April 1, 2019

From Hot to Warm

Dear Clients and Friends,

From the headline above, you may be thinking we have our seasons confused. We're referring to the economy and markets, which we believe have gone from running hot to something closer to room temperature. We view this as a welcome change.

As Northern Trust's chief economist, Carl Tannenbaum, put it, "With a strong job market, modest exposure to trade, and easy financial conditions, the American economy is better positioned to settle comfortably at a lower level." Additionally we see the hot equity markets of 2017 and the first quarter of 2019 gradually moving back to more normalized trends for the balance of the year.

As a quick refresher, markets surged in 2017 on expectations of the tax cut package, which eventually played out in above-average GDP and earnings growth in 2018. Last October, the Federal Reserve seemed determined to hit the brakes on the economy by raising interest rates, following comments from Fed Chairman Jay Powell that we were a "long way from neutral." Despite the hard, year-end sell-off, we closed out 2018 with equities down only modestly, as investors turned their sights to slower economic growth in 2019 and the potential for further downside amid Federal Reserve actions.

By the end of December, Powell had started to signal a more dovish outlook for interest rate hikes in the year ahead. Investors embraced the announcement, and stocks snapped back sharply in the first quarter of 2019—even as the economy downshifted from hot to warm.

What's the Bond Market Telling Us?

While we generally focus on the headline-grabbing stock market in these quarterly letters, we thought we would spend a minute on the less flashy (but nonetheless significant) bond market. Investors look to the bond markets widely as a gauge of the health of the overall economy, specifically focusing on Treasury bond yields. If the economy has stable inflation and steady growth, investors generally expect to earn more (in the form of higher interest rates) for a bond that will mature several years out versus one that would mature sooner. This logic—and the buying and selling that reinforce it—creates an upward-sloping yield curve (most of the time). However, when the economy appears to show signs of weakness, longer term bond yields may fall below short-term rates, creating a downward sloping curve—sometimes also called an "inverted yield curve."

Historically, when the yield curve inverts, as measured by the difference between 2-year and 10-year Treasury bond yields, the inversion has foreshadowed a recession (typically 12-14 months out). During the first quarter of 2019 the yield "curve" took the shape of a ladle, with the 2-, 3-, 5-, and 7-year Treasuries offering lower yields than the 1-year.

So, what does this partially inverted yield curve mean for the economy, bonds, and stocks? In general, we think the yield curve is telling us that bond investors are split about the next move in the economy: Some expect a recession, while others see modest growth ahead. Our sense is that 2- to 7-year bond yields may remain low for some time. Regardless of the drivers, the oddly-shaped yield curve likely suggests some choppiness ahead for stocks as investors debate the timing of the next recession.

What's Next for Stocks?

Corporate profits appear headed for a year-over-year decline of 3-4% in the first quarter—decidedly worse than last year's blistering profits growth of more than 20% in three of the four quarters. We expect corporate profits to recover modestly in the second quarter, but we'll be watching closely. A profit recession is considered to take place when earnings decline for a period of 6 months or more and can be another sign of a broader economic downturn ahead.

For now, we're sticking with our forecast from our last client letter in that a sharp stock market recovery in early 2019 will lead to a period of more gradual market upside for the second and third quarters. However, we still expect rising stock market volatility at the end of the year as investors debate the timing of the next recession.

In terms of positioning, we've generally moved most portfolios to a more defensive stance favoring bonds, cash, and Treasuries. Within equities, we have been making a slow migration toward more defensive stocks. Our recent stock purchases have included electric and renewable utilities, defense companies (which tend to be counter-cyclical), and healthcare insurers. We continue to view this modestly defensive position as reasonable. At this point in the cycle, we want to capture some economic and profit growth, while also remaining cognizant that we could see a recession in the next year or two.

As the calendar turns from a harsh winter and hot markets, we embrace the opportunity to shift toward warmer weather and a warm economy, ever mindful that cool days often come with the spring season. As the year unfolds, we continue to be committed to our core investment principles and your objectives.

With Warm Wishes for Spring,

FBB Capital Partners

Please keep in mind if there are people in your life who you think would benefit from a conversation with us, please let us know.