SARSI LLC

Second Quarter 2019 Market Newsletter Summary

- All asset classes except commodities and the US dollar rose during the quarter.
- The trade war has negatively impacted global trade and the global economy.
- In response to a weakening economy, central banks around the world have signaled their willingness to ease monetary conditions. Governments in some regions such as Europe and China are also providing fiscal stimulus.
- The yield curve has inverted, signaling the possibility of a recession and this bears monitoring closely. Interest rate cuts by the Fed, further good news on the trade front and fiscal stimulus in global economies could correct the inversion.
- This recovery has been one of the longest but also the shallowest. Cyclical components of the US economy have not peaked. This could mean a shallow recession at worst.
- US corporate earnings fell in the first quarter of 2019 and are expected to fall in the second and third quarter as well. However, the results are better than what was anticipated in the beginning of the year.
- US stocks are slightly more expensive than their 25-year history. Non-US developed and emerging markets stocks are cheaper than their 25-year history.

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Table 1: Market indices

(*Returns include dividends*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	4.30%	18.54%	10.42%	14.19%	10.71%
S&P Mid Cap 400	4.02%	19.09%	2.32%	11.25%	8.22%
S&P Small Cap 600	1.87%	13.69%	-4.88%	11.97%	8.41%
MSCI Emerging Markets	0.74%	10.78%	1.61%	11.06%	2.87%
MSCI EAFE	5.97%	14.49%	0.39%	9.65%	2.74%
Investment Grade Credit (C0A0)	4.33%	9.55%	10.43%	3.95%	4.03%
Non-Investment Grade Credit (H0A0)	2.55%	10.12%	7.56%	7.53%	4.69%
Bloomberg Commodity Index Total Return	-1.19%	5.06%	-6.75%	-2.18%	-9.15%
Dollar Index (DXY)	-1.19%	-0.04%	1.76%	0.00%	3.80%
Vanguard Total Bond Market Index (VBMFX)	3.04%	6.06%	7.76%	2.12%	2.78%
10 Yr Rate	2.00% 06/30/2019	2.69% 12/31/2018	2.85% 06/30/2018	1.49% 06/30/2016	2.51% 06/30/2014

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 7/5/2019			
	Latest Release	Recent Trend	Notes
Non Farm Employment	224,000	Positive	Jobs number was better than expected in June after a weak May. Manufacturing, services and the Government sectors all added jobs during the month. The unemployment rate rose to 3.71% because more people are looking for jobs.
Weekly Claims for Unemployment Insurance	227,000	Positive	Unemployment claims have stabilized at a low rate after spiking earlier in the year. This number is reflecting strength in the jobs market.
ISM Manufacturing Index (Number over 50 points to growth)	51.7	Negative	The latest report was better than expected but manufacturing growth rate has fallen sharply and is at a three year low. It is still growing though.

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	Latest Release	Recent Trend	Notes
ISM Non Manufacturing Index (Over 50 points to growth)	55.1	Positive	Unlike manufacturing, non manufacturing activity is strong.
Consumer Prices (Month over month change)	0.1%	Positive	Inflationary pressures have eased up. CPI is up 1.8% as compared to a year ago. If you take out the volatile food and energy prices, it is up 2% well within the level that would be concerning.
Producer Prices (Month over month change)	0.1%	Positive	Like consumer prices, producer prices are reasonably low. Year over year prices are up 1.8%. Excluding volatile sectors, it is up 2.3%
Retail Sales (Month over month change)	0.5%	Positive	After some choppy numbers earlier in the year, retail sales came in better than expected in May. April number was revised significantly higher(From -0.2% to +0.3%)
Consumer Confidence (Conference Board)	121.5	Positive	Trade and tariff tensions have affected consumer confidence, however it is at the same level as it was at the beginning of the year but way below the record highs set last year.
Durable Goods Orders (Month over month change)	-1.3%	Negative	Although the headline number was very weak, the details were better. Core capital goods (Non defense and excluding aircraft sales) was up 0.4%, better than expected.
Industrial Production (Month over month change)	0.4%	Positive	Industrial production was stronger than expected in May, but the details were a bit mixed. The year over year number is improving as compared to the last several months.
Capacity Utilization	78.1%	Positive	Capacity utilization is leveling off after dropping for several months.
Housing Starts	1.269MM	Positive	Housing starts have been increasing helped by activity in the multi family sector.
Home Prices (Case-Shiller 20 city Index- Month over Month)	0.0%	Negative	Housing prices in major cities around the country have stabilized but are growing at a lower rate as compared to years past. Year over year, prices were up only 2.5%.
GDP (Real, Annualized)	3.1%	Positive	The latest estimate for first quarter GDP shows the economy was reasonably healthy. Consumer spending was lower than expected, but residential and non-residential investment provided support.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org.

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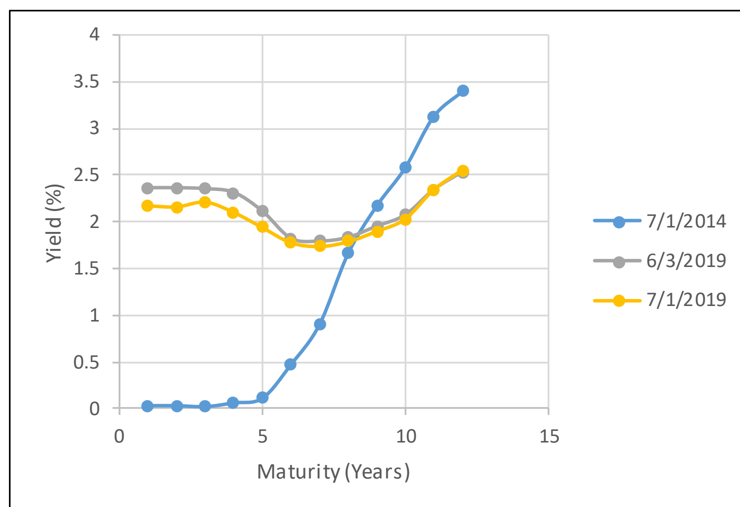
All asset classes, except commodities and the US dollar rose in the second quarter but prices did not rise in a straight line. Stocks sold off in May after trade tensions between the US and China flared up, only to recover in June as the two sides agreed on a détente. Trade tensions have led to a significant slowdown of global trade and a weakening of manufacturing activity. In response, central banks around the world have signaled their willingness to ease monetary conditions further (By cutting interest rates or by other mechanisms such as purchasing bonds from the market, which lowers interest rates) in order to support and revive the economy. In the US, the Federal reserve (The Fed), which increased interest rates just over six months ago in December, is now expected to cut rates in 2019 and the markets are placing a 100% probability that will happen.

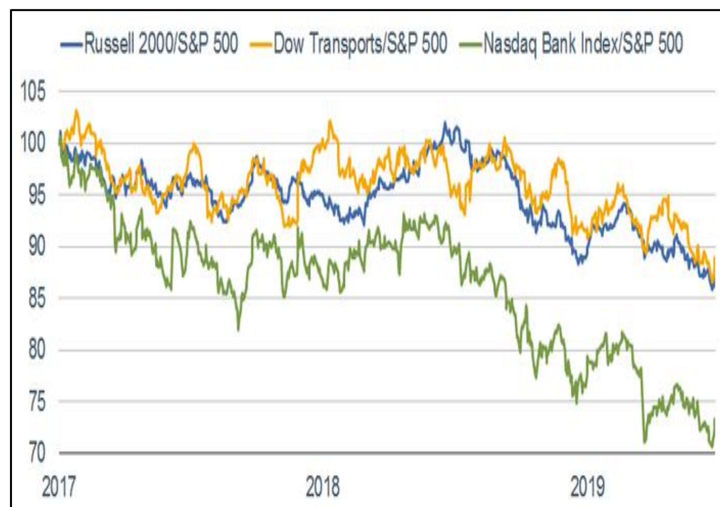
The uncertainty in the economy has caused the US 10-year interest rate to fall to 2%, a level last seen in 2016 and all the experts that previously warned of a sharp rise in interest rates have fallen silent. The yield curve (A plot between interest rates and maturity) has inverted in the 3-month to 10-year region as seen in figure 1. While, an inverted yield curve is a worrying sign because it has been a harbinger of imminent recession in the past, there may be other factors for the inversion this time. For example, interest rates in other developed markets are extremely low (The 10-year interest rate is *negative* in Europe) and that is increasing the demand for US bonds by investors searching for yield- this may be keeping the interest rates in some parts of the yield curve artificially low. Interest rate cuts by the Fed, further good news on the trade front and fiscal stimulus in global economies could together lead to the yield curve steepening (i.e. 'un-inverting'). In late June, at the G20 summit, China and the US seemed to have agreed on a détente and the yield curve steepened a bit as seen in Figure 1. If the yield curve 'un-inverts' without a recession, it would not be the first time that has happened. In 1998, the yield curve inverted briefly, but after the Fed cut interest rates, the yield curve steepened and over the next two and a half years, the economy grew, and the stock market rose. How this pans out bears close monitoring.

Figure 1: The US yield curve



Source: ST Louis Fed, Sarsi

Figure 2: Relative performance of key sectors



Source: Sarsi, Charles Schwab

Unlike the bond markets, the stock markets don't seem to be worried about a recession. After falling in 2018 on concerns about a slowing economy and decelerating corporate profit growth, the S&P 500 is up over 18% so far this year. However, on closer inspection, there are a few cracks in the rally. Notably, while major US stock indexes are making all time highs, there has been no 'confirmation' by small cap stocks, transportation stocks and bank stocks- Fig 2 shows the relative performance of these three sectors versus the S&P 500. Usually, in a bull market, these three sectors join the major averages setting new highs, to reinforce the rally. In addition, the latest rally since April has been powered by more defensive stocks and not economically sensitive cyclical stocks such as real estate investment trusts and healthcare stocks, casting a doubt on the strength of the rally. It is possible, that the markets are front loading the good news expected in the

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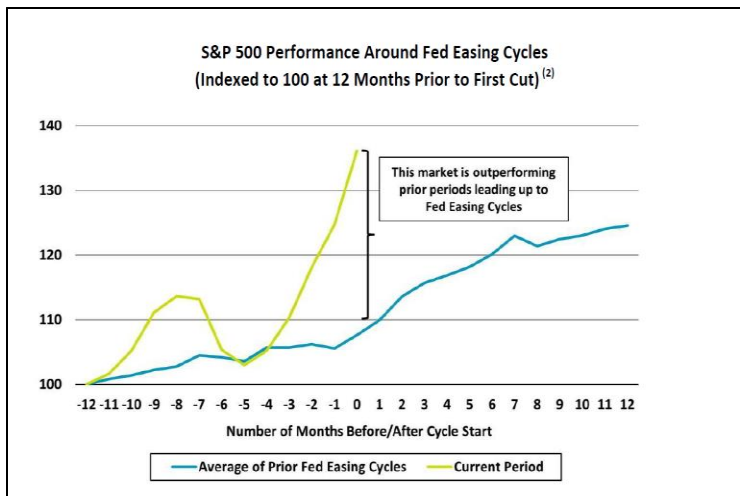
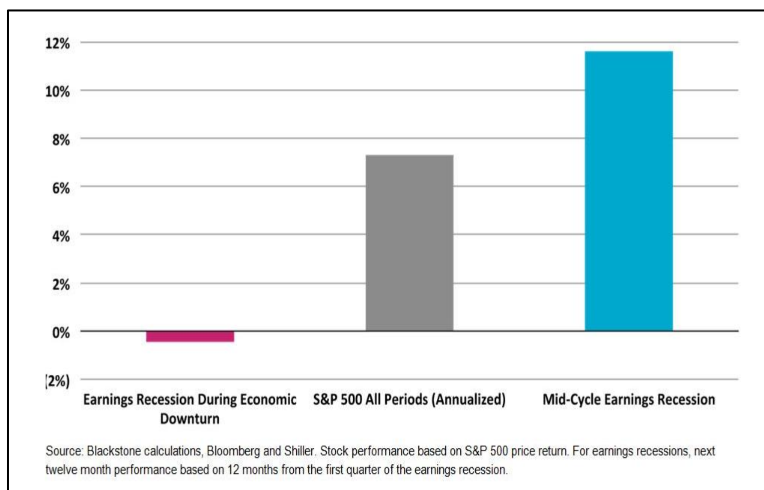
future. As seen in Figure 3, the market has rallied much more than it usually does prior to a Fed easing cycle. Stocks are currently trading at a valuation slightly above their 25-year average (Price earnings multiple of 16.74 versus 16.19). It is possible that any sign of bad news, however temporary, may make the markets volatile.

Figure 3: Market action before and after Fed easing



Source: Blackstone

Figure 4: Stock performance during earnings recession (1945-2018)



Source: Blackstone

Corporate earnings have contracted this year but have come in better than expected. In the first quarter of 2019, earnings of companies in the S&P 500 declined by -0.4% from last year. This was better than what was expected at the start of the year. According to Factset, corporate earnings are expected to fall by -2.6% in the second quarter and by -0.03% in the third quarter. Corporate earnings are crucial for stock prices and a contraction in earnings is a worrying sign. However, as seen in Figure 4, historically, stocks have risen even after an earnings recession if it was not accompanied by an economic recession (i.e. a mid-cycle earnings recession).

Apart from being unusually long, this economic recovery has been unusually shallow as compared to previous recoveries. As a result, the cyclical components of the GDP such as residential investment and business fixed investments have not peaked as seen in Figure 6. Usually, these components peak at levels well above average before beginning to crack, leading to a recession. One can argue that the magnitude of an economic contraction would be small if there is a recession without these components rising well above average.

Similarly, investor sentiment indicators are neutral to slightly high but not frothy. The Ned Davis crowd sentiment poll has a reading of 65 currently, which is reasonably below the threshold of 70 which would indicate extreme optimism. Extreme optimism is usually a contrarian indicator and indicates that the stock market may fall.

Conditions outside the US are mixed, with slowing economies countered by positive Government and central bank actions. In Europe, economic growth has rebounded from dismal levels last year, but the recovery has been anemic (Fig 6). Apart from trade tensions, that are especially painful for an export dependent region such as Europe, political uncertainty from rising nationalism and uncertainty around Brexit are exacting a heavy toll on the economy.

The European central bank has indicated it will be accommodative for the foreseeable future and the European Commission has embarked on a fiscal stimulus plan, both of which should support the economy. Unlike in the US, the European stock market is relatively cheap and is trading at a valuation below its 25-year average (Price earnings multiple of 13.9 versus 14.56).

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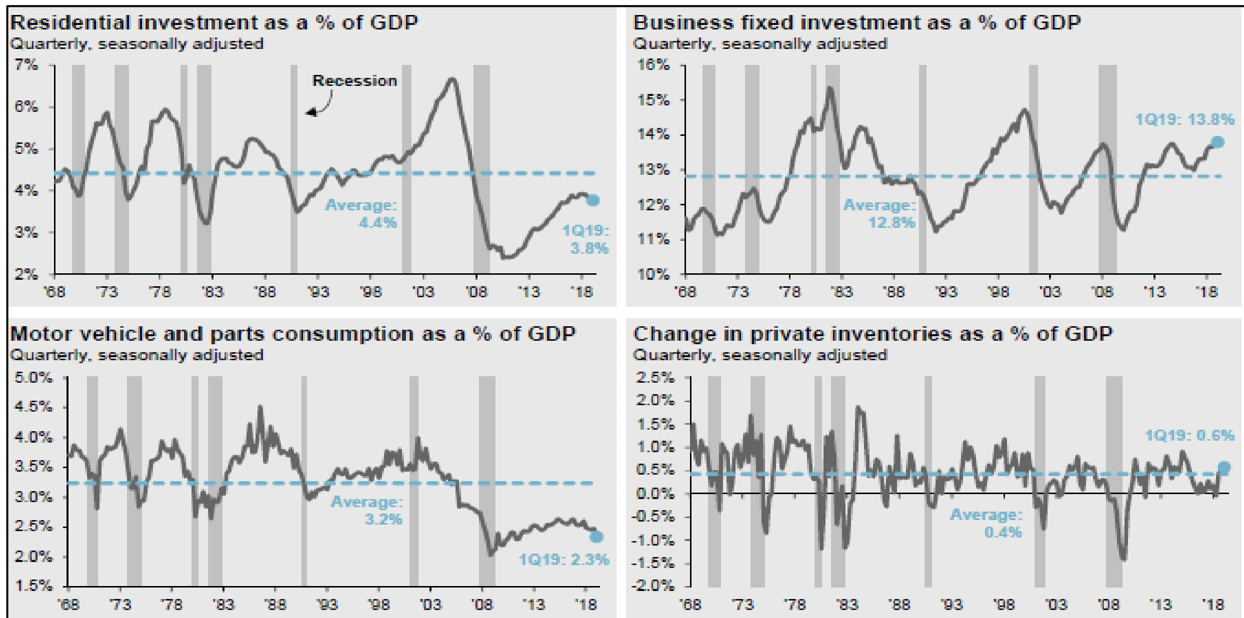
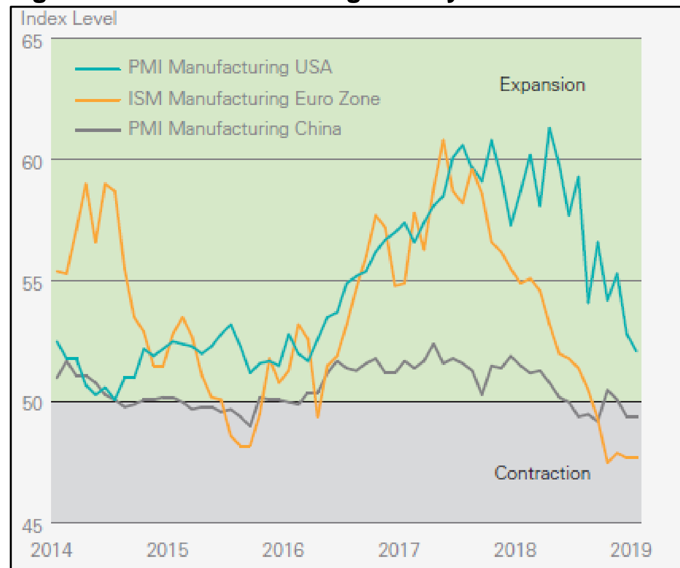
Figure 5: Cyclical components of the US economy.



Source: JP Morgan

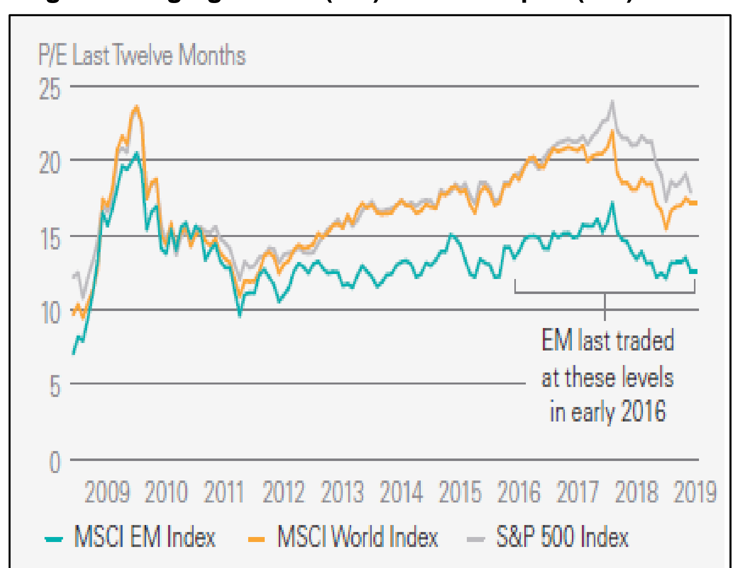
The Chinese economy, which was severely affected by the trade war (Coinciding with a self-imposed slowdown), has stabilized recently. The Chinese Government is continuing to administer fiscal stimulus and the Chinese central bank has expressed its willingness to provide monetary stimulus if needed. China is now the second largest economy in the world

Fig 6: Global manufacturing activity



Source: Lazard

Fig 7: Emerging Market (EM) vs. Developed (DM) valuation



Source: Lazard

and accounts for a significant portion of the global economic growth rate and therefore is key to an improving global economy. Chinese stocks are trading below their long-term average. Across emerging markets (Including China), stocks are trading at a price earnings multiple of 12 which is lower than its 25-year average.

Please reach out to us if you have any questions.

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