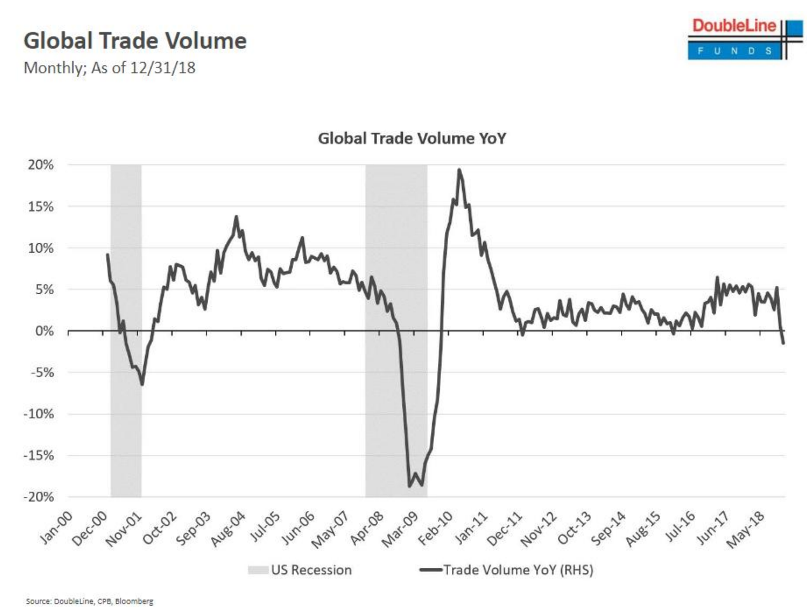
FED to the Rescue

The stock market staged a dramatic rebound in the first quarter with the S&P 500 up 13.52% marking virtually a complete recovery from the scary decline at the end of 2018.

While there were many factors in last year's sell-off, we believe the most important was the Federal Reserve (Fed). Investors feared the Fed was making a policy mistake by continuing to raise interest rates and shrinking their balance sheet when global growth metrics were slowing dramatically. The volatility of the stock market got the Fed's attention, and to the surprise of many, they reversed their position completely at the beginning of the year and are now quite dovish. Moreover, the other source of angst was the uncertainty surrounding the China-U.S. trade talks which too has faded away. The resolution of these two fears largely explains the rebound in the stock market.

We sold some stocks into the rally to reduce risk. Let's review the factors driving our strategy.

First, it's worth pointing out that the stock and bond markets are at odds. With the recent rebound, the stock market is optimistic about the future. **The bond market is flashing major warning signs that global growth will continue to slow (chart).** Overseas negative-yielding government debt has jumped above $10 trillion while rates here have declined by over 0.75%. Our yield curve has spent some time inverted which is an ominous sign if it persists. One of these markets is wrong.



S&P 500 earnings are expected to decline in the first quarter and not return to growth until the fourth quarter due to rising wages and energy costs and the waning effects of lower taxes. Wages grew at their fastest pace in nearly a decade in February, accelerating a trend that started a year ago. Plus, according to FactSet net margins for the S&P 500 hit 10.7% in the fourth quarter, the highest level on record. It's unlikely expanding margins are going to fuel earnings growth in the future and may be a source of contraction. Stock investors may have to count on an improving world economy, but that outcome is far from certain given the behavior of the bond market. All of this would be tolerable if valuations were attractive but that is not the case anymore after the sharp rise so far in 2019.

In addition, supply and demand conditions are not ideal. Just recently, ride service hailing firm Lyft had its IPO. The IPO pipeline is full including rival Uber, Airbnb, Palantir Technologies, Pinterest, Slack Technologies, and other unicorn companies. This is activity that usually occurs as markets near a peak. On the demand side companies in the S&P 500 spent a record $806 billion on their own shares in 2018 shattering the previous record of $589 billion that was set in 2007. This buying was powered by the tax cut and repatriation of overseas cash, is unlikely to persist, and usually happens near market tops. The year 2007 was not a good time to be aggressive in stocks.

Every U.S. recession of the modern era has started with the S&P 500 heading downwards so it's vital to adjust the portfolio before a recession arrives, especially considering the recent fragility of the stock market. Stocks have been largely calm since the financial crisis, but since 2016 have suffered more abrupt and violent shocks, including two episodes in 2018. These are signs that liquidity has deteriorated across markets. Since volatility has historically clustered more should be expected.

Stocks are not egregiously overvalued and should perform well over the long term. However, we feel a more conservative approach is warranted in the medium term given full to high valuations, near-term earnings decline, a bond market signaling a slow global growth story and potentially a recession, negative supply/demand characteristics, and an increasingly fragile stock market. While logical, our analysis doesn't guarantee we are right, especially concerning timing. In the summer of 1999, we argued strenuously that technology stocks were extremely overvalued. In hindsight we were right, but not before being spectacularly wrong as the NASDAQ doubled in price by the end of the year. For now, we'll look for signs that global economic activity is picking up and adjust the portfolio if necessary.

James Tillar, CFA and Steve Wenstrup