Quarterly Newsletter

First Quarter Review: In Like a Lion, Out Like a Lamb

Shattered nerves gingerly stepped back into the post-New Year capital markets, wondering if the demons of December had finally been laid to rest or if there was more pain ahead. The answer presented itself fairly quickly and stayed constant throughout the quarter: for now, at least, the worst is past. The S&P 500 enjoyed its strongest quarter since 2009 (though, of course, that followed the worst quarter since 2011). Moreover, this performance was largely bereft of the head-swiveling day-to-day volatility that had accompanied the autumn pullback. Standing back to look at the larger picture, though, puts forward more questions than answers. The stock market is roughly where it was at the beginning of Q4 2018. Much ado about nothing, it would seem. What should we expect next, and why?

Most market observers will attribute the Q1 2019 rally to one key catalyst: the decision by the Federal Reserve in late January to signal that, for the moment anyway, it was done with rate hikes. This was a sharp pivot from the December meeting that brought stocks to within a whisper of a technical bear market. Indeed, "dovish pivot" quickly became the two words pronounced by financial media pundits the world over. Add to this the apparent abating of trade tensions between the US and China (if nothing else, at least the expectation that a full-blown trade is not imminent) and the recipe was in place for an extended relief rally.

The quarter wasn't just about stocks though, and here is where the story gets a bit trickier than the simple "Fed plus China" bull mantra. The bond market also had a corker of a quarter. Intermediate term bonds rallied strongly in March, at one point sending the yield on the 10-year US Treasury back down below 2.4 percent. Even more significantly, that rally was enough to push the 10-year yield below the 3-month yield: yes, the yield curve finally inverted for the first time since 2007. An inverted yield curve can be a prescient harbinger of recession. It seems that bonds are signaling one thing while stocks suggest another. Something has to give – but which will it be? Is there enough gas in the tank to extend this growth cycle ever further, or, apropos the final season of "Game of Thrones," is winter coming?

Second Quarter Outlook: Animal Spirits Seek New Narrative

For the time being the upper hand would appear to lie with the bulls. This has less to do with the fundamental landscape of the global economy, and more to do with the simple mechanics of short-term trading. Risk asset trading patterns oscillate between FOMO and FOBI – fear of missing out versus fear of being in. As the first quarter rally gained strength the FOMO mentality took over. There is still a reasonable volume of "pain trade" activity supporting the steady incremental gains that have continued into the early weeks of the second quarter. At the same time, there is a palpable sense that the reliable dovish-pivot-plus-no-trade-war narrative that won the first quarter needs a new chapter to sustain the momentum. Because the fundamental background context is not reassuring.

We saw the first wobble as to why the old narrative may be running stale several weeks ago, after the Fed wrapped up its March FOMC meeting. If anything, the takeaway was even more dovish than the January meeting, to the extent that Fed funds futures markets are now predicting that a rate cut – not a hike, but a cut – has anywhere from a 60 to 80 percent probability of happening before the end of the year. This is the kind of "bad news is good news" story that traders generally love: the growth outlook is poor so rates are coming down, let's party! This time, though, the market's reaction was rather more dour. Stocks fell (not massively, but more than has been the 2019 pattern to date) and Treasuries rallied sharply. The sense is that there may not be much magic left in the Fed's bag of tricks. Interest rates are still very low in comparison to the patterns of the previous growth cycles of the mid-2000s and the mid-late 1990s. Real (inflation-adjusted) interest rates are barely positive. Over in Europe, where the economic outlook is markedly worse than that at home, negative interest rates are back in fashion.

Watching what happens on a day to day basis is rarely edifying: stocks move one way or the other based on a slew of factors that pop in and out of existence like so many quantum particles. But it can be instructive to see what, on any given day, is pushing those trader bot triggers hither and yon. Fleeting headlines – China PMI is up! Company XYZ beat its (dramatically lowered) earnings expectation by a couple pennies! – supply the raw material for a rally. The problem with this pattern is that it won't take much to shift the momentum – a vortex of negative headlines similar to what happened during the intense pullback periods of last fall. We will see how key data such as Q1 corporate earnings, GDP for major economies and the like play out. And, to be clear, a US recession does not appear to be on the near term horizon. But, at best, growth appears to be slowing around the world. Absent a compelling new narrative, this may prove to be an increasingly stiff headwind.

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