MILLRIVER
WEALTH MANAGEMENT

OUTLOOKS

March 2019

ECONOMIC OUTLOOK

Summary

Is the U.S. economy already in recession? This is a question posed by market economist, David Rosenberg at Gluskin Sheff, and he has some interesting anecdotes. First, no, we are not in a recession, but some of David's data points indicate that the economy may not snap back as quickly as the financial markets did from Q4 2018 to Q1 2019. Let's examine some of his data points, these are economic indicators released over the last three months (at an annual rate): existing home sales (Jan): -19.8%, auto sales (Jan): -17.6%, nonresidential construction (Nov): -6.6%, core capex orders (Dec): -4.8%, real retail sales (Dec): -1.8%.

Now, if these economic statistics continued in a negative direction for a full year it is likely we would be in a recession. Thankfully, that does not seem to be happening. The government shutdown in December delayed some economic releases, but on balance, recent survey data and broad economic release statistics have shown a bounce from depressed Q4 2018 levels. However, we must keep in mind that this business expansion is approaching the decade mark and there is not a groundswell of pent-up demand.

This takes us to the global economy, which may be bottoming in Q1 2019 as China pulls many levers to stimulate their economy and major trade tensions begin to subside. However, Brexit is still an unknown and growth in major European countries has slowed to stall speed, while Japan readies a Value Added Tax (VAT) increase in October this year. Synchronized global lift-off? Hardly but incremental positives, a patient Fed, low inflation, easier financial conditions and time, could extend this business expansion for a few more years.

Positives

ISM Non-Manufacturing Index survey surprises to 59.7, 57.4 was expected

Q4 GDP came in at 2.6%, 2.2% was expected

Personal income increased 1.0% last month, 0.4% was expected

Negatives

New home sales revised to 599k (annualized) from 657k in November

Housing starts fell to 1,078k units (annualized), 1,256k expected, in December

Factory orders were up 0.1%, 0.6% expected, in December

EQUITY OUTLOOK

Summary

The January recovery extended into February with most major equity indexes firmly higher. The S&P 500 Index gained 3.2% bringing the year to date return to 11.5%, marking the best two-month start to any year since 1991.

Again, as in January, the rally in domestic stocks was extremely broad. Growth and value stocks both participated as the Russell 1000 Growth and Russell 1000 Value indexes rallied 3.6% and 3.2% respectively. All 11 economic sectors posted gains in February. Information technology and industrial stocks led the pack climbing 6.9% and 6.4%. The communication services and discretionary sectors, while still positive, were the laggards rising 0.8% each. Middle and small sized U.S. companies did particularly well last month. The Russell Midcap Index rose 4.3% while the Russell 2000 Index added 5.2%

Foreign equity markets were largely higher but didn't keep pace with domestic markets in February. The developed international MSCI EAFE Index rose 2.6%. The MSCI Emerging Markets Index, though, gained a mere 0.2%. International market performance was partly a result of the strength of the U.S. dollar, which appreciated 0.6% against a basket of foreign currencies in February.

Investor sentiment has done an about face since making recent lows on December 24 of last year. Many of the risks that were causing concern at that time have seemingly been forgotten. One of the more significant headline contributors to the selloff and subsequent rally has been the trade rift between the United States and China. It has recently been hinted that substantial progress has been made on this particular front. Much of the rally to start the year can probably be attributed to trade progress but it's impossible to say exactly how much. We suspect, if/when a deal is finally reached, those results have already been baked into the market. It wouldn't surprise us to see the markets pause or retreat somewhat over the near term after an agreement is announced.

While we believe equity conditions have become overbought within the last several weeks, we ultimately think the markets will make fresh highs again in 2019. We also see the recent rally as an opportunity for clients to reevaluate risk tolerance and asset allocation targets and rebalance as appropriate.

Positives

Accommodative Federal Reserve

China/U.S. trade progress

Negatives

Slowing economic growth domestic and abroad

Investor sentiment overly optimistic

Unknown

Mueller report

Brexit path and impact

FIXED INCOME OUTLOOK

Summary

After months of dramatic swings, the relative calm that settled over the Treasury market in January continued during the entire month of February. The 2-year Treasury note traded in a relatively narrow 8 basis point (bps) range, ending the month 6 bps higher at 2.51%. Similarly, the 10-year and 30-year bonds traded in ranges of 10 bps, ending the month 9 bps higher at 2.72% and 3.08%, respectively. These high-low ranges are about half the size normally experienced on a monthly basis over the past few years. Since yields were down a little bit in January, yields are now within a handful of basis points of where they started the year across the entire curve. Credit spreads also remained extremely stable during February after experiencing one of the best months in history for corporate bonds in January.

With the "Fed pause" clearly here and no change in policy expected until at least June, we think the bond market has found an equilibrium level that reflects even probabilities of rate hikes and cuts in the future. If there is a new trade pact with China and the labor market remains strong, the economy should perform well enough to justify at least one more rate hike. In that scenario, yields across the curve could trend slightly higher, maybe back closer to 3% on the 10-year Treasury note. On the other hand, if little comes out of the trade negotiations and the use of tariffs escalate; China's growth rate will take another step down. Globally the outlook for growth is already fading with Europe as a whole and Japan nearing recessionary levels. In this case, we believe that a rate cut could happen as soon as June, as there is no ocean wide enough to insulate the U.S. from a significant global downturn. The yield curve could steepen in this scenario with all rates moving lower but more so on the shorter end of the curve.

Even with an uncertain outlook, we remain optimistic on corporate bonds and believe that the current spread levels are attractive. Even in a slowing economic environment, a diversified portfolio of well-researched credits should deliver higher returns than Treasury notes over any upcoming market cycle.

Positives

- Weakening global economic outlook, particularly in China, Europe and Japan
- Modest inflationary pressures with core PCE still below the 3% target

Negatives

- A successful trade deal with China could unleash a wave of economic optimism
- Massive federal budget and trade deficits

Unknown

- Trade negotiations with China
- Brexit negotiations and their impact on the U.K. and Europe