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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

Focusing on the Forest, Not the Trees

Following a strong performance in the first quarter, the S&P 500 had a total return of 4.3% during the second quarter. The pathway to a positive return was a circuitous one. The month of May saw the broad stock market averages decline 6.5% amidst concerns about the possibility of additional tariffs on imports from China as well as signs of deceleration in global economic growth. During the month of June, two developments provided a boost to investor sentiment: President Trump and Chinese President Xi agreed to formally re-start trade negotiations while simultaneously calling a halt on additional tariffs. Secondly, recent informal communication from central banks in Europe and the U.S. have hinted at additional monetary stimulus in the months ahead. The combined force of these developments was a key factor in the stock market rally of over 7% during the month of June. In short, the stock market chose to focus on the "forest" (a macro environment of modest economic growth and low interest rates) rather than the "trees" (a yet to be concluded trade agreement and tepid near-term economic data).

Stock market returns were also boosted by a continued decline in short and long-term interest rates. The yield on the benchmark 10-year U.S. Treasury bond declined from 2.4% at the end of March to 2.0% on June 30. As recently as September 2018, the yield on the 10-year Treasury bond was 3%.

Within the stock market, U.S. stocks outperformed international stocks and large stocks beat medium and small capitalization companies. Growth stocks continued to outpace their value counterparts.

A $13 Trillion Question

The strong stock market performance this year is, in many ways, at odds with the recent economic news. In early summer the World Bank lowered its estimate for 2019 global GDP growth to 2.6%. The reasons for the lower estimate include softer European growth (particularly in manufacturing), as well as evidence of decelerating growth in China and Japan. In the U.S., consumer spending continues to grow at a modest pace and consumer confidence remains at a multi-year high; jobs are plentiful, and the unemployment rate remains historically low. However, in the U.S. too, we are seeing signs of slower manufacturing activity, and the housing and automobile sectors have also been lackluster during the first half of the year.

What is behind the slowdown in economic growth? There are multiple factors. In Europe, trade tensions have had a dampening effect on manufacturing export industries such as machinery and chemicals. In the U.K., the lack of progress on a Brexit agreement has had a noticeable impact on economic activity over the last six months. There are a variety of additional factors that weigh on European economic growth and these include inconsistent progress on economic reforms, elevated sovereign debt levels in southern Europe and political gridlock related to the rise of populist movements in Italy, Turkey and several other European countries.

Outside of Europe, trade tensions have led to a rise in uncertainty in Asia, and Chinese economic growth has been particularly impacted. In Japan, a forthcoming excise tax increase has dampened demand from both consumers and businesses. Like Europe, debt levels have risen in Asia; Japan's debt/GDP ratio reached 250% in 2018, by far the highest level of any developed economy. By contrast, U.S. debt/GDP stands at 100%.

Another factor behind slowing global growth is simply the age of the current economic recovery. Following the financial crisis of 2008-2009, the U.S. economy bottomed in late 2009 and we are now in the 10th year of an economic expansion. By virtue of the length of the recovery, demand in certain sectors of the economy has abated. The automotive industry is a prominent example of this dynamic. Total vehicle sales in the U.S. bottomed in the first quarter of 2009 at an annual rate of 9.2 million and subsequently rose to a peak annual sales rate of 18.3 million in 2017 where sales have subsequently plateaued. A similar trend has been witnessed in other sectors of the economy such as new home sales and durable goods, such as household appliances.

One distinguishing feature of the current global slowdown is that it has taken place against a backdrop of low inflation and historically low interest rates. Following a modest rise in 2018, the U.S. Consumer Price Index has averaged an annual increase of less than 2% so far in 2019. The current yield on the benchmark 10-year U.S. Treasury bond hovers near 2%. However, the real interest rate story lies outside the United States where borrowing rates are significantly lower: In the U.K., the 10-year yield is 0.75%, or less than half that of the U.S. Elsewhere in Europe, yields are not only lower than the U.S. but in many countries borrowing cost are negative *i.e., the lender pays the borrower* (the owner of the security receives less at maturity than the original investment). Germany, France, Austria and Denmark all carry negative interest rates on their 10-year government bonds. Japan, the world's third largest economy, also carries a negative government bond yield. The negative interest rate phenomenon is not limited to a few isolated cases, and the volume of negative yielding debt has grown considerably in the last year; the publication *Grant's Interest Rate Observer* recently noted that the global volume of negative yielding debt has reached $13 trillion. Negative yielding debt is not an unprecedented occurrence; yields on short term U.S. bonds turned negative briefly during the height of the 2008 financial crisis. However, the current volume of outstanding negative yielding bonds is unprecedented.

There are several causes of negative interest rates, but the primary force appears to be the monetary policies of the European Central Bank and the Bank of Japan. Since 2016 both of these institutions have adopted a negative benchmark interest rate. The thinking behind this policy was to encourage banks to lend to businesses and consumers. However, given the tepid economic growth rates, bank lending has been restrained. A secondary influence on negative interest rates relates to the overall demographic, fiscal and debt picture in many European economies. A combination of an aging population, high tax rates and elevated debt levels have a dampening effect on borrowing in Europe. In Japan, where debt to GDP levels are even higher than Europe, many of the same conditions prevail.

The policy of negative interest rates was intended to boost economic activity, but Eurozone GDP growth has been steadily decelerating over the past year. In addition, there have been unintended consequences of negative rates for individual savings as well as pension funds. In the case of pension funds, negative rates have the effect of increasing liabilities while simultaneously reducing the expected return on the fund assets.

Given that the condition of negative interest rates is no longer an isolated instance, investors must consider the longer term implications of this development. One conclusion is that negative interest rates are a purely monetary phenomenon and will reverse once central banks "normalize" policy. Certainly, monetary policy is a dominant factor impacting negative rates, however the anemic economic growth rates and other burdens cited above also appear to be important influences. *Grant's* notes that the volume of negative yielding debt has *more than doubled* since late 2018 and so the role of economic and other non-monetary factors should be given additional weight. Concurrent with the increase in negative yielding debt has been a rise in the price of gold as well as the trade-weighted value of the U.S. Dollar.

For investors, these developments pose several questions: 1) Does the increase in negative yielding debt presage further economic weakness? 2) Does the rise in the price of gold and the strength of the dollar call into question the limits of negative interest rate monetary policies in Europe and Japan? 3) Does the combination of negative interest rates and subdued inflation indicate an increased risk of global deflation?

A Balancing Act

Weighing the potential risks of negative interest rates against the backdrop of modest global economic growth and low inflation is a balancing act for investors. Global equity valuations, while not cheap, are about average and S&P 500 earnings are expected to grow 3-4% in 2019. The innovation sectors of the economy such as software, communication services and technology are growing considerably faster. On the one hand, investors must be cognizant of, and prepared for, unanticipated consequences of negative interest rates. On the other hand, portfolios need to be positioned to benefit from the long term economic growth trends. With this in mind, our portfolio positioning is as follows:

- Our equity weightings are slightly above the midpoint in balanced accounts. We continue to focus on companies with strong organic revenue growth and free cash flow generation, and these form the foundation of client equity portfolios.
- We continue to emphasize high quality, short duration bonds in our fixed income portfolios and we are maintaining an allocation to short-term U.S. Treasury securities.
- We perceive the recession and/or deflation risks to be elevated in both Europe and Japan, and we are therefore under-weight these markets. We maintain a constructive view of emerging markets, primarily in southern Asia.
- Owing to the significant increase in negative-yielding debt and the potential implications for currency stability, we are maintaining an allocation to gold via the gold iShares.

As always, we welcome your comments and questions.