Market Commentary

Second Quarter 2019

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The second quarter of 2019 was a positive one for financial markets. Following the phenomenal gains of the previous quarter, US equities moved upwards in a zig-zag pattern with strong gains in both April and June sandwiching a decline of nearly 6.5% in May, as measured by the S&P 500 benchmark. For the full three-month period the S&P 500 rose by 7.05%, bringing the year-to-date gain to 18.5%. Fixed income yields continued to decline during the quarter, as investors became more convinced the Federal Reserve was moving closer to a rate cut. The benchmark 10-year Treasury ended the quarter at 2.00%, meaningfully below the 2.42% rate on March 31, and briefly touched the lowest level since 2016 during June. While the yield curve has been inverted at times (meaning that short-term Treasury bills had a higher yield than 10-year Treasury notes), we believe that declining inflation expectations are driving longer-term rates lower which is a positive. If the Federal Reserve cuts rates later this year as many expect, the yield curve should normalize with short-term rates lower than longer-term rates.

While acknowledging that most investors dislike volatility, we remind you to focus on longer-term returns and to eschew day-to-day movements. From the September 2018 peak in the S&P 500, the benchmark index declined over 19% through Christmas Eve before starting a sharp rally of more than 26% through quarter end. This left the index virtually unchanged from its September levels, although it unnerved many investors along the way. Fixed income yields have taken a similar path, rising significantly through the latter part of 2018 before declining rapidly during the first half of 2019. At Tandem, we look at the fair value of a security and hold through ups and downs provided the fundamental value has not changed. While many investors sold stocks in December after a sharp decline only to buy them back after a 20% rebound, Tandem made minimal changes to client portfolios, rebalancing where prudent, and staying true to our investment discipline. This restraint benefitted client portfolios during the last several quarters and has proven to be a long-term winning strategy.

Economic and Market Outlook

The US economy continues to confound many critics with stronger than expected growth over the past few quarters. This month the current economic expansion which began in July 2009, becomes the longest consecutive period of growth in the history of the United States. With unemployment near 50-year lows, muted inflationary pressures, and significant amounts of cash on corporate balance sheets, we can make a plausible case for the expansion to endure for several more quarters if not years.

Oil prices remained volatile, moving in a zig-zag pattern during the quarter. After beginning the quarter at $60.14 for the West Texas Intermediate benchmark, oil prices climbed to a peak of $66.30 in April before starting a steady slide through mid-June, bottoming at $51, before rebounding during the final weeks of the quarter. The decline in oil prices came despite rising geopolitical tensions and threats of supply disruptions after the bombing of two oil tankers in the Straits of Hormuz and the downing of a US drone by Iran. Record amounts of shale production along with concerns over declining global demand pushed prices lower. At quarter-end, West Texas Intermediate was at $58.47, down 3% for the three-month period. Using supply and demand fundamentals, we predict oil should remain in a range of $50-70 a barrel barring any significant geopolitical events.

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At its late-June meeting, the Federal Reserve signaled the likelihood of one or more interest rate cuts during 2019. At the beginning of this year, the Fed was predicting two or three interest rate hikes this year. Currently, eight of the 17 Fed officials project the Fed will cut the Fed Funds rate this year, with seven of those eight expecting two quarter-point rate reductions. The sharp decline in the benchmark 10-year US Treasury yield from 3.25% in late 2018 to approximately 2% currently is seen by some as a harbinger of an economic decline. We note there is currently more than $13 trillion of sovereign debt with negative yields making the US a very attractive place for fixed income investors on a relative basis. This has driven up demand for US Treasury securities. We have been asked why the Fed would consider rate reductions in the face of a strong US economy. Typically, the Fed cuts interest rates when the economy is weak, in order to spur economic activity. While the economy is slowing modestly, we do not expect pronounced and broad-based economic weakness in the near future. The answer is that inflation is “too low”, i.e., below the Fed’s targeted rate of 2%. Contrary to the Fed’s position, we feel that low inflation in a healthy economy is a good thing, allowing for productivity gains and continued economic growth. Further, with interest rates even lower than the current environment, the Fed would have fewer arrows in the quiver to stimulate the economy when economic weakness eventually takes place. We point out inflation has been below 2% for several years, including the past two years when the Fed was hiking interest rates. Despite our belief that the Fed does not have to cut rates, the markets are clearly expecting at least one rate cut this year and if the Fed does not cut rates after telegraphing a cut for several weeks, markets may react negatively.

Finally, we note a few potential overhangs that could negatively affect equity markets in the coming months. The primary risk that concerns investors is the trade dispute with China coupled with fears of extended periods of higher tariffs. Additional concerns include earnings growth that has slowed modestly from the significant gains in 2018, along with a global economic slowdown.

Portfolio Positioning

With expectations of continued, albeit uneven economic growth in the coming quarters, we have made minimal changes to client portfolios over the past several months. Our focus remains on those sectors and companies that can show growth in revenue and earnings even in an economy that is expected to slow from the growth rates of the past several quarters. Based on current valuations and interest rates, along with our forecasts for economic growth and subdued inflation, US equities are slightly above fair value. This does not mean we are calling for a sharp decline, but rather that stock prices may take a breather to allow earnings growth to catch up with the advance over the past several months.

Conclusion

Looking out over the next 12 months, we believe economic fundamentals will remain positive at least into 2020. GDP growth rates in 2019 are expected to slow from last year, and 2020 will likely show a further slowing, although it should remain at or above the trendline growth rate of approximately 2% with minimal inflationary pressures.

As always, we welcome feedback from our clients. Please call or email us if you have any comments or questions about your investment portfolio.

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