1Q 2019
Market Commentary

Last quarter's "famine" turned into a first quarter "feast" as the market's fear-driven declines abated and many stock markets generated double-digit returns. In our last market commentary, we advised clients with a resounding "no" when considering a head to the exits to reduce stock exposure. Fears that the Federal Reserve Board would maintain aggressive plans to raise rates two or three more times in 2019 and that trade talks with China would languish, leaving corporations in limbo and unable to make meaningful capital allocation decisions, led to major stock market declines. By the end of the year, Wall Street's building consensus suggested the U.S. was headed for recession at the end of 2019 by as much as a 35-40% probability. However, we did not share this dour outlook on the economy.

In the meantime, however, the federal government shutdown, the uncertainty surrounding trade talks with China and massive winter storms from coast to coast muddled the timing and reliability of government economic reports. Conflicting and sometimes weaker reports on industrial production, business orders and sentiment, consumer confidence, exports and housing activity caused a divergence in the direction of stock and bond markets. Remarkably, bond yields across the curve ended the first quarter even lower than the panic-driven buying that drove yields down at the end of 2018. Yet in the midst of bond market fears about recession that drove interest rates down and bond prices up, the stock market produced double-digit returns.

SKBA has often stated the normal pattern of stock and bond markets, as well as individual stock price movements, is to "overshoot" the true change in underlying fundamentals. Federal Reserve Board statements and actions can trigger events that lead to this overshoot phenomenon. Chairman Powell made some rookie mistakes by first stating in December that more hikes were coming and the Fed's balance sheet management was on "autopilot," only to completely reverse his stance a mere two months later.

Swinging from a statement of confidence about the pace of the economy to putting its actions on hold indefinitely caused bond investors to ask, "What does the Fed know that we don't?" – which triggered speculation that the economy is in worse shape than previously believed. Bond investors subsequently rushed into a "safety trade," pushing the 5-year yields down 30 basis points from the highs to end the quarter and about 20 basis points lower than the 6-month T-bill. The resulting inverted shape of the curve suggests the market now expects the Fed to actually cut rates, perhaps as soon as June. Stocks, particularly banks and financials, gave back some of their gains in March as fears once again rose that both net interest margins would shrink and credit availability would tighten. One thing is nearly certain and that is that Fed statements and actions are likely to be a continuing source of volatility throughout the remainder of the year.

Furthermore, while we agree that worldwide economic growth has slowed, relying on recently announced U.S. economic indicators to project future recession is itself backward looking and fraught with risk. Commodity prices aren't projecting an immediate recession. Oil consumption grew, and West Texas Intermediate (WTI) prices rebounded 32% in the first quarter and recaptured most of the decline in the fourth quarter, moving back toward the $60 plus range we believe is "normal" for WTI. Here's a short list of the mixed changes in the quarter: hog prices up 27%, copper 12%, cotton 7%, wheat -9% and natural gas -9%. In addition, lower tax rates and regulatory burdens remain tailwinds to economic growth, and a resolution

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of the trade dispute with China could have a salutary effect on corporate decisions regarding U.S. investment. As a result, the bond market's near term recession fears appear to be overdone.

Growth in Europe remains muted and the return to negative interest rates (using the German 10-year Bund as one measure) are unlikely to help. Furthermore, conservatives in the UK Parliament have repeatedly rejected Prime Minister May's proposals for the negotiated exit plan from the EU, leaving only three real choices. May has volunteered to resign upon a successful vote on her Brexit plan, and failure with her own party might cause her reach across the aisle to the Labor Party for support. Another option is that the UK could depart the European Union with a "hard" no deal Brexit (without any trade or customs agreements), but the country has done nothing domestically to prepare for such a result. The final option is to resubmit the "Leave" question to another popular vote in the UK. The hope from a second vote on the issue is that this time, voters will select "Stay" rather than "Leave." The first choice would inevitably create a period of disruption in trade relations between the EU and the UK and lead to a reduced role for London as a worldwide financial center.

Turmoil between the UK and Europe would not be good for the corporate profit growth for many multinationals, including those domiciled in the U.S. Year-over-year corporate profit growth in the U.S. is already expected to be nil in the first quarter but likely to reaccelerate in the second half of the year. A "hard" Brexit, however, might make a near-term recovery in world economic growth and profits somewhat more difficult to achieve.

While U.S. real GDP growth is likely to be at or less than 1% in the first quarter of 2019, even greater certainty regarding completion of negotiations with China on a trade deal would come too late to cause 2019 GDP growth to get above 2.5% for the year. As a result, we would not throw caution to the wind. Economic reports in the coming months will determine if the first quarter slowdown was mostly a weather event or the beginning of a more significant rise in the risk of a recession in 2020 or beyond. After such a sharp rebound in stocks, returns for the balance of the year could be more modest after an initial pop associated with successfully completing a trade deal with China. We will be on the lookout for the out-of-favor stock ideas that can both hold up in volatile markets and advance with cyclical improvement in the economy.

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