Economic and Market Newsletter Summer 2019

Hallmark Capital Management, Inc.
1195 Hamburg Turnpike
Wayne, New Jersey 07470
973-808-4144
www.hallcapmgt.com

A FAST TURNAROUND

The wire services recently picked up the remarkable story of 103-year-old Julia "Hurricane" Hawkins, who set records and won gold in the 100 and 50-meter events at the National Seniors Games track and field meet. When sprinting 50 meters, she covered 2.5 feet every second, about the same time it takes to blink three times. As remarkable as that achievement may be, it pales in comparison to the speed of the pivot last quarter for the 227-year old New York Stock Exchange. Early in the quarter, investor pessimism was rife and by June 3, stock prices had dropped over 7% in a month, with the major indexes falling below their 200-day moving averages. Rising trade frictions and slower global growth led to apprehensions that second-quarter earnings would disappoint. Just when the Bears were ready to say, "I told you so…," the stock market turned on a dime and rallied over 8% in only 14 trading days, pulling the major averages to all-time highs. The Dow Jones Industrials sprinted ahead at an average pace of almost 160 Dow-Jones Industrial points per day in that stretch. Pretty fast for a bicentenarian!

The energy source behind the stock market's stride was Fed Chairman Jerome Powell's speech on June 4, when he stated that, if trade issues negatively impacted the economy, the Fed would act in an "appropriate" way. On the surface, Chairman Powell's statement seemed to be a commonsense assertion that the monetary policy would be guided by the economic data. (Would the Fed ever announce a plan to act "inappropriately"?) Stock market investors, however, automatically assumed that the most "appropriate" way for the Fed to act would be the one that would make them the most money. Dovish rhetoric from several foreign central bankers reinforced the market's belief that a preemptive U.S. rate cut was in the cards. After a very disappointing employment report from the Department of Labor for the month of May, the consensus opinion quickly jumped to an expectation that the Fed Open Market Committee would cut the Fed funds rate by half a percent (50 basis points) at their July meeting. Mr. Powell subsequently reminded investors that the Fed should not respond to any single piece of data and, later, Fed Presidents Daly, Bullard and Kaplan tried to walk back market expectations. Since then, June's employment report rebounded back, so the interest rate forecast is now leaning toward 25 basis points, rather than 50.

Twenty-five years ago, an economist would have questioned the sanity of interest rate reductions in the current economic climate. After all, inflation-adjusted interest rates are only slightly above zero, while the unemployment rate is near a fifty-year low. The old schoolbooks taught that a rate cut under these circumstances would distort the economy by encouraging overconsumption and the accumulation of excessive debt. Ultimately, this would create severe inflation, stimulate unproductive investments and erode the value of the dollar. The conditions of today, however, were not imaged decades ago, when professors were developing these theories. Globalization, technological innovation and low population growth have led to a world with greater deflationary tendencies than anyone could have imaged back then. The Fed cannot solely focus on domestic economic data when the global economy is slowing. The old rules no longer apply. Central bankers have faced plenty of criticism since the Financial Crisis, but policy makers have been correct to consider non-traditional steps during unusual times.

TWO DIFFERENT WORLDS

Like the lyrics of the old Hank Williams ballad, the stock and bond markets are living in two different worlds nowadays. Despite the obvious signs that the global economy is losing momentum, equity investors appear to believe that everything will work out fine. Price/Earnings ratios expanded, even though earnings are not expected to improve very much this year. Investors seem to believe that lower interest rates will ultimately prove to be the solution for any and all potential economic difficulties. Equity market confidence abounds, with examples of real exuberance in the new-issue market last quarter. Despite eye-popping valuations, keen demand for shares in the most sought-after deals caused the kind of explosive first-day price gains only seen in the early days of the Internet Bubble. Stock valuations were not a drawback for corporate managers either, with corporations purchasing $208 billion of their own shares in the first quarter alone. Buybacks for the twelve months ending in March were almost 50% greater than the year before. Everything seems bright and beautiful for equity investors.

Fixed-income investors do not seem to share the same sense of economic optimism. U.S. Government bond yields have now fallen for three consecutive quarters and as we mentioned in our last letter, the yield curve is at least partially inverted.

Yields on three-month Treasury Bills are higher than those on ten-year Treasury Notes and, for a short while, even on thirty-year notes. How bizarre that the Government can borrow more cheaply for several decades than for several weeks! Historically, this relationship with the thirty-year bond has occurred only a handful of times and almost always during periods of deep economic distress. Anxiety seems to be intensifying; rates are not only dropping, but the pace of decline has accelerated. Yields on two-year Treasury Notes posted their largest quarterly decline since the Financial Crisis. The size and strength of the move has caused an outburst of worried commentary from bond market analysts, who worry that the bond market is sending a recession warning. Yet, many investors buy both stocks and bonds. How can the same people be sending two completely different messages?

MIXED SIGNALS FROM BOTH WORLDS

If one digs a little deeper, the messages from the financial markets are not nearly as distinct as it first appears. Equity investors retained some risk aversion, even as the overall market climbed. Despite the record new highs for the major stock market indexes, mutual funds saw a net outflow of monies, which accelerated as stock prices rose. The Ned Davis Trading Sentiment Composite, a measure of investor pessimism, may have improved from its worst levels, but it still indicates that equity investors retain a level of skepticism about future stock prices. Additionally, a recent survey of professional fund managers showed that half of them believe the global economy will weaken over the next year. Large-capitalization stocks, traditionally seen as relative safe havens, outperformed the more speculative small-cap indexes in the second quarter. After several weeks of revising estimates upward, Wall Street analysts reduced their forecasts for second-quarter corporate profits and are now anticipating that earnings will be down year-over-year. These are hardly consistent with the idea of an over-enthusiastic bullishness permeating the equity markets.

If equity investors were not quite as elated as they first appeared, bond investors may not be as pessimistic as analysts believe either. One would expect the prices of lower quality bonds to be hit especially hard when fears of a recession are building. Yet junk bonds, even the worst rated CCC bonds, have done quite well this year. Perhaps recession fears are not the only forces pushing bond prices up. We believe some of the following factors are also at work.

DECIPHERING THE CHANGES IN MONETARY POLICY

While the media has been absorbed with the Fed's interest rate decisions, they have largely ignored the other tactic being used to normalize monetary policy. In addition to hiking rates, the Fed was simultaneously reducing some of the assets it accumulated during its Quantitative Easing (QE) program. In its efforts to counteract the Financial Crisis, the Fed allowed its balance sheet to balloon from 6% of GDP to an amount equal to 26% of GDP.

In 2017, the economy appeared stable enough to start reversing QE and the assets at the Central Bank began to shrink. QE had not been tried in the U.S. before and the Fed had few guideposts of how reversing course would impact the economy. Policy makers have been forced to experiment as they went along. By May 2019, the Fed's Governors had reduced the assets by 13%, from $4.5 trillion down to $3.9 trillion. The Fed was probably tightening far more than it realized. Even though the Fed's interest rate hikes this cycle have been the most gradual in the past fifty years, they were too aggressive in conjunction with the balance sheet changes.

Despite the low level of interest rates, the realization began to spread that inflation was likely to be lower for far longer than most observers had previously believed. Back in December 2015, when the Fed began to raise short-term rates, economists assumed that inflationary pressures would start to build when the unemployment rate dropped below 4.9%. This was long held to be the non-accelerating rate of unemployment, known by the acronym NAIRU. This estimate of NAIRU turned out to be wildly off the mark. The unemployment rate has fallen to a range of 3.6% to 3.7%, yet the inflation rate has remained obstinately below the Fed's 2% target. Consumer expectations of future inflation hit a forty-year low in the widely followed University of Michigan survey as wage gains have stalled. Similarly, the five-year inflation rate imbedded within the inflation-adjusted Treasury markets is at the lowest level in almost three years. Bond investors anticipated that, if policy makers were serious about pushing inflation toward their 2% target, the Fed would be forced to cut interest rates in a non-recessionary environment.

LOW RATES ARE A GLOBAL PHENOMENON

Viewed in isolation, even if economic conditions in the U.S. justified higher short-term interest rates, the Fed's hands are somewhat tied when foreign yields are at sub-zero levels. Over $13 trillion of bonds globally now have negative interest rates. Not only are the ten-year Government bond yields below zero for the large economies of Germany and Japan, but Belgium's ten-year yield also has gone negative and the entire Danish bond curve is negative out to twenty years. Swiss government bonds only achieve a positive yield at a fifty-year maturity. U.S. Treasury yields seem low, but they offer foreigners an attractive opportunity to earn positive returns with very low risk.

When the Fed raises U.S. interest rates above comparable foreign yields, it tends to drive up the value of the dollar. Among its other effects, a higher dollar tends to lower the prices of imported goods, thereby dampening U.S. inflation. Balancing this foreign exchange impact makes it harder for the Fed to reach its own inflation target. Also, much of the private debt in emerging market economies is denominated in U.S. dollars. When the exchange rate changes, the difference flows through to their cost of borrowing. Thus, when the Fed increases U.S. interest rates, it can act as a brake on the entire global economy, further dampening inflationary pressures. The bottom line is that U.S. interest rates may have to fall, given the slow economies and unheard-of interest rates in Europe and Asia.

VALUATION DISTORTIONS HAVE CONTINUED

The powerful ten-year rally of growth stocks has remained in place this year, with particularly strong performance from the technology sector. Interestingly, the most expensive technology stocks, as measured by Price/Earnings ratios, have done the best this year, even when their 2019 earnings outlook was not significantly different from the overall market. The rapid expansion of Price/Earnings ratios among the most expensive stocks have widened the gap with low Price/Earnings stocks to extremes not seen since the Internet Bubble. This may seem strange at first, but such outperformance is consistent with a decline in interest rates. More of a growth company's expected stream of earnings fall into the distant future. If the intrinsic value of a stock is determined by the cumulative future profits of the underlying company, they must be discounted back to today's dollars by the cost of money. As interest rates decline, these future profits are valued more highly when discounted by a lower number.

HAS THE EQUITY MARKET GOTTEN AHEAD OF ITSELF?

As we mentioned earlier, in the wake of some poor economic statistics and Chairman Powell's press conference, investors' expectations for future rate cuts grew. At one point, anticipation was building for an initial reduction of 50 basis points, with additional cuts over the next twelve months, totaling a full 100 basis points. While there have been similarly sized Fed moves in the past, such large reductions only occurred when the U.S. economy was in recession. Certainly, the Index of Leading Economic Indicators, although weaker, has remained near record highs: comfortably above the levels that would signal an imminent recession. If the trade conflict got significantly worse, that could push us over the edge. With the economy slower, but still positive, any adjustments in monetary policy are more likely to be a course correction than a sea change. Equity investors should also be careful what they wish for. The Fed would most likely lower rates aggressively when it was faced with serious economic disruptions. The benefits to stock prices from lower interest rates could easily be offset by disappointing earnings results.

All-time highs in the stock market are always welcome. Earnings growth for the S&P 500 companies has been low so far this year, so most of the broad market's advance has been thanks to multiple expansion. Historically, when stocks have been as richly valued as they are now, future returns have been below the long-term trend. The key question for all investors is if a slower earnings environment is fully discounted relative to the outlook for lower interest rates. If investors have overshot their interest rate expectations, then there could be some short-term vulnerability for stock prices.