The Long-Awaited End to a Very Volatile August... What's Next?

Last week was the end of a very volatile August. The month consisted of market swings between 2 and 3% daily. U.S. indexes lost between 1.5 and 2% overall. During this time, bond yields plummeted and are now at multi-year lows. There was also inversion in the yield curve, whereby the 2-year Treasury note is now yielding more than the 10 year. This condition has been a reliable indicator of a forthcoming recession in the past. I read today that an inversion of the 2 year and 10-year Treasury Note has preceded every recession in the U.S. since 1950, save two. That is a pretty remarkable track record and worthy of strong consideration as we move forward. I also read that the current inversion is "different" in that we typically see this phenomena occur as a result of the Federal Reserve raising rates at the short end of the curve and expected market growth failing to keep up at the back end; thereby causing short term rates to rise above long term rates. Today, we see the Fed lowering rates (after raising them quickly last year) and increasing worldwide demand for positive-yielding long-term U.S. treasuries, which pushes long term rates down below short-term rates. In other words, investors around the world are dumping money into safe haven U.S. treasuries faster than the Federal Reserve can lower rates. While the cause of the inversion may be different, the result is the same. This is strong evidence of unhealthy economic conditions. It doesn't take a genius to figure out that you shouldn't be paid more for loaning your money out over two years than for ten years. Not only does the inversion signal weak demand side growth across the globe, but it makes it very difficult for banks to make money. If banks can't make money, they stop loaning it out. The risk is not worth the reward!

The U.S. equity markets remain the strongest in the world by far (on a relative basis). All major domestic indexes remain just below their 50-day moving averages and above the all-important 200-day moving average. This has been the case for the past eighteen months. I have commented on this fact many times and warned that we could not expect to hold everyone else up forever. We saw this situation lead to large declines in our markets during the fourth quarter of last year as the Federal Reserve continued to raise rates and we are seeing it now as it has played a major part in the above-mentioned yield curve inversion.

U.S. manufacturing came in this morning with negative numbers and the weakest since early 2016. Likewise, the transportation and energy sectors of our economy are especially weak. These bellwethers are an additional cause for concern going forward. Much of this weakness can be attributed to the trade war with China. When the two largest economies in the world announce a self-imposed tax on business of 15 to 25%, it is not surprising that downstream companies suffer. The latest tariffs will impact a variety of consumer and electronic goods, all of which are very much intertwined with the holiday season. Many companies in this space live and die by holiday revenue. This is another area of concern worth watching. Defensive equities like utilities, consumer staples and dividend payers continue to outperform riskier assets. Bonds across the board have been on an absolute tear, as there has been a race to the bottom in bond yields. Note: bond prices move in the opposite direction of interest rates. The last bastions of strength (and two important ones) are employment and real estate. I mentioned this a month or so ago. It is a big positive that employment remains at record levels and housing continues to be strong. If those areas begin to crack, look out below.

All of this is hardly surprising seeing the political and economic climate around the world. Moreover, it is likely to persist or worsen absent a resolution of the trade problems. Clearly, President Trump's re-election hopes hang on the economy and stock market performing well. I suspect he will do whatever it takes to prop things up through November of 2020. The million-dollar question is whether it will be too late to make a difference.

Last week's market commentary can be found here.

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