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THE BULL MARKET'S BIRTHDAY 10 YEARS OR 15 WEEKS?

On March 9, we were tempted to raise a glass in salute of the ten-year anniversary of the stock market's recovery from the Financial Crisis. The rally that began that day a decade ago would go on to become the longest-running bull market in the modern era, quadrupling the level of the Standard and Poor's 500 Index and generating an astounding $30 trillion in wealth. This remarkable ascent reflected the slow, but steady, economic recovery that simultaneously kept inflation under control and cut the unemployment rate in half. Despite our desire to mark the occasion, we suddenly realized that such a celebration might be misplaced. The length of this bull market must be marked with an asterisk.

Although market statisticians and technical analysts have no official definition on how to measure stock market cycles, as a rule, a bull market must continually surpass its previous highs to be considered in an ongoing uptrend. The all-time high for the S&P 500 Index of 2,940 was reached last September 21, and as of this writing, still stands. Therefore, the bull market's continuing existence will be confirmed only after it closes above that level. If the Index fails to hit a new high soon, then market historians will probably mark the end of the bull market as having occurred last autumn at age nine-and-a-half.

If the old bull market died in September, are stocks now in a brand-new bull market? It depends whether the fourth quarter decline last year counts as a bear market or not. The layman's definition of a bear market is a 20% drop in the major indexes. From the September inter-day high to the inter-day December low, the S&P 500 Index was down just over 20%, but using closing prices, the decline missed 20% by a tiny amount. Does that count? Should we characterize the sharp decline last year as an unusually large correction in an ongoing bull market, or as a stand-alone bear market? If the latter, then perhaps we are in a new upcycle that is only a few weeks old. At this point, most analysts seem to favor the idea that the markets went through a correction, but one intensified by computer-driven trading. Most of us are pulling for a general increase in stock prices, whether or not market analysts view the bull market as new or old!

Despite the strong gains shown in the broad market indexes, not all indicators are universally bullish. Large swaths of the stock market have struggled to regain traction, their difficulties partially hidden by the outperformance of the technology sector within the S&P 500 Index. The major large-cap value indexes are still 5% below their January 2018 highs, despite a full fourteen months of trying. There are some worries that these weaknesses point to unrecognized vulnerabilities. Signs from the bond market have also disturbed some investors' confidence.

BOND MARKET FLASHING YELLOW

By now, many of you have already heard about the latest inversion of the intermediate Treasury yield curve. For those who steer clear of financial jargon, in this case, the yield on 10-year Treasury notes recently fell below the rates available on short-term Treasury bills. If you reflect on this a moment, this relationship does seem odd. Extending a loan out for ten years must increase the risks, if for no other reason because inflation might increase over that time. Accordingly, such yield inversions are rare, with the last occurrence taking place back in 2007. In other circumstances, this unusual quirk in the bond market might be viewed as rather arcane, except for the fact that inversions heralded the last nine U.S. recessions. After all, logically an investor only would accept a lower interest rate on longer-term notes if he expected yields to fall, which often takes place in a recession. As it turns out, yield inversions are one of the best tools for forecasting economic declines. On average, the time between a yield-curve inversion and the start of an economic downturn has been fourteen months, so the next recession would not start until mid-2020, based solely on this indicator.

The yield curve's track record isn't flawless, however. The U.S. Treasury curve inverted briefly in the 1960s and again in the 1990s, but no recession followed either of these occurrences. In the UK and Canada, the yield curve inverted in 2000, but neither country's economy saw a subsequent economic downturn. The Australian economy has been recession-free for over twenty-five years, even though the yield curve Down Under inverted three times in that period.

The opposite happened in Japan, where the ten-year/three-month spread has not inverted in well over five decades. Despite maintaining a normal yield curve, the Japanese suffered an extended period of severe economic distress in the wake of the 1980s real estate bubble, not to mention three small recessions in the past five years alone. It is best not to rely too heavily on only one indicator when forecasting either the economy or the markets.

An unusual factor may be distorting our Treasury markets now, having little to do with a recession outlook. Interest rates in several G-7 economies are negative, making it advantageous for foreigners to hedge the currency risk and buy intermediate U.S. Government bonds. This affect can be seen in other parts of the curve. When ten-year Treasury yields were below T-bills, other parts of the yield curve remained positively sloped. To be fair, the amount of inversion, where it occurred, was very slight, making the inversion a very weak signal. To be effective as a forecasting device, the curve should remain inverted for at least several weeks, which has not yet happened. Also, the stock market, not just the bond market, is known as a leading economic indicator. If stocks just had their best quarter since 2009, then investors seem to be anticipating an accelerating economy, not a downturn.

We note, however, that the average lead time for stocks to decline before a recession is seven months, compared to the fourteen-month average for the yield curve inversion. Therefore, it is not unusual for stocks to rise for the first months after the bond market turns. For example, in the run-up to the Financial Crisis, the stock market rose over a year after the yield curve inverted and stocks peaked only two months before the recession officially started. The Federal Reserve Governors may have altered their stance in time to save the day.

THE FED BACKS AWAY FROM THE BRINK

It was no coincidence that the stock market's bottom occurred only days before the Federal Reserve announced a sharp U-turn in monetary policy. After the Open Market Committee meeting last December, Fed officials warned investors that, after already increasing rates four times, "further gradual increases" in interest rates should be expected. Then, only a handful of days later, it was announced that not only were additional rate increase decisions on hold, but the ongoing balance sheet reduction would be ended. Such sudden shifts in policy have been rare at the Fed. Starting with the Chairmanship of Alan Greenspan, the policy makers built a culture based on caution and consensus-building. The Board members preferred to implement gradual, persistent steps over extended periods, whenever changing course. Chairman Powell has demonstrated that the current Board is cut from a different cloth and that they are willing to change direction quickly, if conditions warrant it.

Some of Chairman Powell's critics have complained that the Fed's shift was made due to political pressure from the Trump Administration. We do not share these concerns, as we believe other factors were at work when they made their decision. Economists at the Atlanta Fed were picking up signals that monetary conditions had suddenly become much tighter than anyone had previously realized. Some of this was due to unwinding the widespread application of quantitative easing and other non-traditional monetary tools that were instated in the wake of the Financial Crisis. Over the past year or so, the stated goal of the Fed's Governors was to "normalize" monetary policy by simultaneously raising interest rates, while also first stabilizing, then eventually shrinking, the size of the Fed's balance sheet. Policy makers were blazing new trails, since there have been no prior examples of a large central bank reversing the impact of Quantitative Easing. Would shrinking the balance sheet essentially be a form of Quantitative Tightening and, if so, to what extent? The staff at the Atlanta Fed tried to answer these questions.

The data from their calculations indicated the Fed had attempted to do too much, too quickly. Including the balance sheet effects, their figures showed that the U.S. had not experienced this level of monetary tightening since Paul Volker was wringing runaway inflation out of the economy in the 1980s. Given the weak state of the recovery, there was no economic justification for maintaining a policy that restrictive. The sudden plummet in the stock market also seemed to confirm monetary conditions were too restrictive. Sensibly, the Board chose to shift gears and put further tightening on hold until they could better assess the impact of their previous moves on the economy. The sharp rebound in the stock market may be the best indicator that they acted in the nick of time. Unfortunately, there were so many unusual economic events in the first quarter, that it may take some time to confirm that growth is on the mend.

LOOKING FOR UNDERLYING GROWTH TRENDS

The pace of U.S. economic activity has decelerated in the past two quarters, but the true underlying rate is hard to determine because some extraneous events may have distorted the numbers. The 35-day partial shutdown of the Federal Government, now largely forgotten, probably shaved nearly half a percentage point of growth from the Gross Domestic Product. Correlation isn't necessarily causation, but it seems suspicious that the shutdown also coincided with the biggest drop in December retail sales since the Financial Crisis. Surprisingly, even the "non-store" retail segment, which includes e-commerce, saw a sequential monthly decline at Christmas. Unfortunately, poor 2018 Holiday sales led to some store closings and layoffs during January and February this year. Also, while winter weather impacts economic activity every year, the extreme "polar vortex" this February may have cost the U.S. as much as $5 billion during the first quarter, an equivalent value as one entire day's economic output. Even without a polar vortex, the Government's winter seasonal adjustment factors appear to be incorrectly

calibrated. For the past few years, first quarter GDP numbers have been disappointingly weak, only to be followed by a sharper-than-expected rebound in the second quarter. We will see if the same pattern emerges this year.

Economic problems in other countries moderated U.S. growth. A year ago, there were signs that Europe was starting to show some economic momentum, but the latest data shows that the progress there has stalled. Last month's report on the Manufacturing Purchasing Managers Index for the Eurozone was very disappointing, led by declines in Germany and France. Most analysts expect European GDP growth to hover near zero this quarter, dangerously close to falling into recession. For most large U.S. multi-national companies, a European recession would have far more impact than a breakdown in the Trump Administration's trade talks with China. Annual U.S. corporate earnings generated in Europe are roughly $285 billion, compared to only about $15 billion from China. Fortunately, the Services PMI for Europe mostly remain positive, so we are hopeful that European real GDP growth should stabilize at around 1%.

BALANCING THE RISKS

While the outlook for corporate earnings has been reduced since the start of the year, easier financial conditions should help offset this. We also believe that stock market volatility will remain an issue and that all investors need to avoid complacency after the stock market's recent strong results.

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