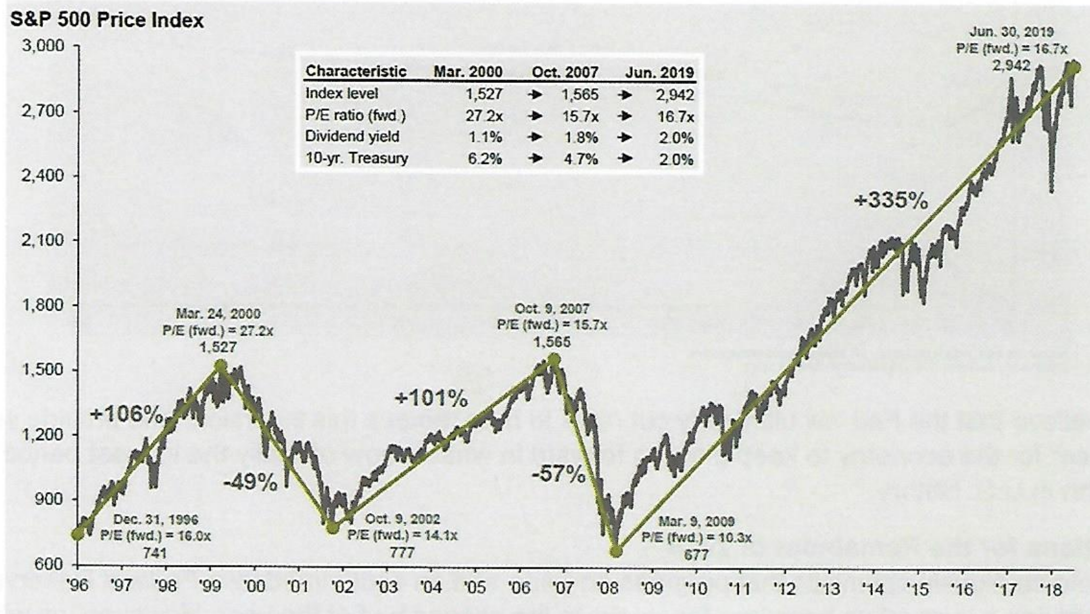
The Longer View

Comments & Outlooks from Longer Financial

July 1, 2019

Markets Approach New Highs, but Volatility Persists

After a wild end to 2018 that gave us the worst December for markets since 1931, we have experienced a broad-based recovery in the first half of 2019. On a year-to-date basis, the Dow and S&P 500 have returned +15.40% and +18.54%, respectively, and the Morningstar Large Value Index has gained 13.75%. While these numbers are impressive in isolation, we are just now regaining the prior highs set in the third quarter of last year, as fears of an economic slowdown coupled with uncertainty over trade have continued to weigh on investors.



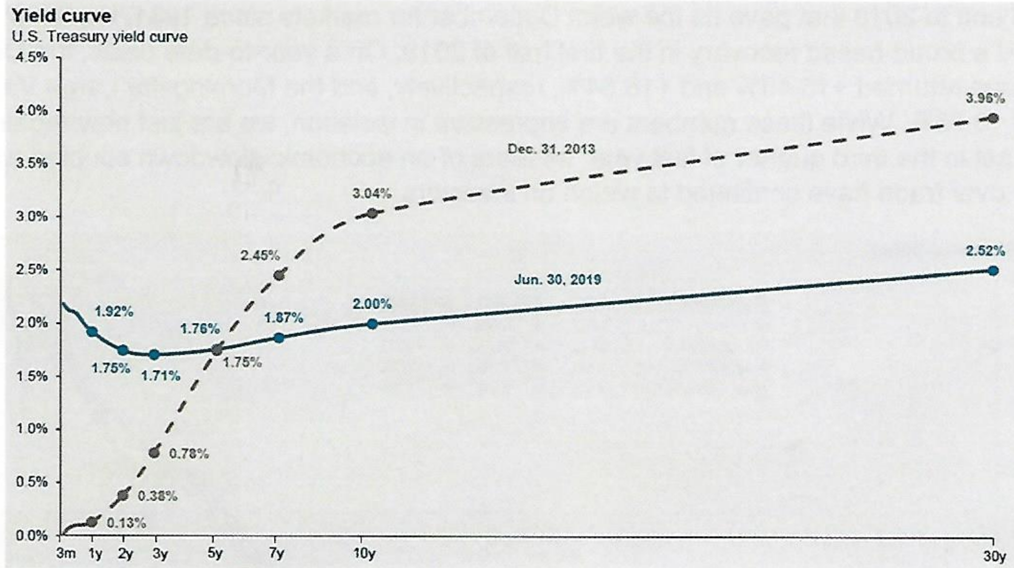
Source: Compustat, FactSet, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.

Though some progress appears to have been made at the recent G20 talks, the ongoing tariff dispute with China has been a central focus for the majority of the year, and it will likely continue to play a significant role for the foreseeable future. While the U.S. should ultimately hold the upper hand in negotiations given our trade deficit, further escalations could significantly damage economic growth both domestically and abroad. Markets warned of this in May, when President Trump's abrupt threat of new tariffs quickly triggered a sell-off of roughly seven percent for the S&P 500. However, in June, more "dovish" language from the Federal Reserve eased investor concerns, as Chair Powell made it clear that the Fed was ready to intervene with rate cuts, if needed, in efforts to fend off a potential recession.

The Federal Reserve and Interest Rates

As referenced above, the Federal Reserve has undergone a dramatic shift in outlook in the last several quarters. Last year at this time, we were discussing how many more rate hikes we would have in the next 18-24 months. This trajectory led the 10-year Treasury yield to approach nearly 3.25% last fall, and was a significant factor in the fourth quarter drawdown in stocks. However, as we enter July of 2019, the market is pricing in two or three 0.25% rate *cuts* before the year comes to a close, and the 10-year Treasury yield is resting near 2.0%. For bond investors, this has been a positive, as the drop in rates has led to an increase in current prices, with the Barclay's U.S. Aggregate bond index gaining 6.11% for the year.

The shape of the current yield curve (illustrated by the blue line in the chart below) paints a more cautious outlook for the economy moving forward. An inversion, where short-term rates exceed longer term rates, has historically been associated with periods of slowing.



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of June 30, 2019.

We do believe that the Fed will ultimately cut rates to help remove this inversion, and provide some "insurance" for the economy to keep plowing forward in what is now officially the longest period of expansion in U.S. history.

Implications for the Remainder of 2019

We remain cautiously optimistic that progress on trade and an accommodative Federal Reserve should provide a supportive backdrop for stocks in the second half of the year. However, we will be closely monitoring earnings reports in the following weeks, and as always, will apply discipline and caution when taking new portfolio positions to limit our downside risk, should the situation change. While it can be tempting to reach for higher-growth names with the market flying high, we believe that a focus on quality fundamentals is critical at this stage of the economic cycle.

We thank you for your continued trust, and as always, welcome any questions or comments that you may have.

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