OmniStar FINANCIAL GROUP
Illuminating The Blind Spots

Market Perspectives

A Glance at How the World Affects You

Tuesday, April 9, 2019

As stock markets go, the first quarter of 2019 was a win all around. The S&P 500 experienced its best quarter overall since the third quarter of 2009, when the recovery out of the great recession was just getting underway. The index also had its best first quarter since 1998, which is reaching back to another bull market entirely.

With the backdrop of a rebound in U.S. employment, stocks rose on Friday. The Dow Jones Industrial was up 0.2%, the Nasdaq Composite climbed 0.6%, and the S&P 500 added 0.5%. Stocks came into Friday with a solid upward bias, leading to full week gains of 1.9% for the Dow, 2.7% for the NASDAQ and 2.1% for the S&P 500. Year-to-date gains are 13.3% for the Dow, 19.6% for the NASDAQ and 15.4% for the S&P 500.

Looking back to last year, just three S&P 500 sectors were positive. In contrast, upside participation is much broader year-to-date 2019. As of the end of 1Q19, no sector in the S&P 500 was negative. Four were up in high-single digits, including Healthcare (last year's best performer). Others up in single digits are mainly defensive, including Staples and Utilities. Materials is up 9%, just missing double-digit growth. Despite fears of recession created by the yield-curve inversion, the stock market continues to favor economically sensitive and risk-on sectors. But some defensive sectors joined the party. Industrials is the year-to-date leading sector, with a 19% gain. Energy (the worst 2018 performer) is next with a 16% gain; turmoil in Venezuela is pushing energy prices higher. Technology is up 15%. Two risk-on sectors, Consumer Discretionary and Communication Services, and two defensive sectors, Financial and Real Estate, are up 12%-13%. While Industrials is leading year to date, it did not budge during the March rally. That could be consolidation or a signal from investors - wanting something tangible before pushing stocks higher.

Economic growth worries subsided a bit last week, and the 10-year Treasury yield closed Friday at 2.49%, up from 2.41% the prior week. The move higher reversed an inverted yield curve that was in place for the prior two weeks. Reviewing last week's economic reports, Friday's nonfarm payrolls report showed the U.S. economy added 196,000 in March, above the consensus for 170,000 and rebounding from February's upwardly-revised, but still weak, 33,000. Wages grew 3.2% annualized, a slight slowdown from February but at the upper end of the range for the past six months. At this point, the sluggish February reading is proving to be an anomaly, driven we think by the federal government shutdown, which had curtailed consumer confidence and spending. The report is not likely strong enough to alter the Fed's thinking about interest rates.

So, it seems the latest buzz is around inverted yield curves – a condition known to spur a short-term rally in stocks. You might be asking, what is an inverted yield curve? Let's have a look at what creates the inverted yield curve and what it could signal. An inverted yield curve is an interest rate environment in which long-term bonds have a lower yield than short-term bonds of the same credit quality. It is important to note that the inverted yield curve, also known as a negative yield curve, is the rarest of the three main curve types and has been considered a reliable predictor of economic recession.

Inversions of the yield curve have successfully signaled many of the U.S. recessions. Due to this historical correlation, the yield curve is often seen as an accurate forecast in business cycle turning points. A recent example is when the U.S. Treasury yield curve inverted in late 2005, 2006, and again in 2007 before U.S. equity markets collapsed. The curve also inverted in late 2018. An inverse yield curve predicts lower interest rates in the future as longer-term bonds are demanded. Demand equals higher prices for the bond, thus sending yields down.

What is it about the inverted yield curve that spurs short-term rallies? Inverted yield curves are known to spur a short-term rally in stocks because bond yields move lower, thus chasing some income-seeking investors back into stocks. Indeed, we

have seen a formidable rally since January, but if stocks are to carry sustainable momentum into the second quarter and beyond, the economy must show that it is still growing.

Policy matters might help stir economic activity. Top of the agenda would be resolving the trade and tariff issues that are disrupting global supply chains and making finished-goods production so challenging. Resolving Brexit would be helpful, although yet another defeat on 3/28/19 casts further doubt on a successful outcome.

The silver lining to the collapse in interest rates in March has been a revival in mortgage originations. A rate-driven recovery in housing activity would impact broad swaths of the consumer economy, including housewares, electronics, and appliances. A rekindling of the consumer economy could lead to more of a soft landing than a recession in coming years.

Let us be clear, we are not forecasting a recession in the foreseeable future. In fact, we are opposed to the idea of a looming recession. Looking to the forecasts of mid-2% GDP growth in 2019 and 2020, it is plausible to have confidence in this low-steady growth. Lest we forget, a similar pattern kept the economy out of recession throughout the bull market to date, and we anticipate more of the same over the next few years.

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