Stegent Equity Advisors Investment Letter

Market Review

July 2019

The second quarter of 2019 brought more gains for investors, with the S&P 500 Index hitting a new record high of 2,954 on June 20th in the process. While impressive, to get there market participants had to endure yet another bout of volatility, including a swift correction in May. Developed international stocks also gained, while emerging markets equities were roughly flat.

Some of the most impressive action occurred in the bond market, as interest rates fell sharply and sent long maturity bonds up almost 6%, outperforming stocks. Broad commodity indexes struggled, but gold was a star performer for the quarter, as the shiny metal jumped by more than 9% to the highest level in six years.

As the quarter came to a close, stocks had rebounded back to record territory, and investors were eagerly anticipating how soon the next milestone would be reached.

Trade War Escalates

Things were moving along fine through April, with the market extending the first quarter rally that followed last year's fourth quarter sell-off. In fact, on April 30th the S&P 500 reached what was then a new record high of 2,945. However, the very next day things suddenly changed. On May 1st, after reports that China had balked at previously agreed upon elements of a possible trade deal, President Trump tweeted that the U.S. was raising the current level of tariffs on $250 billion of imports from China from 10% to 25%, and threatened to implement tariffs on an additional $300 billion. This immediately raised fears that such an escalation of the trade war might be enough to tip an already slowing global economy into recession. Consequently, stocks sold off throughout the month of May, with the S&P 500 tumbling by nearly -7% into the beginning of June.

While trade headlines certainly spooked the market, another contributor to the sell-off was increasing evidence of a renewed global slowdown. Earlier in the year, there had been some signs of "green shoots"—that global economic data was beginning to stabilize and pickup. But those proved to be fleeting, as fresh signs of a slowdown reappeared. Perhaps most notable was continued deterioration in the monthly Purchasing Managers Indexes, which are considered very timely indicators of global manufacturing data. The JP Morgan Global Manufacturing Index slipped to a reading of 49.4 in June, the lowest since October 2012. It was also the second consecutive dip below 50, indicating that manufacturing activity globally is contracting. Sub-components of this index that focus on export activity clearly showed that the effects of the trade war that started last year have taken a significant toll on global supply chains.

In addition, the May employment report came in well below expectations, with a gain of only 74,000 jobs, creating the impression that the previously solid labor market was beginning to wobble. That, combined with an increasingly inverted yield curve (where shorter-term bonds yield more than longer-term bonds), had equity analysts suddenly scrambling to mark down their earnings estimates for the remainder of the year. The combination of an inverted yield curve and sharply lower earnings estimates was enough to cause a flood of sell orders, as equity ETFs (exchange-traded funds) experienced record out-flows of nearly $20 billion for the month.

Central Banks to the Rescue(?)…Again

In the midst of growing concerns about trade wars and economic slowdowns, global central banks began to rev their monetary engines again. Earlier in the year, the Federal Reserve made an important shift to a neutral policy stance, when they announced that they were going to "pause" from raising interest rates to assess how previous hikes and trade tensions were impacting the economic outlook. Since then, economic data faltered, inflation remained muted, and Fed Chairman Jay Powell adopted an increasingly dovish tone. In a speech in early June following the latest market

sell-off, he declared that the Fed was ready to "act as appropriate" to support the economy. That was immediately taken to mean that the Fed was preparing to cut rates, and asset prices found a footing and began to rally again.

The Federal Open Market Committee (FOMC) meeting later in the month only added fuel to the fire, as it confirmed that a growing number of committee members supported lowering interest rates this year, with only one official opposed to doing so now. Financial markets were quick to jump on the change in tone and began to price multiple rate cuts.

Importantly, this dovish shift isn't just contained to the U.S. The European Central Bank also recently dropped heavy hints that they're prepared to start stimulating again soon in response to inflation readings that remain well below their target. And a growing number of other countries including Australia, India, Malaysia, Philippines, Russia, Iceland and Chile have all been getting in on the action by cutting rates this year, with others likely to follow suit.

In our view, this is a very significant and somewhat unprecedented shift to a much more favorable policy back drop at a time when the U.S. economy is still growing and sports a historically low 3.8% unemployment rate. With the Fed Funds rate at only 2.4% currently, some are questioning whether the Fed is about to act prematurely (perhaps by succumbing to mounting political pressure) by using some of their limited monetary firepower before clear evidence of economic difficulty has emerged. Whatever the reason, if the Fed is about to embark on a new easing cycle, it should be supportive of both the economy and asset prices; therefore, it needs to be respected by investors.

Along with positive developments on the monetary front, some good news on trade came from the G-20 meeting held at the end of the month. There, President Trump and China's President Xi held a meeting that helped to de-escalate the trade standoff (for the time being) by agreeing to restart negotiations to try to reach a deal. While this certainly doesn't mean an end to trade tensions because current tariffs remain in place and there are many challenging issues to resolve, it does remove the near-term risk of tariffs being increased even further, which would put even more pressure on global trade.

Positioning: Moving Back to Neutral

What does all of this mean for our portfolios? Well, after positioning portfolios cautiously by raising cash early in the second quarter of this year, we have been working to put that cash back to work. While future moves are "data dependent," our current strategy is to increase risk assets when appropriate to benchmark levels of risk. While we share some of the concerns that economic data continues to slow and corporate earnings expectations are being lowered, increasing policy support and significantly lower interest rates means that risks to the outlook are fairly balanced at the moment. Thus, continuing to gradually move to a neutral position is supported by these factors.

Up to this point, moving back to neutral has largely entailed boosting U.S. equity weightings in a mix of high quality and highly capital efficient stocks. On the fixed income side, our portfolios are carrying slightly above benchmark duration (or interest rate sensitivity), mostly through high-quality, longer-term Treasury Bonds that should continue to benefit if there's more economic weakness ahead, and if interest rates continue to fall. In addition, our portfolios continue to hold both gold and goldmining stocks, to which we are giving a slight increase in exposure over the coming months, and should serve to act as a portfolio hedge if another outbreak of stock market equity volatility occurs this year.

Looking Ahead

As the third quarter gets underway, investors continue to wrestle with forecasting the severity of future ongoing economic softness offset by the likelihood of fresh policy support in the near future. Markets have already posted impressive year-to-date gains and thus may be due for a breather in the near-term, but the much larger risk of the economy falling into recession and driving stocks into a bear market has likely been reduced for the very near term, assuming there is another round of monetary stimulus on the way.

For our part, we continue to execute our strategy of moving portfolios back to neutral levels of risk. Once there, it will allow us to be patient and wait to see how the battle between central banks and economic weakness plays out. In the meantime, we will continue to look for value opportunities to take advantage of across different asset classes.

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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