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Quarterly Market Insights

The Fed and Trade Keep Investors on Their Toes

The Fed (i.e. the Federal Reserve) and international trade – these were the two headlines that dominated action in the second quarter of 2019.

Stock Indices	Q2 Return*	2019 YTD Return %*
S&P 500 (large)	+4.30%	+18.54%
S&P 400 (midsize)	+3.05%	+17.97%
Russell 2000 (small)	+2.10%	+16.98%
MSCI EAFE (intl.)	+3.68%	+14.03%
Bond Yields	**June 28 Yield & Qtr. Change**	**Yield a/o Dec 31, 2018**
3-month T-bill	2.12% (-0.28%)	2.45%
2-year Treasury	1.75% (-0.52%)	2.48%
10-year Treasury	2.00% (-0.41%)	2.69%
30-year Treasury	2.52% (-0.29%)	3.02%
Commodities	**June 28 Price & Qtr. Change**	**Year end 2018**
Oil per barrel	$58.00 (-$2.14)	$45.41
Gold per ounce	$1,413.90 (+$118.50)	$1,279.00

**Stock indices include reinvested dividends and are NOT annualized; returns through 6/28/2019*

Longer term, profits and the price you pay are the leading drivers of equity returns. Shorter term, sentiment can be influenced by various factors.

For much of the year, favorable headlines highlighting progress toward a trade deal between the U.S. and China aided equities. In addition, the Federal Reserve shifted gears, no longer talking about gradual rate hikes. Coupled with modest economic growth, stocks have performed admirably.

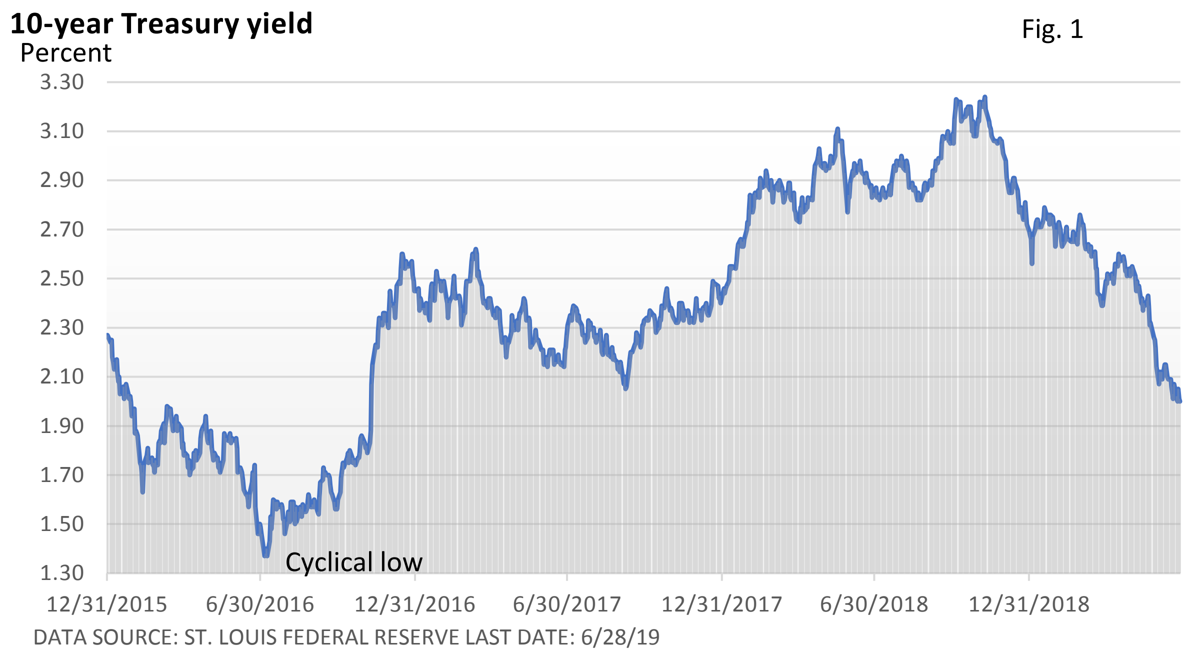
In early May, the rally hit a roadblock when the president tweeted he would impose additional tariffs on China, injecting a new layer of uncertainty into the economic and stock market equation. An unexpected tweet by the president in early June threatened Mexico with debilitating tariffs. Yet, the peak-to-trough decline in the S&P 500 Index from April 30 thru June 3 was a modest -6.8% which is nothing out of the ordinary.

Since 1980, the average annual maximum peak-to-trough pullback for the S&P 500 Index has been -14%.

Shortly after President Trump threatened Mexico, however, Federal Reserve Chairman Powell shifted his stance. No longer was the Fed on hold. Instead, Chairman Powell implied that the Fed would cut rates if the need arose, sparking a turnaround in the markets and lifting the S&P 500 Index (a large company stock index) to a new high.

The Economy and Treasury Yields

The steep drop in U.S. Treasury yields has surprised nearly everyone – see Figure 1.



Why has this occurred and what does it portend?

Some possible reasons for the decline:

- Higher yields in the U.S.: yields have fallen in developed/mature nations, which encourages overseas investors to buy into higher-yielding U.S. Treasuries.
- Flight to safety: worries about a protracted trade war have increased economic uncertainty, which has also encouraged a flight into safer U.S. Treasury bonds.
- Getting ahead of a rate cut: odds of a rate cut or cuts this year have gone up significantly, which also encourages investors to place cash into Treasury bonds in anticipation of this.
- Anticipation of an economic slowdown: if we read the tea leaves, the Treasury bond market appears to be foreshadowing an economic slowdown.

In contrast to the decline in interest rates, other economic numbers are suggesting a different outcome. As an example, the Conference Board's Leading Economic Index (LEI), which is a forecasting tool of future economic activity, is not suggesting the economy will contract this year. Also, consumer confidence remains fairly high which is a positive for the economy.

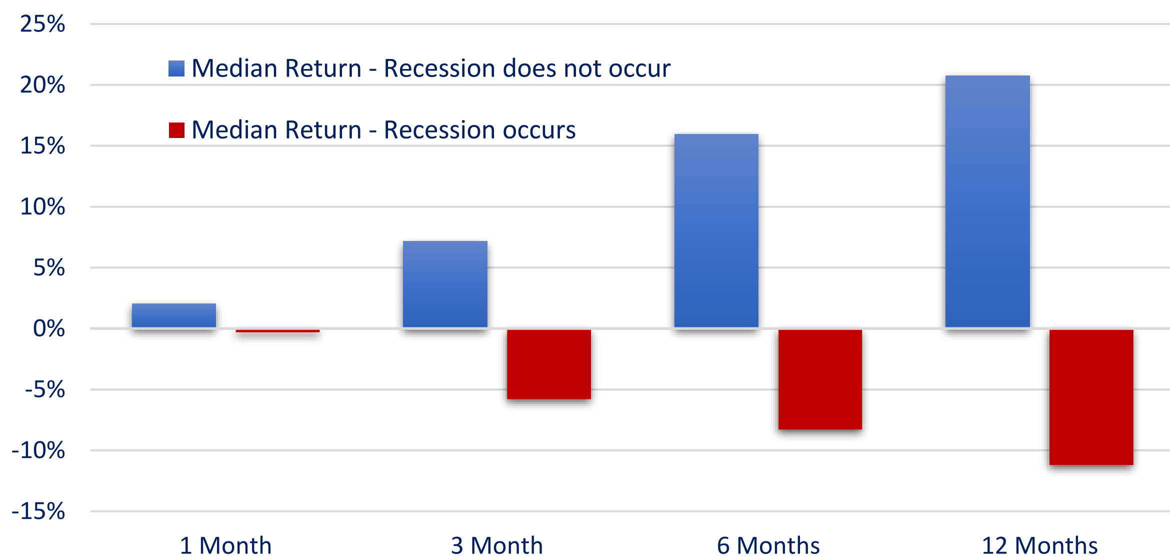
In addition, a quick peek at the difference in yields between safer investment-grade bonds and riskier high-yield debt (junk bonds) are not suggesting a recession either. You see, junk bonds are sometimes referred to as the canary in the coal mine. If investors expect a steep economic slowdown or recession, yields in junk debt can spike higher as investors flee shakier firms. That is not happening now and the yield difference between safer bonds and riskier bonds remains fairly narrow.

While the rally in stocks during June was not as broad-based as we might like to see, action in the large company S&P 500 Index also suggests growth is not about to stall.

Rate Cuts and the Stock Market's Reaction

Since 1974, there have been nine rate-cut cycles by the Federal Reserve. Figure 2 illustrates the S&P 500's reaction, from 1-month to 12-months after the first rate cut in the cycle.

S&P 500 Returns Following the Start of Fed Rate Cuts 1974 - 2007 Fig. 2



Data Source: Barclays, MarketWatch Past performance is no guarantee of future performance

Over the last 45 years, a pattern has emerged, with stocks performing well when the economy side-stepped a recession, such as the mid-1980s, mid-1990s and the late 1990s. When the economy slid into a profit-killing recession, rate cuts did little to bolster investor sentiment and the stock market generally declined.

Whether the U.S. can avoid a recession in the near term seems more likely but not guaranteed. Some of the issues outside the U.S. will affect us and some of the issues at home that are not being confronted (structural reforms to entitlements, high debt levels, etc.) could also tip the balance in the wrong direction.

So, what should an investor do? First and foremost, have a diversified portfolio that matches your long-term goals with your financial resources. Next, make sure that your allocation matches your risk tolerance so you can hold on through the inevitable downturns that will occur along the way. Finally, monitor your portfolio but do not over trade it; in our many years in the business, we have never found someone who can consistently get out of the market at the right time and get back in at the bottom. We think a much better approach is to have a tried and true investment strategy (which should change only when your circumstances change), monitor it, rebalance when appropriate, and then let it do its thing.

Final Thoughts

Thank you for your business. We are taking on new clients and greatly appreciate your referrals. By allowing us to prudently grow with and through you, it gives us the resources to constantly strive to make our offering to each of you even better.

If you need anything from us, please do not hesitate to let us know.

Enjoy your summer.

Hopwood Financial Services, Inc.