Market Review

Fed Dependent

In late 2018 it was well documented that negative global equity market action prompted the US Federal Reserve to pause in its hitherto quite strident hiking of US interest rates, changing its communications to investors from a hawkish to a markedly more dovish tone, in what markets have since termed the ‘Fed Pivot’.

US and Global equity markets have since rallied significantly in this period, with June registering the best performance for the S&P 500 Index for the month of June since 1938, although admittedly it is only now back to more or less where it was at the end of the third quarter of 2018.

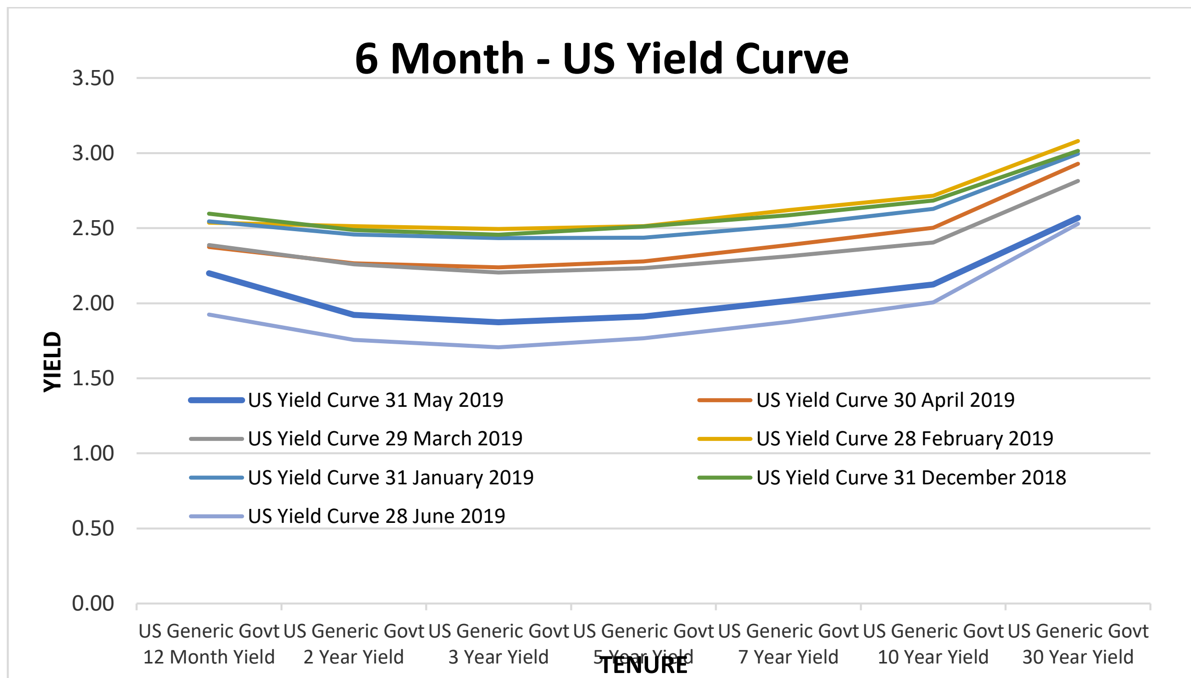
US S&P 500 Index October 2019 to Present

Source: Bloomberg

As we head into the second half of 2019, what we now face is the bond market pre-empting at least one cut and probably more in US interest rates, to counter concerns about slowing global economic growth, inflamed in part by the US-China trade dispute.

In the six-month period since the last Federal Reserve interest rate hike, US interest rate expectations have shifted downwards by over 50 basis points, as evidenced by the chart opposite which shows the US sovereign bond yield curve falling from around 2.5% in the short term to well below 2.0%.

This has helped to fuel the possibility or perhaps the probability that the US central bank will cut rates two or more times by the end of 2019, as can be seen from the inverted shape of the curve on the chart below, that is one that shows very short term rates (1-2 years) being higher than medium term rates (3 or so years), whereas the opposite is normally true. This 'inversion' of the curve points to a slowdown in expected US economic growth within the next two years, suggesting that the US Federal Reserve will provide the appropriate interest rate stimulus (rate cuts) to potentially counter this expected period of relative economic weakness.



Source: MPL/Bloomberg

In its 19th June statement the Federal Reserve changed its interest rate language markedly once more, from where it had previously indicated it was simply being "patient" in determining interest rate policy, to one where it expects to be "acting as appropriate to sustain the (US economic) expansion", and "closely monitoring the implications of incoming information for the economic outlook".

This was reflective of bond market expectations for a US economic slowdown, with the Federal Reserve noting that inflation continued to run below its 2 two per cent target whilst it also downgraded its description of the health of the US economy, saying activity was now rising at only a "moderate rate" as opposed to the "solid rate" the US central bank had noted in May.

Meanwhile in Europe, European Central Bank (ECB) President Mario Draghi similarly struck a notably more dovish tone, stating that should economic conditions deteriorate in the coming months, the ECB would announce further stimulus measures.

The ECB pointed to "lingering softness" in the short term due to geopolitical factors and trade conflicts, which have weighed on two important drivers of economic growth in the Eurozone, that is the manufacturing sector and exports.

This softer economic outlook has prompted the MPL Investment team to take some funds out of the markets, locking in some gains in areas of the portfolios which have performed well in the first half of 2019.

Portfolio Allocation

Some profits were taken in the Information Technology, US Mid-Cap and Large-Cap equity sectors, while at the same time underperforming areas in the Japanese equity and UK commercial property sectors were sold into market strength in the quarter, in line with comments made in our last investment letter to you.

Our decision to reduce overall exposure to the US markets was in the expectation that second quarter corporate earnings reports, which begin to be announced in earnest from mid-July onwards, will indicate both somewhat reduced revenues and softer earnings guidance going forward.

Additionally market liquidity and trading volumes tend to decline in the summer months, as investors and market participants head off on holiday; consequently any weakness sensed and resulting from the coming earnings season may be exacerbated by the expected low levels of liquidity.

Given these expectations of slowing US economic growth on the one hand, and markets currently being bolstered by the more dovish stance from the US Federal Reserve and the ECB on the other hand, any market weakness through the summer may provide the MPL investment team with opportunities to reduce current cash levels in favour of increased defensive positioning. This could for instance be into the healthcare sector (via the AXA Framlington Biotech Fund and the iShares Nasdaq Biotechnology Index ETF), where we continue to see potential upside to valuations.

The welcome resumption announced at the end of June of the US-China trade talks, together with any weakness in global equity markets may also prompt us to increase exposure to Asian and Emerging Market equities, where valuations remain relatively compelling, this in line with previous comments we have made on this subject.