Good Quarter, but Volatile

Last quarter the stock market continued its recent habit of making big swings. The monthly returns for the S&P 500 were +4.1% in April, -6.4% in May, and +7.1% in June. This rollercoaster ride followed the prior three quarters where the index rose +7.7% in the quarter ending September 2018, fell -13.5% in the final quarter of 2018, and rose by +13.6% in the first quarter of 2019. Historically, this type of stock market volatility is associated with market tops. The market appears a bit schizophrenic on the surface and is equally so upon a more detailed analysis.

The recent push to all-time highs in the stock market has been driven by defensive sectors which is an unusual condition. Investors are pouring into REITs, utilities, consumer staples and other low volatility sectors while the FANG+ stocks are lagging. This could be a positive sign that investor sentiment is not too extreme or a warning that future economic conditions may worsen.

The bond market is worried about global growth. Ten-year US Treasury yields have collapsed to around 2% and negative yielding sovereign debt globally is at a record high. Nothing fires up recession anxiety quite like a negative relationship between the 10-year yield and that of the three-month bill. A year ago, the 10-year yield was 1% higher than the three-month bill. Now, the 10-year sits 0.12% *below* the short-term bill. Not since July 2007 has this important yield curve measure been so negative or inverted.

Clearly underlying pillars of growth have weakened in 2019. In the US, consumer spending has declined for three straight quarters, nonresidential business investment has slowed, and conditions for the trucking industry, often regarded as a leading indicator for manufacturing, are the most negative in a decade.

The Purchasing Managers Index for US manufacturing activity has faltered, according to a survey via Bloomberg (chart). Meanwhile, manufacturing activity in Europe contracted in June, wrapping up the weakest quarter in six years. A similar survey of Japanese manufacturers also found activity was at its worst in three years.

On the positive side, as mentioned above, investors are not giddy (too much bullishness is not good). The share of individuals who say they expect U.S. stocks to rise over the next six months has held below 30% for six consecutive weeks, according to the American Association of Individual Investors. Money managers are also glum. Half of fund managers believe that the global economy will weaken over the next 12 months. Importantly the world's central banks are all once again dovish. Mario Draghi said the European Central Bank could launch a fresh expansion of its €2.6tn quantitative easing program if the inflation outlook failed to improve. Meanwhile, the Federal Reserve set the stage for multiple interest-rate cuts at their last policy meeting.

Stocks are not egregiously overvalued and should perform well over the long term. However, 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. We continue to take a conservative approach by holding more cash equivalents than normal due to full to high valuations, flat earnings the next two quarters, an inverted yield curve, and an increasingly fragile stock market. There's a chance that economic conditions could markedly improve from here given easy money from the world central banks and improving trade negotiations. But we'll wait for hard evidence before adjusting the portfolios.

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