June Monthly Recap: Wall Street Rounds Out Best June in Decades, but Bond Yields Signal Economic Dangers Ahead

After a punishing May, Wall Street and global stocks rebounded sharply in June, with the S&P 500 Index rounding out its best first half in two decades. For the Dow Jones Industrial Average, it was the best month of June since 1938.[1] While impressive, the June rally was largely driven by the Federal Reserve, which gave its strongest signal yet that interest rates were heading lower.

Global Stocks Surge

The U.S. stock market briefly returned to record highs last month, as the major indexes gained between 6.9% and 7.2%. With the rally, the Dow, S&P 500 and NASDAQ more than offset May's sharp decline. The S&P 500 posted its best first half of the year in more than two decades, with all 11 primary sectors rising.

After losing more than 3% in May, Canada's benchmark S&P/TSX Composite Index rallied 2.2% last month and is back within range of its all-time high.

European markets were higher across the board, with the Euro Stoxx 50 adding 5.9%. The major benchmarks in Germany, France and the United Kingdom rose by at least 3.7%.

Chinese stocks were the biggest gainers in the Asia Pacific region, with the CSI 300 Index climbing 5.4% during the month. The MSCI AC Asia Pacific Index also rose more than 5%.

Likelihood of July Rate Cut: 100%

The Federal Reserve has not only abandoned plans to normalize monetary policy, it has given clear indication that interest rates are headed lower. As a result, traders have now priced in a 100% likelihood of a rate cut following the July 30-31 Federal Open Market Committee (FOMC) meeting, according to CME Group's FedWatch Tool.[2]

The central bank kept interest rates on hold at the June FOMC meeting, but one dissenter – St. Louis Fed President James Bullard – voted for a quarter-point rate cut. In their official statement, policymakers downgraded their outlook on the economy and dropped the word "patient" from their forward guidance.

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Underpinning the Fed's dovish turn is a worsening inflation outlook and risks to global economic growth emanating from the U.S.-China trade war. Trade negotiations between the two superpowers are expected to resume after President Trump and China's Xi Jinping agreed to suspend hostilities at the Group of 20 summit in Osaka, Japan on June 29.

Bond Yields Plunge

The prospect of low-rate stimulus was received very differently by the bond markets. For the first time since November 2016, the 10-year U.S. Treasury yield plunged below 2%,[3] a clear sign that markets were questioning the long-term health of the U.S. economy. A string of dismal data releases, including lackluster job creation, weak inflation and sliding manufacturing demand, has hastened the collapse of bond yields over the past two months.

An inverted (and in some cases steepening) yield curve has raised alarm bells that the U.S. economy is heading toward recession. While the latest GDP figures show recession risks are not imminent, an inverted yield curve often foretells a shift away from riskier assets. As Goldman Sachs warned back in March, since the mid-1980s "significant drawdowns in stocks started only when the yield curve began steepening after being inverted."[4]

Portfolio Overview

Our investment process utilizes a multi asset approach which may include Canadian equities, U.S. equities, developed international equities, emerging international equities, currencies, commodities, Real Estate Investment trusts (REITs), bonds, preferred shares and cash. We actively measure the supply and demand for each asset class, and allocate our investments to the strongest asset classes.

With the exception of our All Equity Portfolio, our Multi Asset portfolios consist of two primary components. One component consists of permanent positions in Canadian and U.S stocks, a bond Exchange Traded Fund (ETF), a GIC, as well as individual preferred shares and preferred share ETFs. The second component is flexible and can include any of the previous assets classes previously mentioned. You can see the structure of all the portfolios here.

In the fixed component, the Canadian stock portfolio has performed well unlike 2018. Market leading stocks including Constellation Software and Shopify have helped the Canadian component outperform the TSX/S&P index. In the U.S. investments such as Lululemon, Microsoft, and Workday Inc have contributed to this component's outperformance so far in 2019. If the U.S. portfolio holds up for the balance of the year, it will have out preformed the S&P 500 in 9 of the past 11 years, and will have outperformed the S&P since inception in 2008 by 2 to 1 gross of fees.

In March we invested in the Pimco Monthly Income ETF. Pimco is the world leader in fixed income globally, and this ETF invests primarily beyond Canadas borders with over 96% of the funds' assets invested in the U.S. or international markets. The fund has performed consistent with its benchmark globally, but has underperformed the Canadian bond benchmark so far this year. Pimco provides exceptional portfolio management and diversification which is almost impossible to duplicate domestically.

The Canadian preferred component has struggled so far in 2019, specifically two ETFs. The preferred market in Canada is relatively small, and relatively illiquid. A large portion of the overall sector is reset preferred shares which are influenced by the direction of interest rates. As a result of economic data released in Canada and the U.S., the expectation is that interest rates will be lowered at some point in 2019. In an environment when rates

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are falling, many reset preferreds decline in value. On the other hand, the individual preferred shares held in the portfolio have performed very well. The component overall for the year is almost unchanged.

The second component invests in up to four asset classes. Selection is based on measuring supply and demand of each asset class compared to all others, including cash. The strength of the process is that it identifies significant shifts within the markets overall. The weakness in the process is that it can't anticipate market tops or bottoms. Rather it waits for significant shifts in demand. This means exiting only after market tops, and entering only after market bottoms.

In late October 2018, this component went to 100% cash, which helped us avoid a large portion of the decline in the last quarter of 2018, and added significant value. It was not until mid-February that we began getting the cash reinvested beginning with real estate, then adding investments in the Emerging Markets and the U.S. Since the markets bottomed in December 2018, this delay in investing detracted value from the portfolio. As frustrating as this may be, the process is designed to protect your capital from catastrophic losses even if it means redeploying cash after the market has bottomed.

Interestingly, the U.S. markets peaked again on May 1. Since then, the stock markets have struggled and have begun to correct once again. The correction has been significant enough to shift demand once again in favour of cash, and as a result we have reduced our investments in equities globally, and increased our cash component.

We have no idea if this is the beginning of another significant correction within the markets. However, our experience has told us not to ignore these subtle changes. If demand resumes for other assets, we will reduce cash and increase our exposure to other 'riskier" assets. Until then we remain defensive as we were before last years "bear" market.

The Month Ahead

With U.S.-China trade talks set to resume, investors will be eyeing a swift resolution to the nearly yearlong tariff war that has gripped global markets. U.S. Treasury Secretary Steven Mnuchin told CNBC last month that both sides were "90% of the way" to reaching a new deal.[5]

July also marks the beginning of second-quarter earnings season. According to FactSet, S&P 50 companies are expected to report an earnings decline of 2.6% for the quarter. That would mark the second straight quarter of year-over-year declines.[6]

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Sincerely,

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[1] Fred Imbert (June 28, 2019). “By the numbers: Best June for the Dow since 1938, S&P 500′s best first half in two decades.” CNBC.
[2] CME Group. CME FedWatch Tool.
[3] Thomas Franck (June 20, 2019). “10-year Treasury yield drops as low as 1.97%, first time below 2% since November 2016.” CNBC.
[4] Yun Li (June 27, 2019). “The bond market is doing something that is usually a sign for investors to ‘flee for the hills’.” CNBC.
[5] Sam Bourgi (June 28, 2019). “U.S. Stock Market Rounds Out Turbulent Quarter on Positive Footing; Bitcoin Rebounds 15%.” Hacked.
[6] FactSet (June 21, 2019). Earnings Insight.

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