First Commonwealth Advisors

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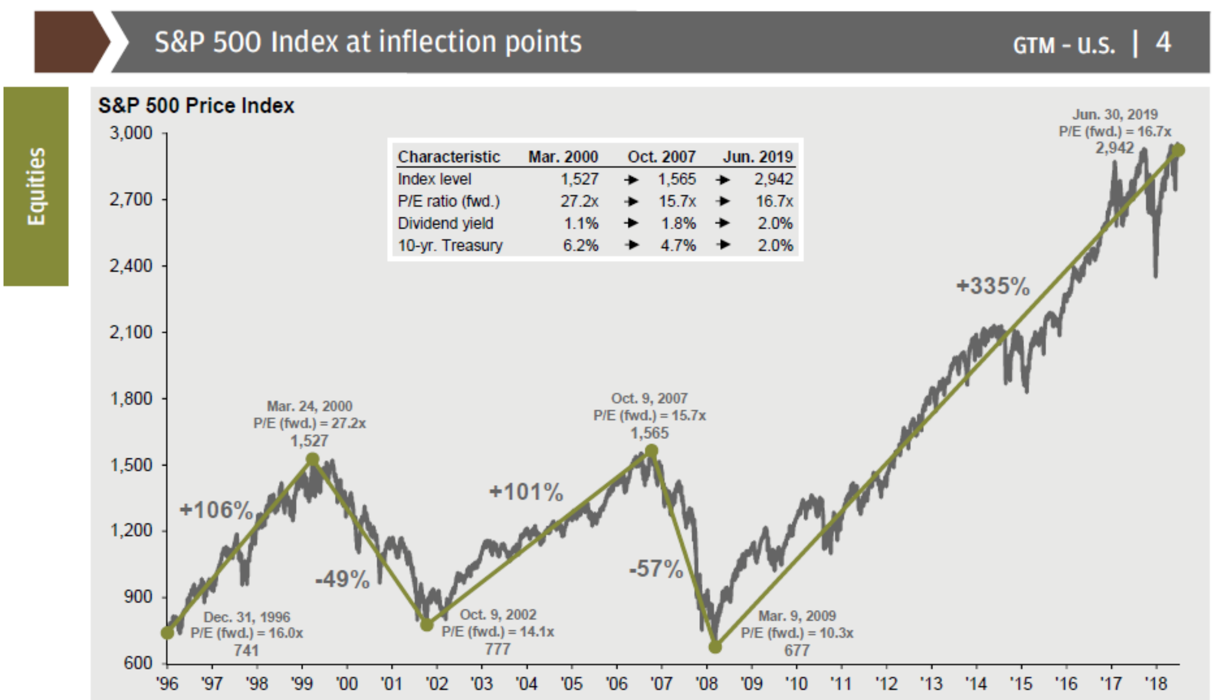
Quarterly Review & Outlook

June 2019: "Should They Stay or Should They Low…er"

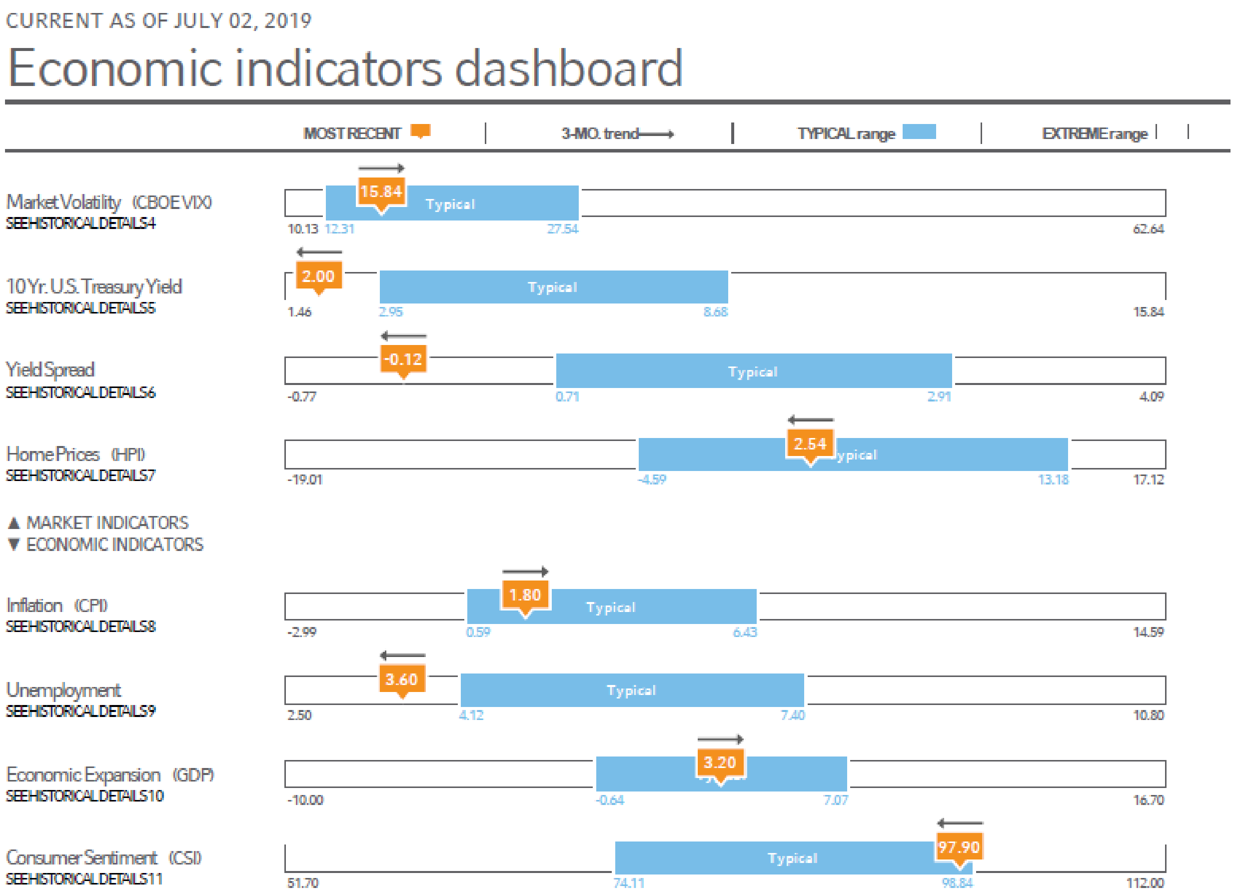
A Look Back – 2nd Quarter 2019

Of course this quarter's title is a take on The Clash's 1982 hit, *Should I Stay or Should I Go.* It was the band's only number-one single, and reached #228 on Rolling Stones 500 Greatest Songs of All Time. It has further been used many times in pop culture by those faced with a difficult decision. It came to mind when thinking about the Fed and their upcoming July meeting and what they plan to do with short-term interest rates. Market participants certainly believe they are going to lower rates. Based on current forward future markets, there is almost a 100% chance that they lower rates by at least .25% when they meet in late July. With the U.S. economy still grinding along with low unemployment and positive GDP growth, some wonder why the need to reverse course from their rate-increasing path of the last few years. Indeed, it was only last October when Chairman Powell said that we were not near "rate neutrality"…or the level that the Fed felt comfortable with in keeping inflation in check. With this abrupt change of direction, the S&P 500 keeps marching forward, as shown in the longer-term graph below. The big-cap index gained 18.5% in the first half of 2019, and has tacked on another 2% in July.



After a 14% decline in the fourth quarter of 2018, you could have won a lot of money betting on a nearly 20% rise over the next six months. There was a sense that the worm may be starting to turn, and that the nearly decade-long expansion was really starting to show its age. There were trade war concerns with China. Market valuations were certainly questioned. North Korea and other geo-political landmines were in the forefront of daily discussions. Many thought we were teetering…at best. We have talked many times about the resilience of our markets, and the first half of this year has been exhibit #1. We have officially marked a record economic expansion of 120 months.

As the Economic Dashboard below illustrates, most of the key indicators remain in positive territory. Market volatility remains stubbornly low. Ten year Treasury yields, impacted by the Fed's new patient stance, are historically low. It should be noted here that there is a flip-side to lower rates. Although good for borrowers of money, those seeking traditional income from savings and CD's are not so happy. The 5-6% yields on short-term investments that several generations remember are just not there right now. This has led many down a path of seeking yields elsewhere (higher dividend-paying stocks for example). Those in or close to retirement may have more risk in their investments than they want…or even realize. Additionally, corporations continue to take advantage of the low rates and borrow to fund their own share buybacks. This activity can make the earnings component look better, but also loads the balance sheet with additional debt.



When I started in this business in the mid-1980's, most economists considered an unemployment rate of 5% to be "full employment", or the lowest level that full-functioning, broad economies could get to. The unemployment rate stood at 3.6% at the end of the 2nd quarter. So much for that theory. We haven't seen the acceleration in worker wages that many want to see, but the sustained level below 4% cannot be minimized. For most of those seeking, there is a job to be had. GDP for the 2nd quarter of 2019 was just released, and showed our economy growing by 2.1%, down from 3.1% in the 1st quarter. Expectations were more in the 1.5% range, so even the lower number is being viewed favorably by many. The high level of consumer optimism, as shown above, was borne out in the latest GDP release, as consumer expenditures rose 4.3% in the quarter, the best since the 4th quarter of 2017. The better-than-expected GDP number was also bolstered by Uncle Sam, as Government spending rose 5%, the fastest pace since 2009, as the economy was coming out of the Great Recession. It is true that this historic expansion in length of time has been one of the weaker ones on record. Total GDP growth has only been around 25% since 2009. But we do continue to grow.

The Asset Class Returns table below shows just how strong the first half of the year was across a variety of asset classes. In fact, there are no negative numbers. None. In fact, every one of the 38 broad-based asset classes tracked by Deutsche Bank was positive in the month of June. That is something that hasn't happened in **150** years. We continue to show this table because we believe it important to visually illustrate how asset classes come in and out of favor. The worst of yesterday is often the best of today. The chart does as good of a job, if not better, than any 60 minute verbal rambling may ever do in showing the importance of having a diversified approach to investing. Cash was king in 2018 with a paltry 1.8% return. For the first six months of this year, it comes in last, with a 1.2% return. It is dwarfed by the outsized performance of Real Estate and Large-Cap Domestic Equities, both with returns near 20%. Although substantially trailing The U.S., foreign equities contributed double digit returns as well, with Developed International and Emerging Markets returning 14.5% and 10.8%, respectively.

Another important contributor to overall client performance has been the re-emergence of the Fixed Income market. As marked by the Bloomberg Barclays Aggregate, the asset class gave investors a positive return of 6.1% on their money in just six months. For perspective, that would better than the long-term performance of this asset class for an entire year. It was only last year, in 2018, that the same barometer gave clients no return, and no cushion to dampen negative equity returns. Many are surprised at the level of return in Fixed Income, especially in what was supposed to be a rising-rate environment. However, with the Fed pausing, and most likely reversing their rate policy direction, traditional bond investing has been a much better place to be. As we have discussed before: the Fed can control the short-term Fed Funds rate, but market forces like supply/demand and others control the longer term picture. Finally, we need to show the white asset allocation box some love too. It continues to meander about the table…never the best, but with much less risk still delivering over a 12% return in just half a year. That works out to more than a 25% annualized return!

Asset class returns

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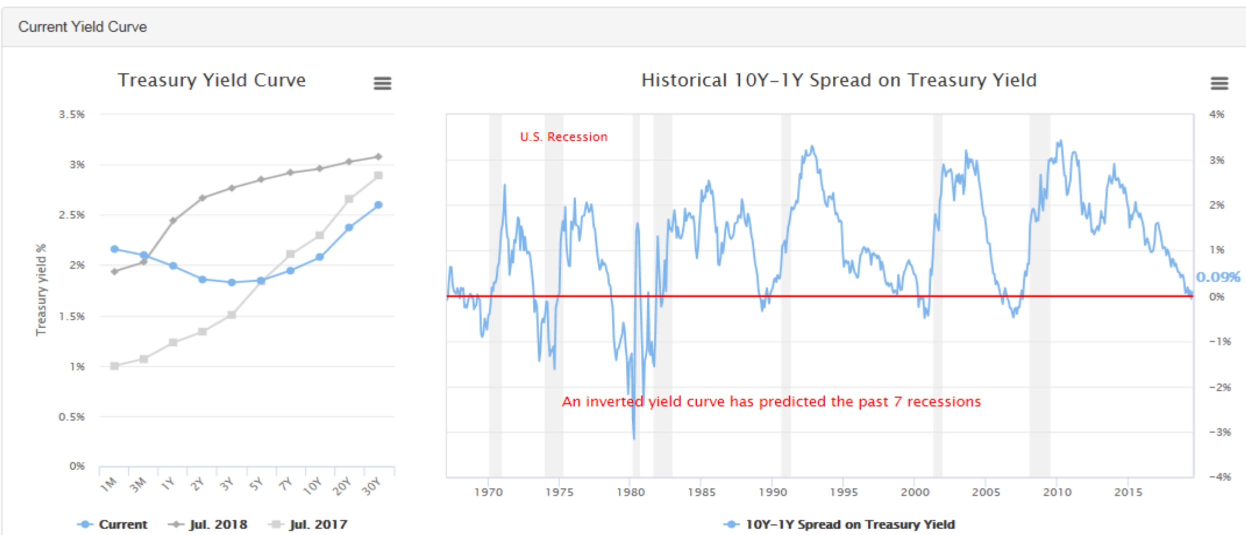
Investing principles

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD	2004 - 2018 Ann.	2004 - 2018 Vol.
REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	REITs 19.3%	REITs 8.5%	REITs 22.4%
EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	Large Cap 18.5%	EM Equity 8.3%	EM Equity 22.1%
DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Small Cap 17.0%	Large Cap 7.8%	Small Cap 18.6%
Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 14.5%	Small Cap 7.5%	Comdty. 18.6%
High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	Asset Alloc. 12.3%	High Yield 7.3%	DM Equity 17.6%
Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	EM Equity 10.8%	Asset Alloc. 6.2%	Large Cap 14.5%
Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	High Yield 9.5%	DM Equity 5.2%	High Yield 11.0%
Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	Fixed Income 6.1%	Fixed Income 3.9%	Asset Alloc. 10.3%
Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Comdty. 5.1%	Cash 1.3%	Fixed Income 3.3%
Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Cash 1.2%	Comdty. -2.5%	Cash 0.8%

A Look Ahead

Another line in The Clash's hit song is, "if I stay there could be trouble." We believe that the same might very well be true if the Fed were to surprise market participants and do nothing with rates or "stay" in their upcoming meeting. As mentioned earlier, the market fully expects a rate cut, and the chairman and other voting members have done little to change the expectation. The market is not so different than most of us. It hates uncertainty, so we do expect the rate cut to happen. The more interesting question is how the market reacts in the ensuing weeks and months. The conventional wisdom is that this accommodative action should act as a tailwind for the equity markets. However, what if the Fed reduces rates by more than the expected quarter percent? Let's say they cut rates half a percent. How might investors react then? We believe it gets a little tricky. It's not as easy as: if a little is good, then more is better. Not in this case. If the Fed takes the more dramatic action of cutting rates by .5%, then you have to wonder what they see in the full economic pipeline that we don't. We believe that it wouldn't be such a leap to think that a quarter point cut in rates could be ok/good, but a half point cut could be not-so-good/bad. That is exactly how fickle markets can be, and accustomed the market has become to perceived transparency from the Fed.

We end with a couple of worrisome charts. The first is of the U.S. Treasury Yield Curve. On the left, you see the current yield curve in blue…looking something like a sick "U". It doesn't look like a normal upward sloping curve, where investors demand a higher yield for longer-dated maturities. Currently, one month treasuries are yielding 2.14%, while 10 year treasuries yield just 2.07%. The worrisome part is that when the curve inverts, as it has recently, it has accurately predicted the last seven recessions. The Fed may very well take some yield out of the short end of the curve, but seven out of seven anything means something. You have to go back to the Eisenhower era to find the last time the yield curve inversion was a false predictor.



The second chart shows the level of corporate stock buybacks mentioned earlier. Again, this is not necessarily a bad thing by itself, but it could be an issue for those companies burdened with much more debt when the economy does roll over and things get a little tougher. We continue to tread cautiously, recognizing where we are in the big picture of this historic economic cycle. We remain true to our diversified portfolio approach for long-term investors, but, like The Clash, some doubt about staying remains.

Chart 1: BofAML corporate client buybacks (through 1H19, annualized) vs. S&P 500 gross buybacks (2012-2018, and 2019 projection based on BofAML corp. client buybacks)

Source: Bank of America Merrill Lynch, BofAML US Equity & Quant Strategy, Haver Analytics