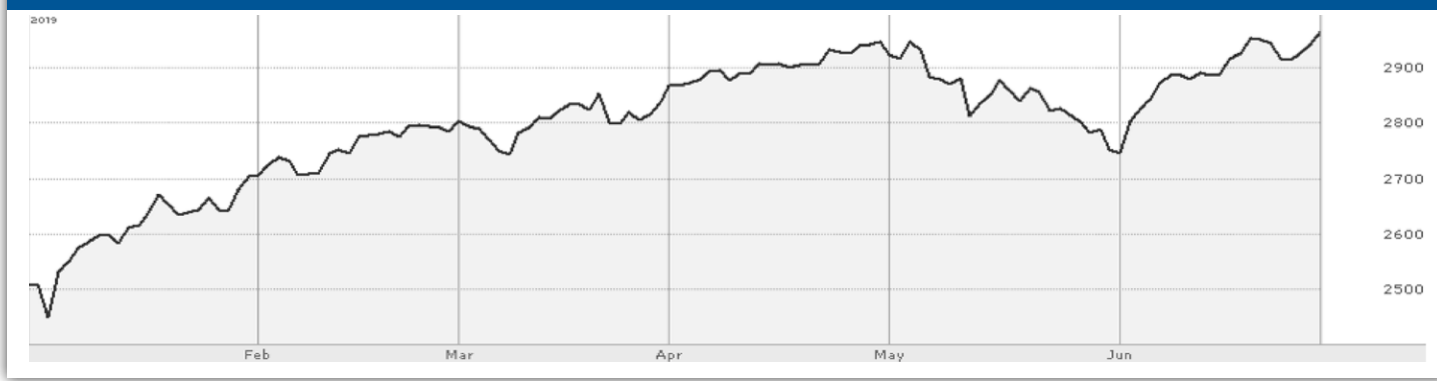
2019 – 1st Half Recap

Another solid quarter is in the books, as the S&P 500 rose in price 3.79% for the quarter. May's 6.4% drop marked the only decline in value for any month so far this year. With June's recovery, the S&P 500 Index appreciated 17.35% during the first half of the year.

S&P 500 – 2019 Price Movement



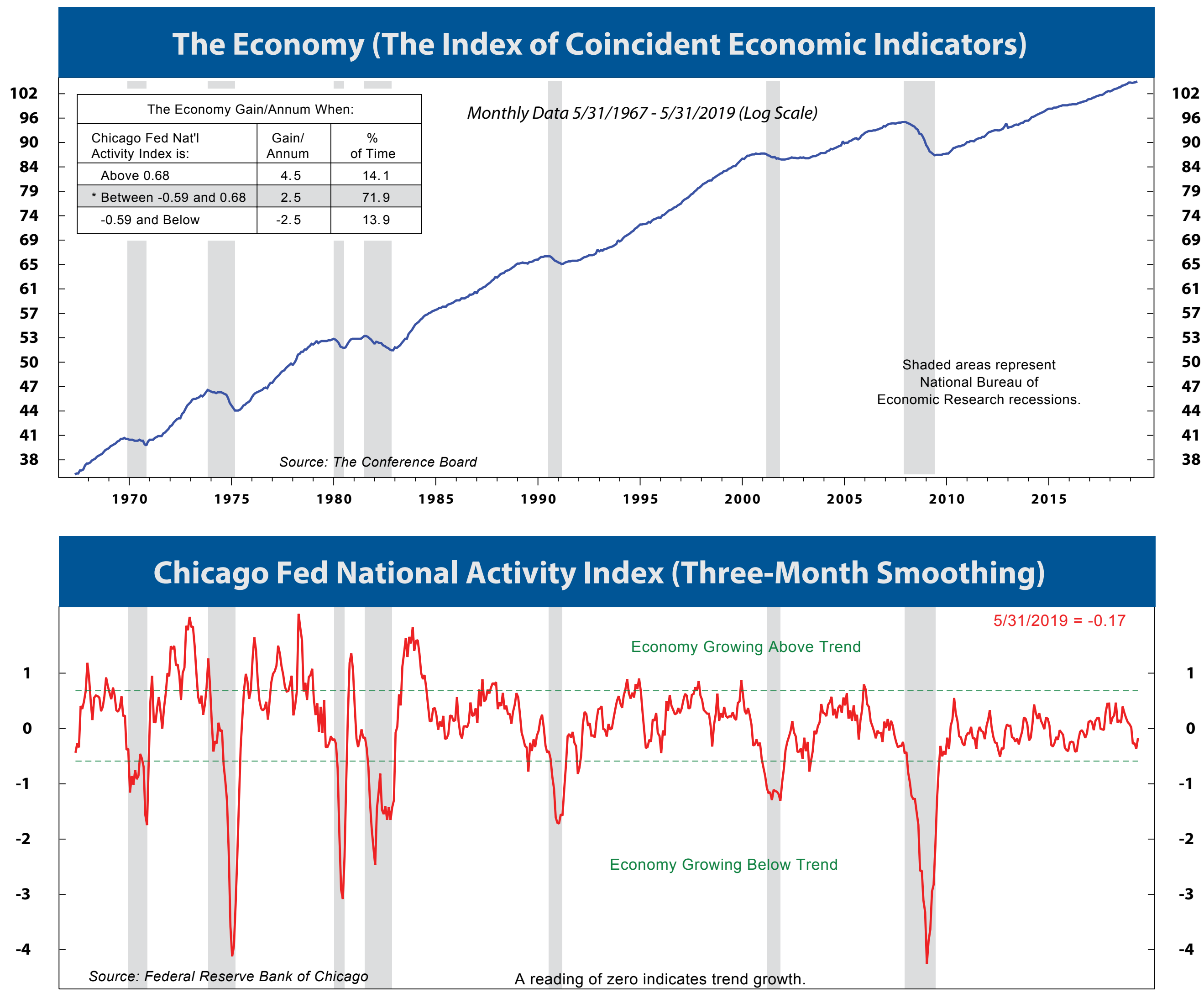
Source: Standard & Poor's

We certainly don't want to look a gift horse in the mouth. I am pleased that the market has rebounded and has shaken off the negative sentiment of last year. But as wonderful as this year's performance has been, the S&P 500 is back to where it was at the end of the third quarter in 2018. As you can see from the chart below (and as we've discussed at great length), Q4 was a rough quarter for the S&P 500, with a waterfall drop from December 1st until Christmas. We experienced a decline of almost 20% from high to low. Q1 and Q2 of 2019 have shown extreme resilience, as it battled its way back to all-time highs.

S&P 500 – September 30, 2018 through June 30, 2019

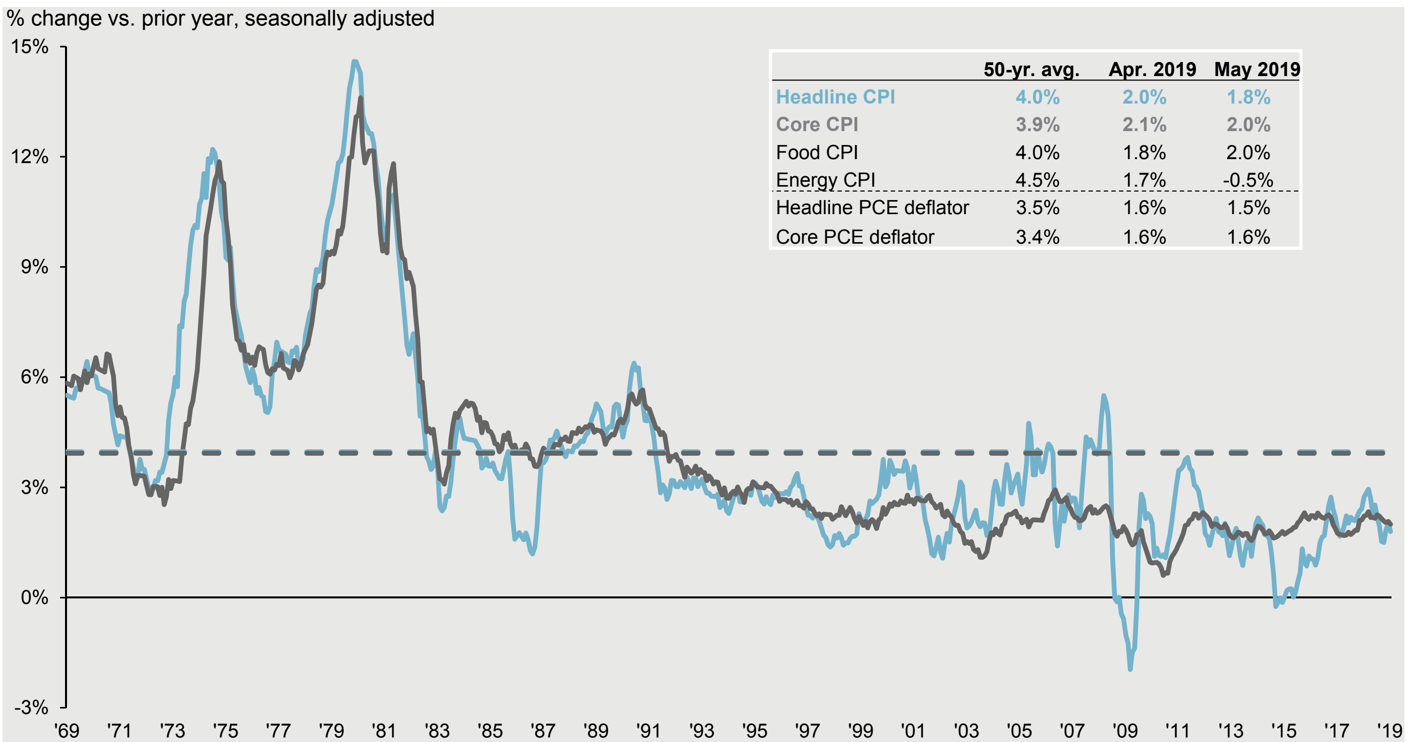
Source: Standard & Poor's & Polaris Greystone Financial Group

While the economy has slowed down from its torrent pace during the first half of last year, the Chicago Fed National Activity Index (shown below) isn't giving us any recession signals. As we've discussed many times in the past, the chart below shows accumulated economic activity (top chart in blue), and the three-month smoothed average of economic growth in the lower half of the chart in red. The two green dashed green lines indicate the historic levels of the economy, inflation (above the top green line), moderate growth (between the two green lines), and recessions (below the bottom green line). As you can see, we are experiencing moderate economic expansion.



The below average wage increase, even with historically low unemployment, is incurring in part due to the our historically low inflation rate. The Consumer Price Index (CPI) ticked up to a 1.8% annualized increase in the cost of living. This is well below the 4% 50-year average.

CPI and Core CPI



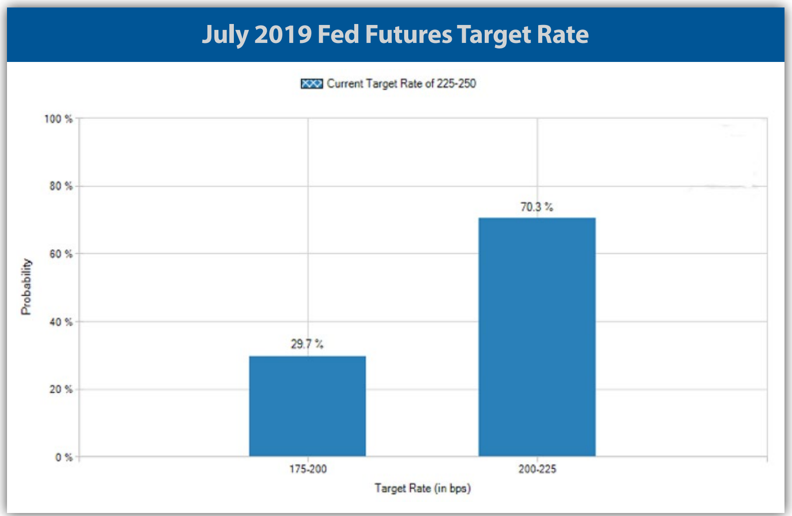
Source: U.S. Bureau of Labor Statistics, FactSet, JP Morgan

Even with below average increase in pay, the average American's lifestyle is improving. Over the past 50 years, wages have gone up 4.1%, while inflation has gone up 4.0%. This means that the average American got a 0.1% increase in pay (wage – inflation = better lifestyle). A 3.4% increase in pay, with a 1.8% inflation rate means the average American has seen a pay raise of 1.6%, well above historical averages.

The Federal Reserve Is About to Cut Rates

Part of the reason that the stock market dropped as much as it did during Q4 2019 was due to investor sentiment. Investor feared that the Fed would raise rates too high, too quickly, and send the U.S. economy into a recession. What a difference a few months make.

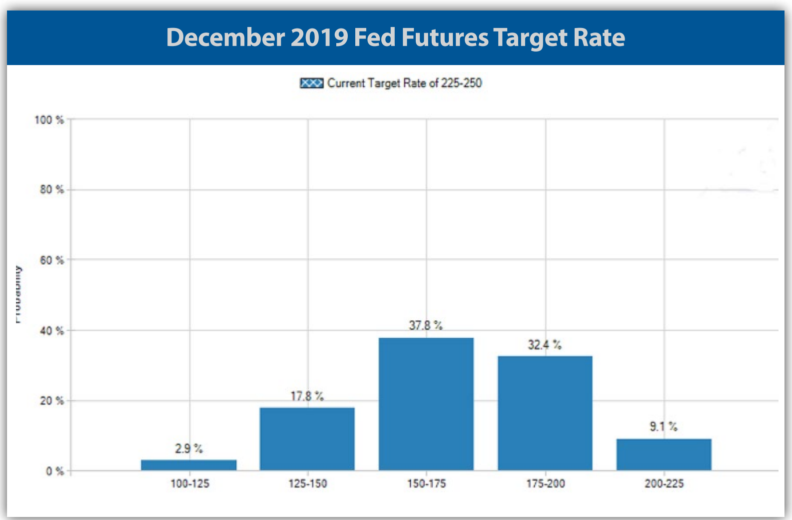
The next Fed meeting is scheduled for July 31st. The Fed's target rate is currently 225-250 (or 2.25% and 2.50%). As you can see to the right, Fed Futures show a 0% chance that the Fed will leave rates where they are currently, a 70% chance of cutting 0.25% and a 30% chance of cutting 0.50%.



Source: CME Group

If you look out to the end of this year, again there is a 0% probability that the Fed will leave rates where they are currently. As you can see from the chart to the right, there is a 9% chance of rate being 0.25% lower, a 32% chance of 0.50% lower, a 37% chance of rates being 0.75% lower, and a 20% chance of them lower rates by 1% or more.

Cheap money is a stimulus to our economy. As I write this update, the Fed futures point to absolute certainty that borrowing money will get cheaper by the end of the year.



Source: CME Group

What Has Us Concerned Going Into 2H 2019

Our biggest concern going into the second half of 2019 is the trade war with China. China's most recent GDP numbers show that its economy has slowed to 6.2% growth. While this might sound high, this is the slowest growth China has experienced in 27 years. As we've mentioned before, the United States is faring much better. Our economy has been performing above average, even with the trade war.

The issue of any trade war is that can spill over and impact the world economy. While some countries and areas are benefiting from the trade war, as some firms move out of China and need to find other low-cost manufacturing, most countries are not faring well. For example, first quarter 2019 Euro Zone GDP has dropped to 1.2% growth, down from 2.8% growth a year and a half ago. Germany, the backbone of the Euro Zone's economy, is particularly dependent on exports. Germany's third largest trade partner (behind the United States and France) is China. China's slowdown has Germany's economy growing at 0.7% annually.

China's economic slowdown is also directly impacting worldwide manufacturing. The most recent Global Manufacturing PMI figures indicate that we are experiencing the first contraction in global manufacturing since 2012.

We are watching to see how all of this unwinds. A meaningful trade settlement with China would be very beneficial to the U.S. economy. An escalation of our trade war would obviously be detrimental. The most challenging possibility is that the trade war drags on without any resolution. As a tactical investment management firm, we will sift our way through these uncharted waters and do everything in our power to mitigate the risks as they arise and take advantage of opportunities when they present themselves.

As always, I welcome all questions and comments. Please feel to reach out to me.

Sincerely,

Jeffrey J. Powell
Managing Partner & Chief Investment Officer