Sterling Advisors

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THE MARKET MATTERS

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The Great American Debate

As we enter the month of July, the current U.S. economic expansion officially becomes the longest in American history. Its origins date back to mid-2009. A decade ago, American businesses and consumers started to regain their balance after the crushing blows dealt by the financial crisis. The U.S. Federal Reserve's unprecedented monetary stimulus and the government's supportive fiscal initiatives deserve credit for reestablishing stability and confidence. Since then, the expansion has overcome significant U.S. political discord and global geopolitical uncertainty to reach this milestone. U.S. growth has outpaced its developed peers in Europe and Asia, who continue to grapple with their own growth inhibitors – Brexit, debt crises among E.U. members, the rise of populism, and demographic headwinds in Japan.

For the past 18 months, trade-based protectionism has threatened growth on a global scale. One wonders how much more powerful this expansion could be in the absence of trade disputes – and whether trade disputes' impact on capital spending and economic growth has fully emerged. Since the mid-1800s, only two decades – the 1930s and the 2000s – produced slower real GDP than that of our current one (Bloomberg). The potential for a more impressive recovery – especially following the second worst recession ever – was there. But, no point in fixating on that now.

Where we currently reside within the current economic cycle is a source of great debate. Nowhere is the difference of opinions more evident than in U.S. markets, where equities have recently set all-time highs while the U.S. bond market paints a picture of growing concern. Investors' appetite for risk has returned with vigor this year. Meanwhile, 10-Year U.S. Treasury yields are flirting with 3-year lows (i.e., very high prices levels). U.S. Treasuries typically serve as a safe-haven for market participants looking to flee riskier assets. Yet their current demand is insatiable despite U.S. equities posting their best first-half performance in more than 20 years. Is it possible to reconcile the stocks-versus-bonds signals, which stand in stark opposition to one another? Can they both be right? If we view the U.S. stock market as a better near-term barometer versus fixed income's longer-term perspective, it's easier to see how the two can co-exist in their current states. In our opinion, the meteoric rise of U.S. equity prices in 2019 is largely explainable through the lens of the U.S. fixed income market's behavior.

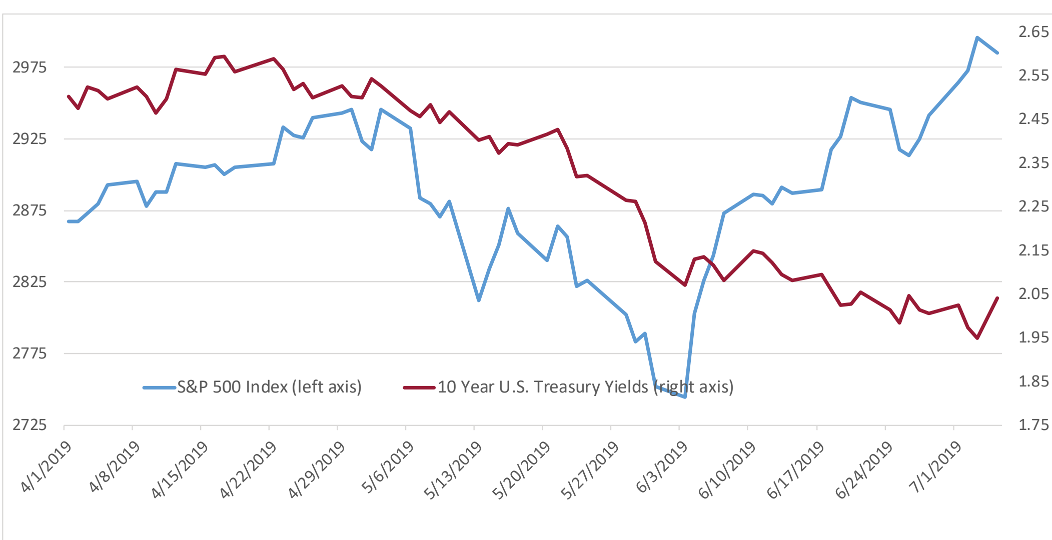

Chart 1. Since June, the S&P 500 and 10-Year U.S. Treasury yields have diverged in atypical fashion

Source: Bloomberg

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The Fixed Income Narrative – The U.S. yield curve is flashing economic warning signals that should not be ignored. It remains inverted between the 3-Month and 10-Year U.S. Treasury maturities, which historically portends a slowdown within the next 24 months. The low absolute yield levels in the 5-30 year range underline the subdued growth and inflation expectations currently held by market participants. Bullish economists downplay the yield curve's inversion, often blaming the curve's distortions on the massive foreign demand that exists for U.S. debt. More than $13 trillion worth of global debt now offers negative yields, an all-time high. Foreign central banks have maintained a greater level of monetary stimulus over the past few years and have combatted even worse growth outlooks than our own. As a result, negative interest rates have become commonplace in Europe and Asia. This global yield scarcity makes U.S. yields look extremely attractive by comparison. It is driving U.S. yields lower (i.e., bond prices up) as overseas buyers seek out these positive yields. We certainly agree that foreign purchases of U.S. debt have affected the shape of the U.S. yield curve dramatically and contributed to the curve's inversion. However, the reasons for the inversion are less important than the signal itself – and it should still be taken as seriously as ever. Using "this time is different" as the basis of an investment thesis is a risky proposition.

The Fed's dramatic pivot from steadfast policy tightening to strong dovishness in early 2019 had a profound impact on the U.S. yield curve. The Fed now foresees at least a couple rate cuts before year-end. Yields offered in the first few years of the curve have fallen 30-60 basis points this year as the Fed has walked back its hawkish guidance from late-2018. The lower yields in the front end of the curve have served to steepen the yield curve as a whole and reduce the magnitude of the inversions. It should be noted that this type of yield curve steepening is not uncommon ahead of downturns. The "good" type of steepening occurs when longer yields rise in the face of accelerated growth and improving economic outlooks. What we are seeing today is steepening as a result of falling short-dated yields based on the assumption the Fed will have to step in and lower rates in response to the growing economic challenges.

The Equity Narrative – Where fixed income sees economic trouble on the horizon, U.S. equities see near-term opportunity. The increased likelihood of Fed accommodation in 2019 is the primary driver of the recent rejuvenation in risk-taking. Its impact cannot be overstated. In fact, U.S. equities have started responding negatively to any positive economic news that could reduce the Fed's sense of urgency to provide new stimulus. The market is currently positioned for two or three rate cuts this year. If the Fed delivers upon these dovish expectations, it would provide a near-term stimulative effect for the U.S. economy that should boost business and consumer sentiment. U.S. equities are using this temporary boost to justify the lofty valuations we a recurrently seeing. President Trump's nomination of two economists with dovish tendencies for two vacant Fed Board positions may make the Fed's dovishness more sustainable if the nominees receive Congressional approval. From a fundamentals perspective, equities are emphasizing the real-time performance of the U.S. economy more so than the obstacles facing the U.S. over the longer-term. The latest quarterly GDP prints are still above 3.0%, the June jobs report looked particularly strong after a lackluster May, and wages are currently growing at a healthy clip. Furthermore, seeing the U.S. and China reopen trade talks has helped risk sentiment since the G-20 summit in late June. However, the impact of these developments on U.S. equities is somewhat mixed as these positive releases simultaneously hurt the case for imminent Fed accommodation.

The Equity Narrative – A more dovish Fed and stable fundamentals should provide near-term support for U.S. equity strength. However, we are acutely aware of the mounting economic challenges and the Fed's limited ability to respond to them. The Fed's balance sheet is already massive. Interest rates remain in close proximity to the zero-bound. Each cut this year will reduce that cushion even further. There is real risk of a U.S. downturn arriving while the Fed lacks any of the appropriate tools to respond. The unprecedented globalization of the world economy makes us more vulnerable to external threats than ever. And right now, our sovereign peers are generally in worse economic shape and have even less policy options at their disposal with which to respond. The fuel propelling near-term optimism is unsustainable. The life cycle of global central bank easing is finite. The "fast money" in U.S. equities are focused on near-term domestic opportunities, while fixed income is emphasizing longer-term global concerns.

We are preparing for both.