Market Commentary
Summer 2019

Northern Oak Wealth Management, Inc.
555 East Wells Street, Suite 1625
Milwaukee, WI 53202
414-278-0590 Fax 414-278-1294
Toll Free 888-283-1884

What Goes Up, Comes Down Faster

Last Monday, the broad markets fell 3% which followed the worst week of the year. In total, the markets pulled back 6.0% since hitting an all-time high on July 26th. The S&P 500 rose 7.1% in June, but it only took three days to give almost all of it back. There appears to be two culprits that explain the drop. First, while it was expected the Federal Reserve would cut rates last week, it was not expecting to hear language of a possible "one and done" cut (a.k.a mid-course adjustment). The other factor is the escalation of the trade war. On August 2nd, President Trump announced new tariffs on China and on the following Monday, China responded by devaluing its currency.

The Fed's decision to cut rates just seven months after it raised rates put its credibility somewhat in question. It also said back in December that its decisions would be "data dependent." This was in contrast to its October call of last year implying that it was set to raise rates four times in 2019. That was likely the key catalyst that started the fourth quarter 2018 market correction. If the Fed is data dependent, what economic data would suggest a rate cut is needed? The economic data, while it has slowed, it still showing decent growth. The 2nd quarter GDP number was reported at a 2.1% annual rate (compared to 3.1% in Q1), jobs data remains strong, and unemployment remains historically low.

We do not believe the Fed is succumbing to pressure from the White House to cut rates. In fact, we believe part of the reason for December's decision to raise rates was to show that it was, in fact, independent from the pressures coming from President Trump. We further believe that this recent cut was partially done to offset the December increase. However, all of this has come at the expense of the Fed's credibility and now it has painted itself into a corner. The Fed has left itself open to go either way in the coming months, although the expectation is growing for another rate cut in September. Whatever the Fed does, we hope it does a better job of explaining its rationale for the move.

On the trade front, an agreement between the US and China that we felt was so close a month ago, now seems unlikely for the remainder of the year based on actions from both sides. President Trump recently announced further tariffs on China, and China responded by devaluing its currency. The parties are scheduled to meet again in September in hopes of coming to an agreement. In previous letters, we stated that concern regarding a trade war was warranted, as it can have a fundamental impact on the markets. The uncertainty created by the trade war is the largest reason behind the slowdown in global growth and also caused most of the market volatility in the past week, in our opinion. A resolution to this is too hard to predict, but as we have said in the past, it is in the interest of both sides to resolve this dispute.

Earnings

Corporate earnings are estimated to be down 1.9% in Q2 compared to a flat Q1. However, at the start of the year, earnings were expected to grow in Q2 by 6.5%. Despite the decline, the equity markets have risen as participants believe there was support coming from the Fed in the form of interest rate cuts. Asset prices typically rise when interest rates fall. Some have even argued based on the current level of interest rates that the market is well undervalued. Nevertheless, the steep rise in the markets this year somewhat concerns us; it was sharp and in some specific cases irrational, based on company fundamentals. For the full year, consensus

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earnings are expected to rise 2.4%, but significantly down from 7.6% at the start of the year. Importantly, most of the 2019 earnings growth is confined to the fourth quarter, and a failure to realize that growth could harm the markets. It is hard to see earnings growth meeting expectations if there is no resolution to the trade war.

If history is any guide, 2020 earnings estimates are too high and need to be ratcheted down. For the past several years now, earnings estimates have declined as the year has progressed and we see the same thing happening for 2020. However, the market will not give much thought to the 2020 outlook until after the October earnings season, when companies give more detail into their forecast for the upcoming year.

Interest Rates

We have to admit the recent behavior of interest rates is disconcerting. Inverted yield curves, where short-term rates are higher than long-term rates, have hinted at recessions in the past. The yield on a US one-year Treasury Bill is at 1.76% compared to the US 10-year Note yield of 1.70% as of mid-day on August 7. Lower interest rates suggest that a slowdown is in the offering. Others have argued that lower rates are driven by the insatiable demand for government debt, especially that of the United States, and is not a prelude to a recession. Only time will tell.

Inverted yield curves are one thing, but negative interest rates are something few of us thought would ever happen. Imagine investing your money, knowingly getting less money back than when you started, and be accepting of these returns. This is just illogical. The entire German yield curve, out to 30 years, is negative. The 30-year bond briefly hit -0.14% on August 7th as investors sought safety from an escalation in the trade war. According to TradeWeb, over 50% of European government bonds have a negative yield.

Are low interest rates due to demand for bonds or slower growth to come? We think it's probably a combination of both. The question is, how much will growth slow. Much of that depends on the trade war. If the trade dispute was resolved, we believe stocks would rise in anticipation of higher economic growth and a corresponding move would be seen in interest rates.

Conclusion

The escalation in the trade war with China will dominate the direction of the market in our opinion in the second half of the year, and perhaps even longer than that. Our confidence in a deal by year end is less than what it was a month ago. We are somewhat cautious here, but that will not stop us from taking advantage of any material weakness in the market or specific issues since we believe a trade deal will eventually get done. We also know from experience that investors can grossly "overdo" valuations both up and down when emotions take hold. When a trade deal gets done is a difficult question, but one that we will be monitoring.