Second Quarter 2019

Far From Shallow, Economy Falling in the Deep End?

Key Takeaways:

- Economic data is trending lower on many metrics. A return to slow growth does not mean a recession is imminent in 2019.
- The S&P 500 has been in a bull market for over 10 years. After the new tax legislation was enacted, corporate profits jumped over 20% last year, pushing down valuations relative to long-term averages.
- Treasury yields of short and long maturities are similar, signaling bond investors are not optimistic about the future economy. Yet credit spreads are below their 15-year averages. Bonds are giving mixed signals.
- The risks in the market are the same culprits as last quarter, but risks around the trade war and the possibility of the Fed over-tightening have come down.

The economy seems to be singing Lady Gaga's award-winning song, *Shallow,* right now. After the Fed took away the raft for the economy in 2018, raising rates four times, the economy is far from "the shallow" being in the second longest expansion since World War II. It is safe to say we are in the deep end of the pool right now. The economy is having a hard time keeping it "so hardcore" and is "falling".

It is widely expected that economic growth in the U.S. will continue to slow, the question is by how much. If it slows to expected levels, that would be in line with prior years before the tax legislation boosted markets and economic growth in 2018. The expansion's length is a product of its pace too. Growth has been slower compared to prior expansions, and the economy has not overheated. While growth is anticipated to slow this year, we still do not anticipate a recession in 2019. The economy may be trending lower, but it won't sink quite yet.

Following the economic tailwind, equities are in the longest bull run ever, despite narrowly missing a correction in December. The surge in earnings, coupled with the stock market sell-off late in the year, lowered valuations such as (P/E) ratios to near their 15-year averages. This year, stocks had their best start since 1991 as the Fed renewed its dovish stance and trade negotiations between the U.S. and China seemed to advance in the right direction. Now that a lot of the good news has been priced into stocks, there are fewer catalysts to move the markets higher. Equity markets appear fairly valued right now.

Equity investors are also paying attention to the bond market for clues about the economy. The U.S. Treasury yield curve is flat, but generally not inverted, which could be a sign that future economic growth prospects are dim. An inverted yield curve, where short-term yields are higher than long-term yields, can be a leading indicator for a recession. Credit markets are telling a slightly different story though. Credit spreads, the extra compensation or yield spread for taking on downgrade and/or default risk, have compressed this year.

Risks to the outlook appear similar to those of last quarter, although they may have shifted to some degree. The risk that the Fed will continue to hike rates into 2019 has come down substantially, as has the risk of a trade war. The U.S. economy was somewhat immune from the global economy, but more recently has become more susceptible to slower global growth. The major risk now appears to be economic growth slowing more than projected and lower than expected corporate earnings.

To recap, while the economy may be in the deep end, we think it should stay afloat and do not see a recession this year. Equity markets seem fairly valued and lack some of the upside catalysts from prior quarters. We think volatility will pick up after a calm start to 2019. Fixed income markets are giving mixed signals with a flat yield curve and narrow credit spreads. Overall, we balance the risks in the outlook and lack of positive catalysts in equities by increasing duration in fixed income to buffer against volatility that we anticipate in the second half of the year. Keep in mind that we are still underweight duration as bond yields have already come down off their highs.

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Glossary

The S&P 500 is an index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

The Bloomberg Barclays US Aggregate Bond Index, which was originally called the Lehman Aggregate Bond Index, is a broad based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government–related and corporate debt securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency) debt securities that are rated at least Baa3 by Moody's and BBB- by S&P. Taxable municipals, including Build America bonds and a small amount of foreign bonds traded in U.S. markets are also included. Eligible bonds must have at least one year until final maturity, but in practice the index holdings has a fluctuating lerage life of around 8.25 years. This total return index, created in 1986 with history backfilled to January 1, 1976, is unhedged and rebalances monthly.