Review & Outlook

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Second Quarter 2019

Review and Outlook

The CRSP index was up over 18% from January through April of this year, giving the stock market one of its best starts in decades. But that doesn't mean that most investors shared those gains. Focusing too heavily on the gains ignores the complicated reality of a stock market that has been extremely volatile for the past fifteen months, and will continue to be volatile for the foreseeable future.

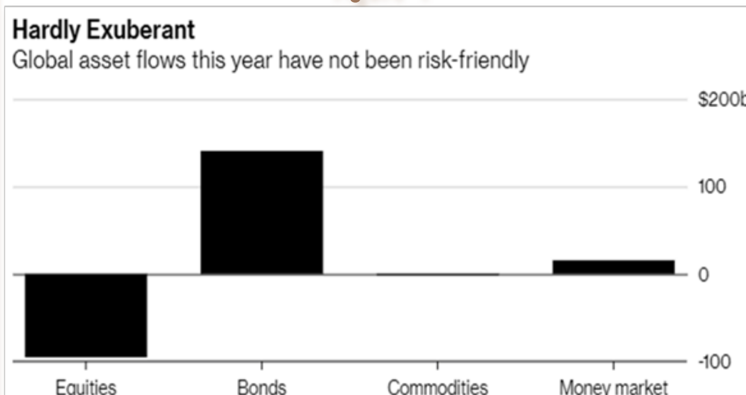
Index Performance Data
Total Return as of 6/30/2019

Indices[1]	Q2 2019	Trailing 12 Months
CRSP U.S. Total Stock Market Index	%	%
MSCI Global ex-U.S. Total Stock Market Index	%	%
Bloomberg Barclays U.S. Aggregate Bond Index	%	%

Early this year, many investors avoided the stock market altogether or were significantly underinvested in stocks, choosing instead the relative safety of bonds. And in the second quarter, investors continued to pursue bonds, pushing the yield on 10-year U.S. Treasuries below 2.2%. Figure 1 illustrates the flow of money from equities to bonds during the first four months of 2019. This tells us that investors do not seem particularly confident, despite the stock market's significant gains.

We are also concerned, so we took steps this spring to be slightly more conservative due to increased uncertainty and declining fundamentals. We invested a small portion of what is usually allocated to stock mutual funds in specific bond funds with yields over 3%. And for clients holding fixed income, we purchased a mix of short and intermediate-term bond ETFs. We implemented this strategy because we think that interest rates will stay low for an extended period, possibly even falling. We see little risk in holding bonds that mature further in the future, which can decline in value if interest rates rise.

Figure 1[2]



One reason for our caution is the appearance that the labor market is weakening. While the unemployment rate is low, it is not due to a lot of hiring. Fewer people are looking for work than ten years ago, and the economy created significantly fewer jobs in May than expected. If the next few labor reports remain weak, the stock market could decline even if the Fed lowers rates.

We do not subscribe to the idea that bad economic news is good for the stock market because the Fed will reduce rates, ultimately helping stocks, as that view is too narrow. The next few months of data will be crucial for us to determine if the labor market is really softening and if the economy is slowing, or if the disappointing reports were anomalous. Parts of the labor market continue to do well, and there is a certain inertia to having happy consumers, since consumer spending accounts for the bulk of economic activity. But right now, the labor market data is sending mixed signals, and the elevated uncertainty around trade and tariffs could slow investments and the economy.

We think uncertainty and volatility will remain elevated for the foreseeable future. We expect periods of optimism as the Fed takes steps to help the economy, but also periods of concern. What the Trump

administration does in the next few months regarding tariffs and trade policy with China, along with steps taken by the Federal Reserve, will be critically important for the stock market. We will remain somewhat conservative until some of that uncertainty subsides.

In Focus

There has been a lot of talk in the news lately about the prospect of a Green New Deal, the proposed economic stimulus package that would focus on addressing climate change, infrastructure, and economic inequality. But the price tag associated with such a massive overhaul has many people asking how the government would pay for it. Supporters of the Green New Deal argue that the best way to raise the cash is for the government to print or borrow more money, while critics contend that doing so would only cause inflation and drive up interest rates. At the core of this debate is Modern Monetary Theory (MMT), the idea that governments are not constrained by revenues like taxes since they can just print the money needed to pay for their programs.

The mainstream view is that if the government simply printed money to pay its debts, the value of money would plummet and inflation would spiral out of control, and conventional wisdom suggests that borrowing more and more money to pay our debts would result in higher interest rates and slower economic growth. But proponents of MMT argue that our public debt has grown significantly without causing inflation or higher interest rates. Indeed, inflation in all developed countries is quite muted and interest rates extremely low, despite high levels of debt and borrowing, which invites the question, “How much debt is too much?” Some believe that the U.S. government could borrow and spend considerably more than it does, letting the debt increase to deal with issues like climate change and aging infrastructure, without worrying too much about how to pay it down in the short-term. Others believe that more debt would cause significant problems, driving up interest rates, slowing the economy, and ultimately hurting our ability to address important issues.

Many proponents of MMT say the biggest potential risk with the federal debt increasing over time is that it might be inflationary, but if the U.S. does not have rising inflation, it does not have a problem with its debt. We recognize that if the return on investment (especially for capital projects) is greater than the cost of borrowing, then more debt might be justified, but we should not run fast and far with the idea that taking on more debt for government programs is always acceptable. Simple narratives can be appealing, but they are often misleading.

Looking at countries in Central and South America illustrates why debt matters, showing how interest rates can be exorbitant when debt is too high relative to the size of the economy. In Mexico and Brazil, the yield on 10-year bonds is over 8%, more than 6% higher than U.S. Treasuries. Money is expensive in those countries, hurting investment and presenting challenges for their stock markets. But we can look at Japan as an example of how a lot of debt is not necessarily a bad thing. Federal debt in Japan is more than twice GDP, but inflation is steady and interest rates remain very low. Their debt just does not appear to be a problem. So, while we know debt can cause problems, there is no specific threshold above which debt is a significant burden and below which all is well.

When it comes to managing money, we believe that debt does matter, and that too much debt can drive up interest rates. Japan makes it seem like we could increase our debt significantly without worry, but the U.S. has greater foreign ownership of debt than Japan, and the Japanese have a higher savings rate than we do in the U.S. These differences make us worry about using Japan as proof that we could borrow considerably more without affecting interest rates. As such, we will continue to consider debt when structuring our fixed income investments.

1. Index price data is downloaded from ICE Data Services. Index performance data is calculated by Axys portfolio accounting software, a product of SS&C Advent.
2. Lee, Justina. “The Fast Money Never Liked This Rally. That May Be What Saves It.” Bloomberg.com, Bloomberg, 8 May 2019, 6:31 AM PDT, www.bloomberg.com/news/articles/2019-05-08/the-fast-money-never-liked-this-rally-that-may-be-what-saves-it.

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