Investment Commentary

April 16, 2019

1st Quarter Recap

After an ugly December, the stock market exhibited the best start to a year in the last 10 years during the quarter. The overall stock market rallied strongly and is now about 1.6% below the highs reached in mid-September last year.

The bond market has been in a narrow trading range during the quarter. And with recent comments from the Fed indicating they may hold off on raising rates for the foreseeable future, rates may continue to stay in a narrow range.

The Current Economic and Investment Environment

We are in the late stages of the economic cycle but it remains to be seen how long this expansion can continue. The economy continues to perform well and the Fed may not raise rates again during this cycle. This has been an unusually long expansion but could continue for longer than we think.

Corporate Profits

We are now entering earnings season and while corporate profits have slowed they are still in good shape. With a low interest rate environment and barring any unexpected shocks, companies are likely to continue showing good earnings.

Corporate earnings are lower than they were a year ago but they are higher than they were two years ago. And they should continue to grow over the course of this year.

Trade Issues

The recent trade agreement with Mexico and Canada will face trouble in Congress. The current agreement will remain in place until the new agreement is ratified. As the treaty goes through the ratification process the daily stream of news will likely be unsettling to the financial markets. But ultimately the new trade agreement will be ratified. The economic implications of not ratifying the treaty are simply too great.

Trade negotiations with China continue to drag on. The primary sticking point is intellectual property and I am skeptical much progress will made in that area. We are likely to see an agreement that will be short on big changes and long on rhetoric.

Trade disputes with Europe seem to be off the radar screen lately since there is a preoccupation with Brexit. The British Parliament cannot come to an agreement on how to proceed and little progress is being made. The European Union has given an extension until October 31st. But it remains to be seen how this will eventually play out.

Ultimately, these trade disputes will come to an end but when the dust settles, very little will have been accomplished.

Growth versus Value

Growth style stocks (new economy stocks such as technology and social media) have been outperforming value style stocks (old economy stocks such as industrial and financial stocks) for the past 10 years. It is unusual that one style will outperform another style for such an extended period.

There are some reasons for this. Value stocks tend to perform best during the early part of the economic cycle and growth stocks perform best during the late part of the cycle. We are certainly in the late part of the cycle. And growth stocks tend to perform well during periods of slower economic growth and lower interest rates which is the environment we have been in for the last few years.

Ultimately investors gravitate to the companies that are the most profitable. In this environment the profitable companies are Apple, Amazon, Facebook, Alphabet (Google), etc.

The Next Recession

It is virtually impossible to predict when the next recession will arrive. I prefer to think in terms of “scenarios” rather than outright predictions when looking at future economic environments. No two recessions are the same. But most people think the next recession will look like the last one and that is almost never the case.

The scenario I envision is a recession that is not as deep as previous recessions but one that lasts longer. It is more a case of a sluggish, low growth economic environment. In this environment there is not much upside for stocks and interest rates will remain very low historically.

Typically, in a recession the Federal government will lower interest rates, increase the money supply, lower taxes and increase government spending. But those polices are currently in place. The actions of the government are as if we are currently in a recession when we are not. The next time we are in a recession there is not much more the government can do. And that is a primary reason why the next recession will likely linger on for a longer period of time.

Review of Asset Classes

Domestic Stocks
Domestic stocks have already moved up about 14.0% this year and could move sideways over the next several months. A positive resolution to trade issues with China and a continuing low interest rate environment could be a catalyst for a move up. But ultimately I do not expect much return from stocks over the next several months.

International Stocks
International stocks remain undervalued and have moved up about 10.3% this year. Going forward I expect continued underperformance as compared with the U.S. stock market. Slowing global economic growth in addition to Brexit and trade issues will prevent much upside over the next several months.

Investment Grade Bonds
Intermediate and long term interest rates continue to be in a trading range. The overall return for conventional investment grade bond funds is likely to be in a range of 2% to 3%. The current yield of the10 year U.S. Treasury Note is 2.56% and could range from 2.0% to 3.0% over the next several months.

There is not be much difference in the investment returns of intermediate term bond funds, short term bond funds and money market funds in the current environment.

Floating Rate Bond Funds
Floating rate bond funds appear to be close to a point where they have served their purpose and may not provide any more benefits to a portfolio. Interest rates are likely near a peak this cycle and may not move up much more. And this asset class typically does not perform well in a recession.

Multi-Sector Bond Funds
In the current interest rate environment Multi-Sector bond funds appear to be a good place to invest a portion of an investor's bond allocation. These funds can invest in various sectors of the bond market and the yields are higher than conventional investment grade bond funds although with a bit higher level of risk.

REITs
This asset class performed well this quarter due to the interest rate environment. For now I am not recommending REITs and would prefer to invest in this asset class when it is undervalued.

Energy Sector
The energy sector has moved up substantially in recent months after a significant move down late last year. Oil prices have been moving up but are likely close to a near term high. I am not currently recommending investment in this sector and would sell any holdings in the near term.

Going Forward
Unless there is an unexpected shock the financial markets are likely to be in a narrow trading range over the next several months. A lot of uncertainty has been lifted from the markets in the near term. But there are not many catalysts that would result in a significant move up.