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The First Half of 2019 Has Been Great — How About the Second Half?

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The sharp sell-off in the last quarter of 2018 was capped off by over a 9% drop in the month of December alone resulting in a losing year for the market. 2018 was a strong year for the economy and for the stock market through the end of the third quarter. The US GDP (Gross Domestic Product) grew at a 3.1% rate. So, the question is why did we have the sell-off? The customary three influencers seem to be the blame: the Federal Reserve (Fed), the uncertain trade negotiations, and the slowdown in the global economy.

When 2019 began, the market had a dramatic recovery, up 7.8% in January and 13.1% up in the first quarter. Again, why? It seems that the same three influencers were the reason. First, the Fed indicated that they were not going to be raising rates any further and that the Quantitative Tightening (QT) or shrinking of the money supply will be ending. Second, the information or rumors regarding the US – China trade talks were more positive. Third, the other major central banks of the world were lowering rates and creating more money to combat the global slowdown.

The second quarter of 2019 proved to be no less volatile but ended up with a roughly 4% gain. Although in May, the outlook for a positive quarter was in doubt with a 6.5% sell-off, mostly due to a negative view on the possibility of a trade deal with China. Then in June, especially the latter part of the month, optimism began to reappear. The Fed began hinting that an interest rate cut may be coming in late July and the Fed watchers have predicted that it may be a series of rate cuts. President Trump and President Xi met at the G20 Summit and agreed to some concessions on both sides and to restart the stalled trade talks. Finally, the global economies were beginning to show some signs of life from all of the money creation by the central banks.

We are now entering the third quarter of 2019, and we need to examine what our three primary market influencers are doing. First, the Fed is expected to cut interest rates from one to four times (usually .25% each time). The rationale for the rate cuts has supporters and detractors. Those in favor cite the fact that the US economy is slowing, interest rates all over the world are falling, inflation has not heated up even with the imposition of tariffs on China, the interest rate yield curve remains inverted, the large national banks in the US are calling for rate cuts, and the President has criticized the Fed for reducing GDP because of its tight monetary policy. On the other side, the so-called "rate hawks" are saying that the US economy is strong and does not need help from reduced interest rates, the stock market is in good shape and is actually near an all-time high, the Fed should save its interest rate ammunition to use when the economy is actually sliding into a recession, the China tariffs may ultimately cause inflation, and the Fed should retain its independence and not respond to Presidential criticism.

It is true that the US economy is slowing: the expected GDP for the second half of 2019 is forecast to come in at a 2.1% rate which will bring the whole year down to 2.6%. This is a drop, but it surely is not a reason to panic. So, if the Fed does cut the rate, it will be preventive in nature not to save a failing economy. Also, Chairman Powell may be atoning for his

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A stronger rate cut argument can be made because of the extremely low rates in the other major economies of the world: 10 year bond rates - Germany -.37%, Switzerland -.61%, France -.06%, Japan -.10%, United Kingdom +.72% and United States +1.95%. This causes money to flow to the US seeking higher yields; consequently, the dollar gets stronger making it difficult for US companies to export their products.

The inverted yield curve (which was discussed in a previous newsletter) is another problem caused by the low rates around the world that pulled our 10-year bond rate below where the 3-month Treasury is: 2.20% to 1.95%, or .25% inversion. A prolonged inversion has often led to economic recession, so the Fed may want to proactively drop the short term rates below the 10-year rate.

The tariffs imposed on China by the President may or may not ultimately lead to inflation; therefore, the Fed may decide not to make any rate change until the picture becomes clearer as to the inflationary impact.

The criticism of Chairman Powell by the President may make Powell more reluctant to reduce interest rates (although most financial professionals agree that raising the interest rate by .25% in December was a mistake and should be rescinded). In this case, doing the right thing should triumph over personal pride. Powell could make the case for his actions and state that it is definitely not because of pressure from the President.

The second factor is trade talks with China have a major impact on the markets and the economy both domestically and globally. The US and China are the two most important economies in the world and comprise over 33% of all economic activity. Resolving the differences between these two nations is critical to the success of the world economy. Unfortunately, working out a truly equitable trade relationship is likely to take many years because fundamental change in China's legal system will be strongly resisted. China has benefitted greatly through their predatory trading practices and theft of technology; therefore, it is difficult to get them to voluntarily give up these practices, especially to put in place an agreement that has enforcement consequences for violations. It is likely that an agreement will be hammered out because it will be in the best interest of President Xi and President Trump. When it does happen, it will be positive for the markets and will represent progress, but it will be only the first step on a long road.

The third factor is the slowing global economy. Unfortunately, the US is not immune and that is being reflected in various recent economic numbers. The important message is that slowing from a torrid pace to a moderate pace does not mean slipping into recession. Nevertheless, corporate earnings will be adversely affected which makes stock market gains more challenging.

OUTLOOK

Since the entire body of this newsletter has been a recap of the recent quarter's market performance, we will not cover that ground again.

The third and fourth quarters are unlikely to keep up the pace set by the first two quarters. However, just because a mid-double-digit percent return is unlikely to be duplicated does not indicate that a down market is the expected outcome. We remain cautiously optimistic. We expect continued volatility and more modest gains during the second half of 2019 for the following reasons:

1. Corporate earnings growth will be sluggish in the third quarter but is expected to pick up in Q4.
2. The Fed will likely cut interest rates from one to three times by year end.
3. There is likely to be some trade deal between the US and China (not the ultimate but progress)
4. The global economy should begin to recover because of all of the monetary easing from central banks around the world.
5. There have been some rumors that President Trump by executive order may mandate indexing of capital gains for taxation. This would generate a lot of trading activity and should be positive for the stock market.

As always there are no guarantees and events unforeseeable at this time can dramatically change the outlook, but cautious optimism based on the above reasons is our stance at this time.

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