

At-A-Glance

Economic data is cooling, but still in expansionary territory.

Equity valuations seem fair, but earnings growth is expected to fall next quarter.

Parts of the Treasury yield curve is inverted, yet credit spreads have not widened too much.

A balanced approach seems like the best course of action heading into the second half of the year

THIRD QUARTER 2019 OUTLOOK

Mixed Signals

The S&P 500 is in a record-long expansion, narrowly missing a couple of bear markets and up over 400% (total return) since its bottom in March of 2009. U.S. economic growth is about to hit a record in July, making it the longest expansion in U.S. history and over ten years old. This is no small feat with data going back as far as the Civil War. The unemployment rate is near a 50-year low and there are more job openings than people looking for work for the fourteenth straight month. Borrowing costs are low and, depending on one's creditworthiness and geography, a potential homeowner may even be able to get a 30-year fixed mortgage under a 4% interest rate. This begs the question, why are some economists and investors so cautious?

Economists have been analyzing slowing global growth for several years. Slower U.S. growth, especially after the strong first quarter, is to be expected, and as growth dips under 2%, recession concerns rise. While labor markets look great, economists are worried labor trends may reverse. Historically, the unemployment rate flattens at low rates before reversing course. At near full employment, the unemployment rate can't go much lower. Economic expansions don't last forever, and we are already near the longest U.S. recovery ever. While mortgage rates are relatively low, not all housing data has recovered from pre-recession levels. For instance, new building permits are still at mid-1990s levels. While the economy looks strong, it is expected to slow, and this has many economists predicting that the next recession is around the corner.

Like economists, investors also seem confused. Equity and fixed-income investors appear to have different views. Equity investors are bullish, sending equity indices back near all-time highs, while fixed income investors are bidding up bond prices, sending yields to multi-year lows and even inverting some parts of the yield curve. Longer maturity bonds in some cases yield less than shorter-term bonds. Normally we would not see bond and equity prices rise in unison. Can bond investors and equity investors both be right?

Lower interest rates create lower borrowing costs and discount rates, which can cause asset prices like equities to rise in value. This arguably has been the case with the low rates and asset prices in recent years. As long as economic growth isn't too meager, and we stay in this Goldilocks range of 'just right', perhaps we could continue with near record high equity prices and low interest rates. This may be why equity investors remain bullish. We have already been in this range for many years.

Risks are starting to mount though. If the Fed is not as dovish as investors believe, this could cause a pullback in equities. In addition, escalations in trade tensions could also rattle stock markets. With slowing economic growth, the margin of error becomes slimmer. If slow growth becomes negative growth, the Fed can't lower interest rates as much as they have in the past, because

rates are already low. In addition, federal debt relative to GDP is near World War II levels, which was the highest in the recorded history of the United States, so the potential for fiscal stimulus is also limited, assuming Congress would even be able to set aside party differences and agree on a package. Heightened risks helps to explain why fixed income investors are bidding up bond prices.

Making sense of the mixed signals is tough and slow growth may continue. After all, we have been in this environment for a long time already. We think a balanced approach is prudent in this environment. Sticking to long-term risk and return objectives is even more important. As the economy finds its direction, it is prudent not to have too much exposure to any one source of risk. With more uncertainty comes more volatility. We expect the second half of this year to be more volatile than the first half.

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Glossary

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