Quarterly Newsletter

Third Quarter Review: Smooth Sailing at Home, Rough Seas Abroad

On August 22 we had an event (or rather a non-event) that perhaps symbolizes the times in which we live. The S&P 500 hit a “record” for bull market duration: 3,453 days. Financial media outlets cheered and devoted much air time to this momentous happening. Except…it didn’t actually happen. Technically there never was a bear market in 1990, and the great bull market of the 1990s actually started in 1987 (after the Black Monday market crash, a full 4,494 days before it ended in 2000). The “record bull” stories this past August were really…well, just bull. But the current bull market certainly showed no signs of slowing down. After a lackluster first half of the year, the S&P 500 jumped 7.7 percent on a total return basis in the third quarter. Volatility eased, though not quite to the supine levels of 2017.

What was the catalyst for US large cap strength? For one, the old standby narrative of “strong economy, strong earnings” persisted. Real GDP growth was brisk while inflation remained in check even with continued strength in the labor market. The unemployment rate for September was, at 3.7 percent, the lowest since 1969. Corporations are on track to register earnings growth of 20 percent for 2018 alongside sales growth of 8 percent. This narrative has been durable enough to shake off all the risk factors – trade war rhetoric, expensive valuations, political upheavals around the world – that have been thrown its way.

But perhaps the most compelling reason for the popularity of domestic large cap stocks is the relative unattractiveness of so many other asset classes. Emerging markets got caught on the wrong foot early this year and have not recovered. The negative trade sentiment has worn particularly hard on Asian EMs, none more so than China. The Shanghai Composite Stock Index is down a dismal 27 percent for the year to date – now that’s a bear market! Meanwhile last year’s shine has come off Europe’s economy. The bond market has not been much of a haven this year, with intermediate-long duration fixed income asset classes of almost every ilk in a funk. More recently small cap US stocks, which had been outperforming, have faltered. So it seems we’re back to the TINA syndrome – There Is No Alternative – as a catch-all explanation for the enduring dominance of the S&P 500 and its peer large cap indexes.

Fourth Quarter Outlook: Bond Bears Double Down

During the last week of the third quarter the Fed met and, as expected, raised interest rates for the third time this year. The outcome was largely taken in stride at the time, but the shadow of higher interest rates has extended into the opening days of the year’s final quarter. In the first week of October US Treasury yields of intermediate and long duration suddenly spiked up, sending the benchmark 10-year Treasury yield to 3.25 percent, the highest it has been since 2011. Now, there was nothing particularly new going on in the world when yields backed up on October 3. But for many months – years, even – the bond market’s assessment of rates and the economy has been at odds with the Fed’s own stated outlooks. It’s as if the market woke up on October 3, smacked itself on the forehead and realized that it had been wildly mispricing interest rate risk. We’ve seen this play out before – rates jump, a mild bout of panic ensues, things settle back down and foreigners resume their steady purchasing of US paper with comparatively attractive yields. This time, though, some bond bears smell blood in the water.

What has many bond investors believing that this current uptick in rates is about something more than a passing tantrum is the possible convergence of two trends. The first is wage growth. While the labor market has enjoyed an historically long run of monthly job creation, hourly wages have lagged relative to previous growth cycles. That may be changing, with the overall unemployment rate at multi-decade lows and business sentiment as high as it has ever been. On its own this would be a good thing – wage growth would help stabilize the more worrying long-term trend of middle class stagnation and decline. But at the same time this is playing out, each week seems to bring successive new rounds of tariffs on imported goods as the US administration implements its protectionist economic policies. Those tariffs are starting to show up as price increases on popular retail goods. The problem is that if both wages and consumer prices are kicking into a higher gear at the same time it could unleash a new, previously unexpected spike in inflation. Leading to – yes, higher rates than what the market had been forecasting.

The wage-price spiral scenario is not fated to come to pass – there are other factors at play that could keep the escalation in check. We have a growing sense, though, that in 2019 we will start to see a bit more deviation from the constant stream of positive monthly economic headlines. Early reads on key macro numbers, as well as the fortunes of corporate sales and earnings as we lap the tax cuts of December 2017, may give some indication as to what future scenarios look more or less likely. It’s too early to call “thar’ she blows!” for an imagined recession on the horizon, but not too early to do some serious scenario planning.

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