POST OAK PRIVATE WEALTH ADVISORS

ADVISORY, CONSULTING & INVESTMENT MANAGEMENT

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Quarterly Market & Economic Commentary

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U.S. stocks closed out the first half of 2019 on a run of strong performance. By the end of Q2, the major equity market indexes hovered near all-time highs, but they took a rocky road getting there. The S&P 500 gained 4% in April, lost 6% in May, then rebounded 7% in June. For the entire quarter, the benchmark stock index gained 4.3% with the financial, materials and technology sectors leading the way. Energy and health care stocks were the laggards.

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You would think investors would be joyous during such a good spell of gains, but that wasn't really the case for most of the quarter. In fact, individual investors had mostly been on the sidelines until very recently. Net flows to domestic stock mutual funds have been negative for much of 2019 to date, although money poured into equity funds during the closing weeks of June. Bond and money markets funds were on the receiving end of the stock outflows as investors sought the relative safety of fixed income asset classes.

In addition, investors haven't been too bullish on stocks during the 2nd Quarter. In the American Association of individual Investors weekly sentiment survey, the share of investors feeling bullish about stocks hit a year-to-date low in early June. For much of the year so far, bullish sentiment has been below the survey's historical average.

Stock market indexes may not give any appearance of worry, but there was plenty for investors to worry about in the 2nd Quarter. Most of the attention was directed at the Federal Reserve, primarily because President Trump has directed his attention there too. In fact, I do not recall another period in my career when the markets were so hyper-focused on what the Fed may or may not do with interest rates or whether the president approves or disapproves with their policy decisions.

For much of Q2, investors speculated whether the Fed would cut rates at their June 19th meeting. Rates stayed where they were, but the Fed did signal a willingness to lower rates in response to evidence of slowing conditions in the U.S. economy. A rate cut in June would have been a dramatic reversal in Fed monetary policy; at the end of last year, the Fed was still projecting more rate increases through 2019 (although the markets doubted the central bank's ability to do this, correctly as it turned out.)

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On the surface, there doesn't seem to be much of a need to loosen monetary policy in the current economic environment. The pace of GDP growth for Q1 came in at an estimated annual rate of 3.1%—not as strong as some quarters last year, but still respectable and higher than the average through the current expansion. The jobs market continues to shine—the unemployment rate hit a five-decade low in May, and wages are still ticking higher. Inflation has remained at a fairly level 2% annual rate for the last several months, negating any reason to lower rates to stimulate price growth or raise rates to cool prices down.

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But as of quarter end, the market gave higher odds for the Fed to lower rates by a half-point in the next three months. We think that may be an unrealistic expectation, especially after recent comments made by two Federal Reserve Board governors. Why does the market think the current robust economy will need a shot of monetary stimulus in the next six months? Part of it comes from overseas—global economies are struggling to maintain growth, from developed markets like Germany and Japan, to emerging markets like China. The European Central Bank floated some monetary stimulus measures they may implement in order to stop the slide in growth in the European Union. In response, sovereign debt yields on German long-term bonds slipped into negative territory once again. Japanese long bonds followed suit. A "flight to quality" to U.S. Treasuries caused the yield on the benchmark 10-year Treasury note to fall to 2.0% during the 2nd Quarter. Just eight months ago—November, to be precise—10-year yields were a full percentage point higher, at 3.2%.

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Fears of a global economic slowdown also fueled activity in other asset classes. Gold also benefited from a flight to quality and spot prices for the precious metal hit six-year highs in June. Oil prices were up and down through the quarter, driven in part by news of tanker and drone attacks in the Gulf region and the potential for a wider skirmish between the U.S. and Iran. Normally, an event like the June 13 oil tanker explosions would cause an approximate 20% spike in oil, but prices jumped just around 2.5% following the attack.

Energy markets are skittish right now because of the potential for weaker demand in a slowing global market, but also because oversupply due to U.S. production. Domestic oil stockpiles rose 8% for the year through April, the fastest pace in three years. Pumping at Permian Basis wells surged this spring as per-barrel West Texas crude prices reached a calendar year high of $66.30 in April, but fell to $51 by mid-June. By quarter end, WTI crude had recovered to close around $59 per barrel.

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Oil price volatility and global growth concerns are being driven by another worry—the risks to global trade. This has the Trump administration's fingerprints all over it, mostly because of the tariff threats he issued during the last quarter. First, he set higher tariffs on $200 billion of Chinese imports after U.S.-China trade talks hit an impasse, then threatened further action on all Chinese imports if talks did not progress. Second, the administration took selective aim at several Chinese companies, notably smartphone maker Huawei, and blacklisted the firms from buying U.S. technology. Trump also engaged Mexico in a widening trade war, using the threat of tariffs on Mexican imports to the U.S. to push Mexico into tightening their southern border (which many Central American migrants cross on their way to the U.S.)

Trump's tactics on tariffs were the spark that fired May's stock volatility. Investors grew concerned about the effects of a long and nasty trade war on company profits; many firms issued lower earnings guidance for the second half of 2019 and cited trade concerns as the primary reason. The potential consequences of higher tariffs and tighter trade restrictions hang over nearly every sector of the U.S. economy, but there's also a lot of uncertainty about how many of Trump's threats are just bluster or hardball negotiating tactics and how many will become reality.

The tougher stance on trade isn't popular among Congressional Republicans or business leaders, the latter being typically reliable supporters of the GOP's pro-market policies. However, Trump is finding some degree of success with his approach. For instance, Mexico did decide to bolster

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border security and Trump immediately suspended his proposed tariffs. In regards to China, Trump restarted trade talks with China after meeting one-on-one with Chinese president Xi Jinping at the June G20 summit, after tabling additional Chinese tariffs and loosening some restrictions he had placed on Huawei.

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We head into the second half of the year with many of these concerns unresolved. That could explain why market analysts seem divided on their outlooks for stocks over the next six months. For example, one Wall Street investment house recommended their clients purchase short-term call options on the S&P 500, which would be in-the-money if the index climbs higher. But another firm advised their clients to get defensive by purchasing short-term U.S. Treasuries.

The risks for a global slowdown could spread to the U.S. and potentially end the current economic expansion, which is now ten years old and tied with the boom in the 1990s as one of the longest on record. Expectations for future GDP growth are sharply lower now; the most recent reading of the Atlanta Federal Reserve's GDPNow forecast estimates an annual growth rate of 2.0% for Q2 when the numbers are released in the coming months.

Moreover, we now have an inverted yield curve, that famously reliable indicator of future economic slowdown. Rates between 2-year and 7-year Treasuries are definitely inverted when compared with 30- and 90-day rates. The 10-year yield is also inverted when measured against the shortest Treasury bills, but the curve is positively sloped versus 2-year Treasuries. An inversion of the yield curve doesn't guarantee a recession. If the Fed does take action soon to trim interest rates, that could shift the entire yield curve back to a positive slope. But even if the curve remains inverted, several months may pass before the U.S. economy falls into recession, if at all. Plus, market history shows opportunities for stock returns are possible between a yield curve inversion and the start of the next recession.

It is nearly impossible to time market corrections or "black swan" events. But with all of the uncertainty around trade deals, geopolitical tensions and global growth, this may be an ideal time for investors to adopt a hedged strategy to buffer against market dips and increased volatility. A hedged strategy offers investors the flexibility to seek opportunities to participate in market gains, with a defined level of protection from potential downside losses.