Subzero

In our Market Outlook 2019 newsletter, we maintained our "target 1-2 year range for the S&P 500 at 2,900 to 3,200 conditioned upon interest rates remaining low". Further, we prognosticated that "with so much pessimism in the air, the contrarian streak in us favors the odds for the market to surprise to the upside". Midway through the year, our forecast seems prescient as interest rates have plummeted and the stock market has surged. The S&P 500, Dow Jones Industrial Average and NASDAQ Composite have enjoyed first-half gains of 17.55%, 14.03% and 20.66% respectively.

With the S&P 500 presently trading at 2,975, the middle of our target range, we must evaluate the extent to which stocks may have gotten ahead of the underlying fundamentals. For starters, while the S&P 500 trades at a somewhat lofty PE of 18x 2019 expected earnings, the market is more reasonably priced at 16x forward earnings for 2020. With the 10-year Treasury yielding 2% as the Federal Reserve has taken a decidedly more dovish posture and with U.S. trade negotiations with China seemingly back on track, the stock market would seem to have every reason to celebrate.

Since every recession has been preceded by a negatively sloped yield curve, the recent precipitous drop in yields and subsequent curve inversion (10-year Treasury at 2% compared to 2.18% for the 3-month T-Bill) has spooked investors and the Federal Reserve alike. Indeed, the Fed Futures market favors the odds of a 25-basis point rate cut at the Fed's forthcoming July meeting, even as the unemployment rate nears all-time lows and GDP growth moderates near 2%. The question is begged as to why the Federal Reserve would cut rates in such a seemingly benign economic environment. The nagging question of "what does the bond market know" has permeated investor psyche and leaves the stock market vulnerable to unpleasant economic surprises.

Peeling back the economic onion clearly reveals a moderating economy but by no means does the data point to an imminent recession. U.S. GDP growth has slowed from an annual rate of 3.2% through the March quarter to approximately 2% in the most recent quarter. Five-month annualized private sector job growth has slowed from a December 2018 high of 2.3% to now as low as 1%, the weakest job growth in over 8 years. While still positive in the U.S., manufacturing surveys are in decline around the world with particular weakness in Germany, Japan and China, prompting the World Bank to lower its 2019 forecast for global economic growth to 2.6% from its January estimate of 2.9%. The Morgan Stanley Business Conditions Index, which surveys how analysts feel about the companies they follow, suffered its largest decline ever in June. Meanwhile, inflation is easing and remains below the Fed's 2% target and five-year inflation expectations recently breached an all-time low. Despite a relatively stable U.S. economy, the threat of ongoing trade war with China is clearly weighing on business confidence and global economic activity.

By all accounts, global interest rates continue to decline. ECB President Mario Draghi recently signaled that additional stimulus was necessary, making it clear that the ECB's negative 0.4% benchmark interest remains insufficient to boost the European economy. While Japan's central bank has already set rates at negative 0.1%, JP Morgan predicts that Japanese rates could fall to negative 0.3% by year-end. Central banks of India and Australia have already cut rates. China, Brazil and Russia all seem poised to cut rates and introduce additional stimulus measures. Amazingly, the value of negative yielding sovereign debt surpassed $13 trillion for the first time, with French and Austrian government debt joining the subzero club for the first time.

With such vast sums of subzero sovereign debt afloat, it seems clear that quantitative easing by the world's central banks has distorted the potential signals of our inverted yield curve. Further, secular demographic trends and an aging global population will continue to skew the supply and demand curve in favor of fixed income instruments perceived to be safe. Yes, the decline in global interest rates is a secular trend that is likely to persist much longer than many expect.

Given the Fed's "overarching" goal of "sustaining the expansion" and especially with inflation so low, the Fed is likely to cut rates by a quarter-point at its end-of-July meeting as a form of "insurance" should trade negotiations with China get derailed. With China's economy suffering the brunt of Trump's tariff campaign thus far, it seems that China has added incentive to reach a deal. And with the 2020 Presidential election imminent, President Trump has considerable incentive to negotiate a deal with the Chinese. With the threat of higher interest rates off the table for the foreseeable future, trade talks with China have become the glaring Achilles heel for the stock market.

When interest rates in decline, dividend yields are even more appealing and the stock market should be more attractive to investors. Assuming trade talks with China remain on track, we expect the super tanker U.S. economy to build on its recent record for most durable recovery in history.