough will also cost your portfolios as well.

"How's the ulcer Harry? – Pretty good. How's the hypertension?" - Trading Places