Stegent Equity Advisors Investment Letter

Market Review
April 2019

During the first quarter of 2019, markets staged an unexpected scorching bounce-back from a tough end of the year in 2018, and in the process, washed away investor fears that had built during the back half of 2018. Domestic and international stocks led the charge with double digit returns; commodities and corporate bonds had a very healthy quarter; and even Treasury bonds found a way to post solid returns during a period that was dominated by risky assets.

Pinpointing the cause of a market move is never an exact science, but investors appeared to focus on a friendly pivot from the Federal Reserve regarding interest rate hikes, and expectations of a coming trade deal with China, as the major catalysts for the rally. They also showed a willingness to look past weakening economic data and earnings around the globe. As investors try to make sense of markets that roared back to life in the face of fading fundamentals, they are now left to ponder whether the market is sensing a future pickup in world growth, or simply luring investors into a late cycle bull market trap.

Time will tell.

The Fork in the Road

As we start the second quarter, investors are facing a fork in the road, where one path may lead to a new cyclical bull market, and the other to a fragile topping process that is fraught with risk. How to choose…

Left Fork: The Case for a Goldilocks Bull Market

The case for a new bull market lies in the belief that we'll return to a goldilocks macro environment, which can be characterized as an economic backdrop that is not too hot, not too cold, but just right for risk-asset growth. The key inputs for a goldilocks backdrop are low inflation, improving economic growth, and reasonable central bank and government policy. Some in the analyst community believe that is exactly the environment that markets are sensing now, as they have exploded off the December bottom.

The evidence that aligns with this view starts with inflation pressures that peaked last year, but have been easing ever since. Lower inflation reduces expenses for businesses, enhances consumer's purchasing power, and allows central banks to concentrate on policy that nurtures economic expansions, as opposed to restraining growth in order to keep a lid on prices. In 2018, central banks were raising interest rates and removing liquidity from the system, which worked against global economies and world markets. However, this dynamic began changing in early 2019. Markets celebrated a pivot by the U.S. central bank from raising interest rates to pausing its escalation in order preserve the uptrend in the economy. The European Central Bank followed suit, and announced policy initiatives designed to support growth, and arrest the pervasive downtrend in economic growth within the region.

Big Trouble in Little China?

While policy settings in the U.S. and Europe have both helped to renew investor confidence and bolster stock prices, Chinese fiscal and monetary authorities have been busy enacting a steady stream of impactful policy changes, which are clearly designed to jump start their sagging economy. After announcing more than 70 different policy actions over the past several months, there are tentative signs that their economy is stabilizing. China is the second largest economy in the world, and material swings in its growth rate tend to ripple through the entire global financial landscape. The ultimate effectiveness of these policies is likely the key to whether or not global growth picks up in the second half of the year. If this major policy push in China can successfully accelerate economic growth—and inflation stays tame—it is possible that a return to a goldilocks backdrop can occur. Should this happen, it may help fuel a durable bull market in asset prices.

Aside from the potential for a goldilocks macro backdrop, there are some other reasons to believe that a bear market bottom was established in late 2018, and that a new bull market is currently underway. During the quarter, the message from the corporate bond market appeared to be signaling that businesses are healthy, increasing demand for stocks outpaced supply, and investor enthusiasm picked up during the rally. Lastly, there also seems to have been a meaningful change in how the U.S. administration is approaching trade policy, as the combination of weaker economics, market damage, and an impending 2020 election appear to have U.S. officials working harder towards reaching some sort of deal with China. If a deal is struck, this could remove an enormous risk to economic growth by reversing what was arguably a major policy mistake in 2018.

Right Fork: The Case for a Market Topping Process

While equity markets have celebrated changes in central bank and trade policy, it has been remarkable to watch a wide disconnect develop between global economic data and stock market growth. During the first quarter, data from most of the world has been generally weaker, suggesting that there continues to be a synchronized global slowdown in progress.

The global economy is extremely important, not only for assessing the risk/reward equation between stock, bond, and commodity markets, but for feeding capital directly into U.S. corporate earnings, since many multi-national companies generate a large percentage of their earnings from overseas. Some analysts believe the U.S. economy is more insulated from global slowdowns than in the past, due to its relatively small reliance on trade. While that theory worked temporarily in the first half of 2018, it has faltered more recently, as the U.S. economy has started to succumb to the negative effects of the worldwide slowdown. This is evident in a variety of different indicators, including slowing manufacturing data, ebbing long-term investor and consumer confidence measures, and some leading recession indicators that are beginning to flash early warning signals that risks are rising.

Despite increasing signs that the U.S. is entrenched in a slowdown, investment markets currently appear to be looking past the first quarter valley with an expectation that the back half of the year will reaccelerate. Considering the market run off the December bottom, it seems reasonable to assume that economic data and earnings will show at least a tepid bounce back during the second quarter. The nascent risk for markets lies in what is lurking in the second half of the year. If the economy can't sustain the anticipated near-term bounce, then stocks and risky assets could be vulnerable to a sudden downturn, as investor focus begins to drift from policy relief to a realization that a flagging world economy would create a fresh downdraft for corporate earnings.

Our Current Stance

Back in January, we questioned whether the market had made its bottom or was cycling up into a new bull. Based on historical bear market cycles, the odds were in favor of the market running into heavy resistance and then sliding back towards the December lows as part of a longer bottoming process. While history can be a useful guide to help navigate markets, it is never a guarantee, and so far, the post-bear market experience has not followed the usual tendencies as stocks have enjoyed an almost uninterrupted rebound since making a low on December 26th.

The evidence remains mixed for now, but skewed in a direction that warrants some caution. But we are also reassessing whether we are at an inflection point where the more positive global growth scenario could be at play in driving the most recent rally. If the evidence accumulates so that a goldilocks backdrop has formed, we stand ready to adjust portfolio allocations, intending to take advantage of a potential sweet spot for risk assets that could be developing. At the same time, we'll also continue to be vigilant in looking for indications that the trend of the business cycle is heading downward. Should we see these signs, and any further evidence that the economic cycle is nearing the end, we must also be prepared to de-risk portfolios further to defend against a recession that may come earlier than the consensus believes.

Value Opportunities & Fixed Income Positioning

While we wait to see if an inflection point is at hand, a growing conviction is that international equities may possibly become more of a value opportunity versus domestic stocks. Although there are only tentative signs that global growth is picking up, we have already begun to incrementally lift our positions in emerging market stocks from being underweight to neutral in anticipation of a phase of growth in the future. If more evidence accumulates that China and global growth are healing, it would create an opportunity to turn more aggressive, and overweight this theme as the year progresses. But if the data falters and stocks decline, we may be more inclined to hold onto international assets while paring back on cyclical U.S. stock holdings with higher valuations. Should we get a material decline in risk assets, the current playbook would be to slowly build more global stock exposure intended to set ourselves up for a multi-year run in global versus domestic holdings during the next cyclical bull run.

Bond prices have appreciated recently as interest rates have fallen due to the global growth slowdown, and we have shifted to longer dated maturities to take advantage of the rally. We still believe that portfolios should own some bond holdings, given poor data and ebbing inflation, but if growth turns up, we will still have plenty of dry powder in the form of bonds to apply to assets that will quickly build value during an upturn.

Conclusion

Markets have a knack for proving the masses wrong at major turning points, and the first quarter clearly took most investors by surprise as it delivered a spectacular quarter for risk assets. There is no denying that the quarter was terrific for building wealth, but investors now face the proverbial fork in the road: Did the most recent market move foreshadow a future pickup in economic fundamentals, or did it just reflect an oversold market that was prone to snap back and now looks vulnerable to disappointment over coming quarters? If the bulls are correct, a perfect sweet spot for markets may be developing on the back of accelerating global growth in a low inflation environment. If the bears have this right, then relief over positive policy changes will likely be short lived, as the market reacts to deteriorating world fundamentals.

We still believe the evidence tilts towards a cautious stance, but are wrestling with the notion that a positive inflection for global growth may be in the offing. If more evidence of growth picking up materializes, then we will look for opportunities to build back risk. But if the evidence shows no bottoming in growth, we may have to bolster defenses to guard against the possibility that an economic contraction may arrive sooner than anticipated.

Yogi Berra once wrote, “When you come to a fork in the road, take it.” We believe we are close to an inflection point in the evidence that will dictate which side of that fork to take.

As always, we are grateful for the opportunity to continue to serve as your trusted advisor. Please reach out with any questions or concerns.

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