"Inverted"

Market Commentary – September 2019

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The second 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 2.0% in the second quarter of 2019. This is lower than the advance estimate of 2.1%. GDP is much better than it appears. Consumer spending drove +3.10 percentage points of the second estimate (versus +2.85 percentage points in the advance estimate). Consumer spending is strong! Businesses were apparently not expecting this strong demand, as inventory depletion weighed down GDP by -0.91 percentage point. In future quarters, however, businesses will likely replenish this inventory and drive additional economic growth. The biggest concern is that business spending has cooled. Non-residential fixed investment reduced GDP by -0.09 percentage point, the worst since 2015 Q4. Business spending should rebound with consumer spending.

All eyes are on the Federal Reserve and whether they will continue easing monetary policy to stimulate the economy. Federal Open Market Committee (FOMC) announcements on monetary policy are scheduled for September 18, October 30, and December 11. Fed funds futures are pricing in four 0.25% cuts: by the end of October 2019, December 2019, April 2020, and September 2020. These cuts would reduce the fed funds rate to a range of 1.0% to 1.25%. The Fed is being pressured to lower short-term interest rates to help correct the inverted yield curve.

Investors are worried that the inverted yield curve in the U.S. is predicting a recession. The following were U.S. Treasury yields as of August 30: 2.10% 3-month, 1.76% 1-year, 1.39% 5-year, 1.50% 10-year, and 1.96% 30-year. The yield curve "inverts" when short-term interest rates are higher than long-term rates. Looking back to 1956, the yield curve has inverted (as measured by the difference between the 10-year and 1-year Treasuries) before each of nine recessions. The recession can occur from a few months to a couple of years after the inversion. This time, however, the inverted yield curve may be less a predictor of recession and more of a product of extreme monetary easing from the 2008 financial crisis.

As if the inverted yield curve is not strange enough, $17 trillion (30%) of global investment-grade debt has negative yields. Investors who buy this debt at issuance do not expect to get all their money back at maturity. A massive bubble in the bond market has formed, which is likely another unintended consequence of extreme monetary easing by global central banks. Federal Reserve Bank of Kansas City President and CEO Esther George, who is a voting member on the 2019 FOMC, warned the Forum Club of Southwest Florida in February 2014 that unwinding the unprecedented accommodative monetary policy will be a "turbulent process". She also admitted that we are in uncharted waters regarding economic policy.

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 $170.41, which implies a price-to-earnings (P/E) ratio of 17.2 with the S&P 500 at 2,926. The earnings yield (E/P) of 5.82% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.50%. The spread between the two yields has jumped to 4.32%, the highest since July 2016. Stocks have become an even better value.

The S&P 500 stumbled in August in volatile trade and a new trading range seems to have formed between 2,825 and 2,925. Interestingly, this range is between the 200-day and 50-day moving averages (2,806 and 2,945, respectively). A breakout above the 50-day would likely accompany an attack on the July high of 3,026, while a collapse below the 200-day could see a further decline to 2,625. The period spanning from August through October is historically volatile for stock prices. There is a chance of a severe decline, exaggerated by algorithmic trading. Should this happen, we plan to incrementally buy into that weakness. In the meantime, the 50 stocks in our collective portfolio have a dollar-weighted average P/E of 12.0, dividend yield of 4.5%, and beta of 0.79. Value investors see plenty of opportunities.