

Quarterly Market Outlook

July 2019

US Growth Stabilizing at Low Levels

After slowing in recent months, US leading measures have stabilized in the range of 1-2% real GDP growth¹ and unemployment remains near secular lows at 3.7%.² This would be an unusual environment for the Federal Reserve to begin cutting rates aggressively, as the bond market is now discounting.

The Equity Bull Market Continues

Renewed monetary stimulus in a still expanding economy has been supportive for equity markets. Despite the pullback in May, global equities (MSCI World) were up another 4% in Q2 and are now up 17% YTD through June³.

Shifting Priorities for Central Banks

Despite over 10 trillion dollars of money printing and one of the longest economic expansions on record, inflation is running below targets in every major economy.³ High debt levels, advances in automation, and the weakening power of labor unions have been secular deflationary forces. Central banks are now shifting to proactively defending against the deflationary risks of an economic downturn.

Collapsing Bond Yields

Global bond yields continued to fall during Q2, with the US 10-year Treasury yield falling another 40bps to 2.0%, nearly 20 basis points below 3-month T-Bills. The 30-year Treasury yield collapsed to 2.53% during the month, leading to the flattest yield curve we've seen since 2001.⁴ Every major central bank is now expected to ease going forward with almost 100 basis points of rate cuts expected for the Federal Reserve over the next 12 months⁵. This is a dramatic shift from 12 months ago when central banks were still intent on normalizing monetary policy and investors were generally anticipating rising interest rates for years.

Stimulus is Likely to Take Many Forms in the Next Downturn

The Federal Reserve has typically needed to ease by 400-500 basis points to stimulate a recovery from a recession.⁵ With interest rates near zero across the major developed economies, central banks have limited room to lower rates further. We expect to see stimulus take many forms over the coming easing cycle, including negative interest rates, quantitative easing (money printing), yield curve targeting (setting long-term interest rates), and coordinated fiscal/monetary stimulus (e.g., running large budget deficits and monetizing the debt). Many of these policies are already in force in Europe and Japan and have shown diminishing benefits over time. These policies are likely to result in a devaluation of paper money versus hard assets, such as gold, which is why it continues to be a core strategic holding for us.

¹ <https://www.frbatlanta.org/cqer/research/gdpnow.aspx>

² Source: U.S. Bureau of Labor Statics.

³ Source: Bloomberg.

⁴ Yield curve flatness measured by the difference between the 30-year Treasury yield and the 3-month T-Bill yield

⁵ <https://www.hsh.com/finance/mortgage/federal-reserve-policy-mortgage-rate-cycles.html>

The ECB Chooses a New President

The European Central Bank announced that Christine Lagarde will succeed Mario Draghi as President of the ECB. This was generally good news for markets as she is likely to continue the policies of her predecessor, and her experience in the private sector (as a lawyer), the French government (as finance minister and Chairman of the G20) and the IMF (as Managing Director) will help her coordinate across competing interests. Ms. Lagarde will have a significant challenge ahead of her as European monetary policy is reaching its limits of effectiveness – in recent weeks we have begun to see European junk bonds with negative yields.⁶

US-China Tensions Flare Up

Disappointed with the progress on US-China trade negotiations, President Trump threatened China with additional tariff increases in May. This was followed by sanctions against Huawei limiting its ability to purchase US technology. Trade talks were put on hold until Trump and Xi met at the G20 summit in June. Due to this re-escalation of tensions, volatility resurfaced in May, with global stocks (MSCI World) down 5.8% during the month³. Populism and associated policies continue to be a source of growing risk for the global economy, as cross-border trade and investment face headwinds.

The Expansion Continues (for now)

With a healthy US economy and the benefit of support from the Federal Reserve, the current expansion looks like it may have more room to run. However, we remain mindful of several risks that can derail the expansion. These include policy missteps, potential excesses within financial markets, and increasing global trade tensions.

⁶ "Sub-Zero Yields Start Taking Hold in Europe's Junk-Bond Market", 2019-07-09, Bloomberg

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