# Quarterly Newsletter

## Second Quarter Review: Flat, but Bumpy

In the aggregate, not much happened in US equity markets in the second quarter. The S&P 500 managed to wring out a price gain of about 3 percent from start to finish, but directionally the trend was mostly sideways, bounded on both the upside and downside by technical resistance and support levels. The blue chip index remains about 5 percent below the last record high reached on January 26. Despite a seemingly endless churn of alarming news headlines – trade war posturing, geopolitics, immigration crises and political scandals aplenty – very little has really changed in terms of the background narrative. The US economy continues to grow at a moderate but steady pace, inflation and employment data are largely positive and corporations are flush with record levels of profits and sales.

Of all the volatile news headlines, the only ones with a seemingly measurable impact on investor sentiment relate to the contentious state of trade between the world's major economies, led by the increasingly aggressive protectionism of the US government. By some measures, more than $2 trillion worth of goods and services are in the cross-hairs of tariffs either enacted or proposed by the US, along with retaliatory measures announced by our trading partners in China and the EU. The trade war cloud has, unsurprisingly, had an outsize impact on US companies which rely on these markets for a substantial part of their business.

While the overall equity market trend was flat, there was quite a bit of bumpiness in the dispersion of returns between industry sectors. Nearly 20 percentage points separated the leading tech sector from the trailing consumer goods sector. For the year to date, in fact, US equities have been a tale of technology versus everything else. The only sector to keep pace with technology has been consumer discretionary – and the only reason for that is because Amazon – with an $850 billion market cap and 46 percent return for 2018 to date – is listed as a consumer discretionary rather than a technology stock (the company is responsible for nearly 50 percent of the consumer discretionary sector's total performance). Investors with an eye to history know that similar past periods of narrow dominance tend to end in bloodbaths – the "Nifty Fifty" of the mid-1960s and the late-90s dot-commers come to mind. But so far, the "FAANG" stocks and their fellow travelers show no signs of abating as the main driver of overall performance. How long the positive sentiment around them will last is a question that will hang over the second half of 2018.

## Third Quarter Outlook: The Shape of Things

While equity markets continue to struggle for a decisive directional catalyst, the fixed income area has its own preoccupation with "flat" – namely, the increasingly horizontal terrain separating short-term and long-term interest rates. Just 30 basis points – 0.3 percent – separate the 10-year US Treasury yield from its 2-year counterpart. This is the flattest shape the yield curve has sported since August 2007. The reason for the close focus on the shape of the curve is that flatness sometimes leads to inversion – when short-term rates are higher than long-term rates. Inverted yield curves historically have been one of the most accurate signals for a recession – this was true in 1980, 1981, 1990, 2001 and 2007-08, i.e. for each of the last five recessions on record.

Now, the fact that the yield curve today is flat does NOT mean that a recession is looming – there is literally no hint of a move into negative GDP growth from any of the macroeconomic data at hand. It is also not necessarily unusual for a narrow long-short spread to accompany an economic growth cycle. The average 10-2 spread from January 1995 – December 1999 – a particularly strong period of growth – was just 0.4 percent. At several junctures during that time the curve came ever so close to inverting without actually doing so.

When the yield curve did invert, after that long late-1990s bull run, it coincided with the S&P 500 reaching its peak in March 2000. That was when investor sentiment turned strongly against those high-flying tech stocks, precipitating a general risk-off sentiment and accompanying flight into haven assets like Treasuries. Intermediate- and long-maturity yields fell as demand increased, while short-term rates stayed high as the Fed was in the middle of tightening monetary policy in response to the strong economy.

To be sure, there are major differences between today's market environment and that of the peak 2000 bull. Risk asset valuations today, while by no means cheap, are nowhere near the nosebleed levels of 1999-2000. If anything, the environment might more closely resemble 1997-98, when a handful of external shocks raised investor uncertainty without setting off a stampede for the fire exits. What we do know – from that period as well as others – is that increased uncertainty can lead to rapid changes in directional sentiment. We should not be panicking today at the shape of the yield curve – but neither should we be ignoring it.

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