"Swimming With The Current"

Market Commentary – August 2019

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The advance estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 2.1% in the second quarter of 2019. This is lower than 3.1% in 2019 Q1. The components of the 2019 Q2 GDP number are: consumer spending +2.85 percentage points, investment -1.00 percentage point, net exports -0.65 percentage point, and government spending +0.85 percentage point. The sum of these numbers equals 2.05%. This reading is not as bad as it seems. Consumer spending, which carries most of the weight of economic growth in the U.S., was solid…and the strongest since 2017 Q4. Plus, investment was weighed down by inventory depletion (penalizing GDP by -0.86 percentage point), which tends to reverse in future quarters. Business spending was tepid, however, with nonresidential fixed investing dragging down GDP by -0.08 percentage point (the worst since 2016 Q1). Residential spending (i.e., housing) has been weak for six consecutive quarters. Overall, the economy is doing well, but businesses have become cautious.

As expected, the Federal Open Market Committee (FOMC) lowered its benchmark federal funds rate by 0.25% today to a range of 2.0% to 2.25%. It also decided to stop the balance sheet reduction program effective immediately, which is two months earlier than previously indicated. The Fed's announcement reads, "although growth of household spending has picked up from earlier this year, growth of business fixed investment has been soft." In a conference call after today's monetary policy announcement, Fed Chairman Jerome Powell explained that it is worth lowering interest rates to help sustain the expansion and fuel even more job growth. Even though unemployment is at a 50-year low, there is still empathy for those without work, especially as inflation remains benign. Fed funds futures are still pricing in a second 25 basis point cut by December 2019, followed by a third 25 basis point cut by June 2020. The next Fed decision on monetary policy is scheduled to be announced on September 18.

The Fed has felt pressure to lower short-term interest rates in part due to the yield curve. The yield curve describes the yield on Treasury securities of various maturities. In normal times, short-term interest rates are lower than long-term interest rates. However, there are periods where the yield curve inverts, and short-term rates are higher than long-term rates. As of today, the yield curve was as follows: 2.08% 3-months, 2.00% 1-year, 1.84% 5-year, 2.02% 10-year, and 2.53% 30-year. Note how the yield on the 5-year Treasury is slightly lower than the 3-month Treasury (it is inverted). This is a sign that the Fed is too tight on short-term rates (i.e., they were too high).

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $172.14, which implies a price-to-earnings (P/E) ratio of 17.3 with the S&P 500 at 2,980. The earnings yield (E/P) of 5.78% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.02%. The spread between the two yields is a robust 3.76%, even though the stocks continued to rally in July.

The S&P 500 did punch through resistance around 2,950 in July before creating its next level of resistance at 3,025 (a new all-time high). Support levels should exist around 2,950 (old resistance from October 2018 and April 2019), 2,925 (50-day moving average), and 2,788 (200-day moving average). While stocks sold off after the FOMC announcement today, this is a typical "sell the news" reaction. It was the *anticipation* of the rate cut that drove stock prices to new highs since the December 2018 low.

With the Fed lowering interest rates for the first time since December 2008 (more than 10 years ago), investors are swimming with the current. Lower interest rates should help juice the prices of stocks and real estate. Still, this is no excuse to be lazy with respect to risk. The stock market can turn on a dime for no obvious reason, and we must prepare for that potential downside; it will eventually happen.