How Low Can They Go?

Macro Summary

- The Federal Reserve met in May and June, leaving the benchmark interest rate unchanged at 2.25 percent to 2.50 percent.

- The Fed dropped ‘patient’ in their statement describing its policy, supporting their ‘pivot’ to lower interest rates.

- In March, no members of the Federal Reserve anticipated rate cuts this year. There are now eight participants anticipating one or more interest rate reductions in 2019.

- The economic expansion is the longest in post-war history, but its 2.3 percent average Gross Domestic Product (GDP) trails the 50-year average of 2.7 percent growth.

- Second quarter growth is likely to be near 2 percent and remain at that level in the second half of this year.

- Job openings exceeded the number of unemployed Americans by the largest margin on record in April, but growth in openings stalled in May, indicating a slowdown is ahead.

- The unemployment rate has bottomed and is expected to gradually increase.

- After two consecutive months of improvement, Consumer Confidence levels declined in June to its lowest level since September 2017.

- Consumer debt service rate remains near historically low levels.

- Duke University’s June Chief Financial Officer (CFO) survey found 48.1 percent of US CFO’s believe the United States will be in recession by the second quarter 2020, and 69 percent believe a recession will begin by end of 2020.

- Inflationary pressures remain muted across the globe, serving as the rationale for lower interest rates and increased stimulus.

- The price of West Texas intermediate oil fell throughout most of the second quarter on worries over a global economic slowdown, but found support in late June from Middle East tensions and output reductions by major suppliers.

	Q2 RETURN	YTD RETURN
Standard & Poor's 500	4.3%	18.5%
Balanced Portfolio - 60 / 40	3.2%	12.3%
Dow Jones Industrial Average	3.2%	15.4%
MSCI EAFE	10.4%	10.4%
Barclays Aggregate Bond	3.0%	6.1%
Barclays Municipal Bond	2.1%	5.1%

Like our major political parties, the stock and bond markets seem to live in two different worlds these days. The former sits at record levels, suggesting we live in the best of times. The latter sees the world in a different light - bad and only getting worse.

Who's right? As in many things in life, the truth lies between the extremes.

SEPT. 2018

Fed still expects one more rate hike in 2018, three for 2019

- CNBC

JAN. 2019

Fed Signals End of Interest Rate Increases

- New York Times

What did we learn from the Federal Reserve during the second quarter?

- Their four primary areas of concern are: economic weakness outside the United States, trade concerns, weaker business investment, and risk sentiment in the financial markets.
- The deterioration in the economic outlook is a relatively new trend; therefore, they would like more information before reacting solely to the new data.
- Inflationary pressures are muted, but the committee still expects the weakness in inflation to be transitory (although it may take longer to rise back to the committee's target of 2.0%).
- Chairman Powell appeared to concede that rate cuts are a blunt instrument, but the committee must use the tools at its disposal.

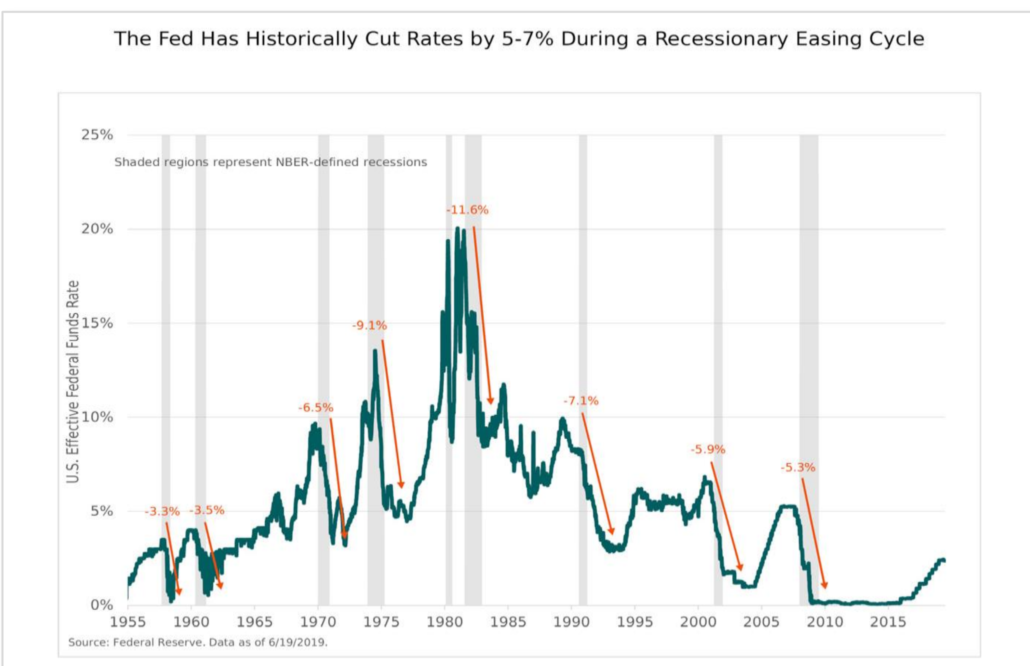
The Federal Reserve

Central bank policy has had an enormous impact on financial markets since the 2008 financial crisis. We've seen that continue in 2019, marked by two major shifts in the Federal Reserve's stance. First, the Fed shifted from tightening monetary policy in 2018 (where it was raising the fed funds policy rate and unwinding some of the assets on its bloated balance sheet) to a 'patient' stance (i.e., rate increases are on hold).

At its recent June Federal Open Market Committee (FOMC) meeting, Chairman Powell signaled the Committee was inclined towards loosening policy once again, setting the stage for rate cuts possibly as early as its July 31 meeting. While the federal funds rate was left unchanged, Jerome Powell stated 'the case for somewhat more accommodative policy has strengthened.' He also noted, 'many FOMC participants believe some cut in the fed funds rate will be appropriate in the scenario they see as most likely.' Specifically, eight of the 17 FOMC participants now project the Fed will cut the benchmark rate this year, with seven of those projecting two quarter-point reductions (50 basis points).

To state the obvious, looser monetary conditions are generally a stimulant for financial markets and asset prices, all else being equal. A lower interest rate implies higher asset valuations (i.e., higher price to earnings multiples). But all else is rarely equal. And the implications of lower rates and monetary stimulus are not so obvious when you go beyond simple, first-level thinking to consider the broader economic context for our low interest rate environment. It is critical for us to understand what information and expectations are already being discounted in current market prices. Regarding the latter, the fed funds futures market is now discounting a 100 percent probability the Federal Reserve lowers rates by at least 25 basis points in July, 92 percent odds of at least two quarter-point rate cuts by year-end, and 60 percent odds of three or more reductions.

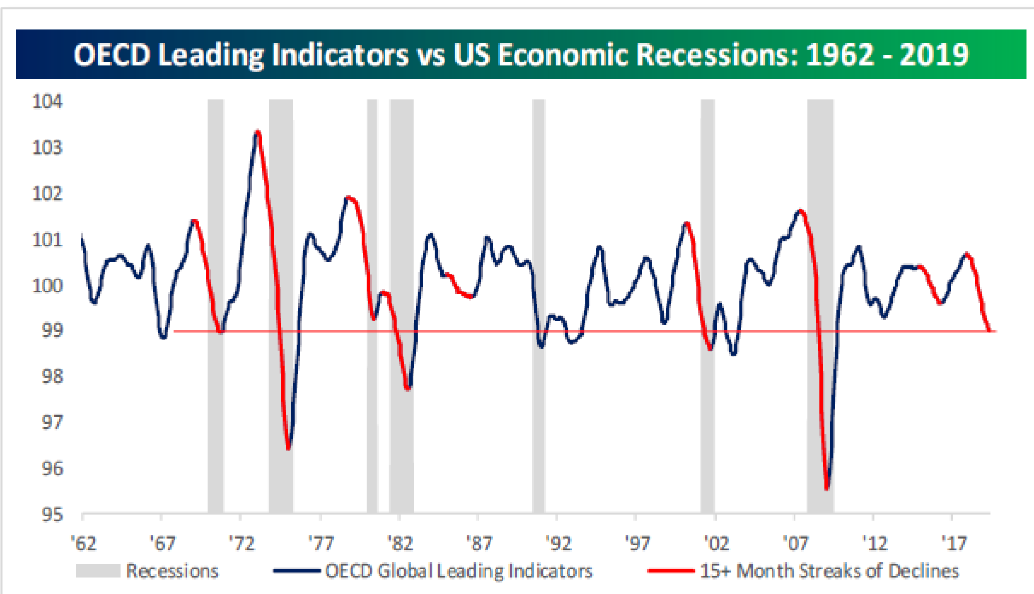
So, there is a non-trivial possibility the Fed disappoints the financial markets by not cutting as much as expected, or at all. Of course, Chair Powell is aware of market expectations and knows that market reactions to their actions can impact the real economy.



If this does mark the beginning of another Fed easing cycle, it should give investors pause looking out beyond just the next few quarters. As the chart on the previous page shows, the fed funds rate is barely above levels where it has ended most other monetary easing cycles. The Federal Reserve will have little room—2.5 percentage points—to reduce rates before hitting the 'zero lower bound,' economist-speak for a zero percent fed funds rate.

US economic activity may be underwhelming, but relative to the rest of the world, it looks materially better. Some of the arguments in favor of the FOMC reducing interest rates have been the possibility of the United States 'importing' a recession from overseas. There is not any historical example of this occurring; however, given the global nature of the economy, the possibility can't be dismissed. The weakness in the global leading indicators from the Organization for Economic Co-operation & Development (OECD) tells us the story is grim:

- May's decline represented the 17th straight monthly decline in the index.
- Of the prior eight streaks, only two did not coincide with a US recession.



Stock prices have performed well in the 12 months after an initial Fed rate cut, unless the economy is heading into a recession. In the last two cycles, in 2001 & 2007, the Fed's first rate cuts came several months before the start of recessions, but severe bear markets followed.

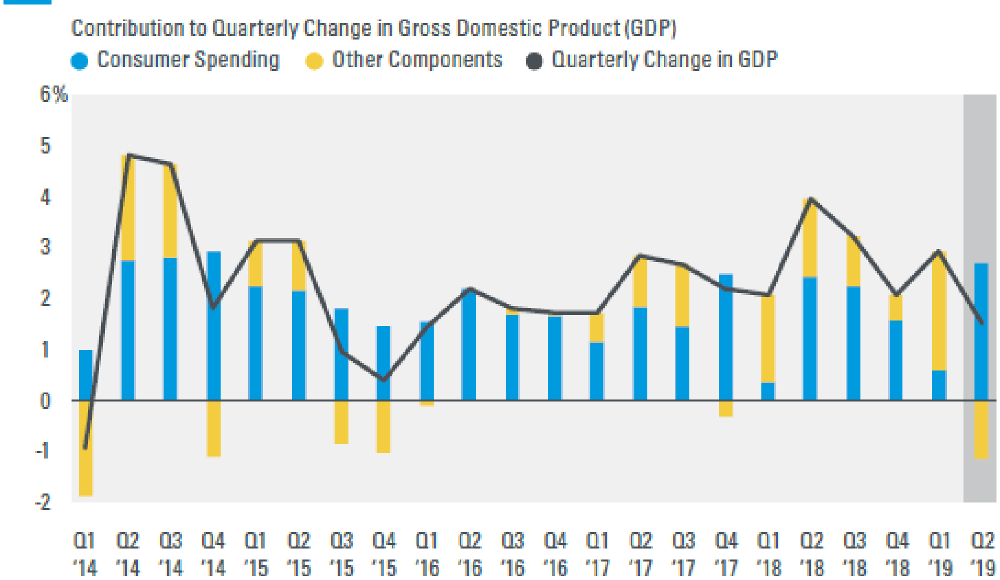
While 'don't fight the Fed' is an excellent rule of thumb, the Federal Reserve is not all-powerful in preventing recessions via monetary stimulus. Conversely, the Fed can ensure a recession happens by tightening too much!

The Economy

Shifting our focus from monetary policy to the economy, US economic growth lately has been squarely on consumers' shoulders. Consumer spending likely added about 2.8 percent to second quarter Gross Domestic Product, according to the Federal Reserve Bank of Atlanta's GDP forecasting model. At that rate, the consumer's contribution to GDP would be the highest for any quarter since the end of 2014.

Still, when the GDP report is released on July 26, we may see that overall growth last quarter was 1.6 percent, the slowest since the beginning of 2016. Consumer activity has meaningfully lifted growth, but projections show other parts of the economy withered. The makeup of growth has been unusual year to date, a product of trade uncertainty that has plagued the global economy for more than a year now.

1 CONSUMERS LIKELY CARRIED THE U.S. ECONOMY IN 2nd QUARTER



Source: LPL Research, Federal Reserve (Fed) Bank of Atlanta, Bureau of Labor Statistics 07/18/2019
Q2 2019 is projected GDP data from the Fed Bank of Atlanta's GDPNow Model

Consumer spending has been primarily supported by a strong US labor market. Domestic companies have added jobs for 105 straight months, by far the longest streak on record. Claims for unemployment benefits have been contained, wages have grown at a healthy 3 percent clip, and the unemployment rate remains near a historic low. Fiscal stimulus enacted in 2018 provided an extra boost of income for the consumer through lower tax rates and added tax credits.

Other short-term catalysts have propelled consumer activity as well. Oil prices are lower after a steep sell-off late last year, allowing consumers to allocate more income from gas purchases to discretionary spending. Consumer activity was also weak in the first quarter (thanks to trade tensions and a record-long government shutdown), so we expected to see a rebound in the second quarter solely from pent-up demand.

The United States consumer provided a solid base for GDP growth in the second quarter, but it did not get much help from other sectors in the economy. Business investment, housing, government spending, trade, and inventories are collectively expected to drag down GDP by about 1.2 percent, according to Atlanta Fed projections. Output from trade and inventories alone likely stripped around 1.5 percent from GDP, almost negating their 1.7 percent boost to growth in the first quarter.

Most importantly, US businesses need to step up at this point in the cycle. We've been watching for a pickup in capital expenditures growth, especially after fiscal stimulus' implementation. Year-over-year growth in nonresidential fixed investment has averaged 3.9 percent in this cycle, the second-lowest rate among all expansions since 1970. We saw a healthy pickup in business spending in the first half of 2018, but that momentum fizzled as companies sidelined expansion plans in the face of increasing trade and political uncertainty.

Business investment is especially crucial for growth prospects as the personal income boost from fiscal stimulus wanes over the next few years. Higher capital spending leads to higher productivity, which directly feeds into higher economic output. Productivity also promotes healthy inflation as it keeps employer costs in check.

All the fundamental pieces are in place for resurgence in business spending, but the effect of uncertainty remains. Our team thinks some trade uncertainty will dissolve with meaningful progress in United States—China trade talks, but only if businesses believe it's safe to plan long-term projects. Once there is more clarity on trade, we expect spending to pick up again as companies take advantage of fiscal incentives, record cash piles, and low borrowing costs.

The Financial Markets

> Stocks soar as Fed Chair Jerome Powell hints interest rate cut likely in July - Washington Post

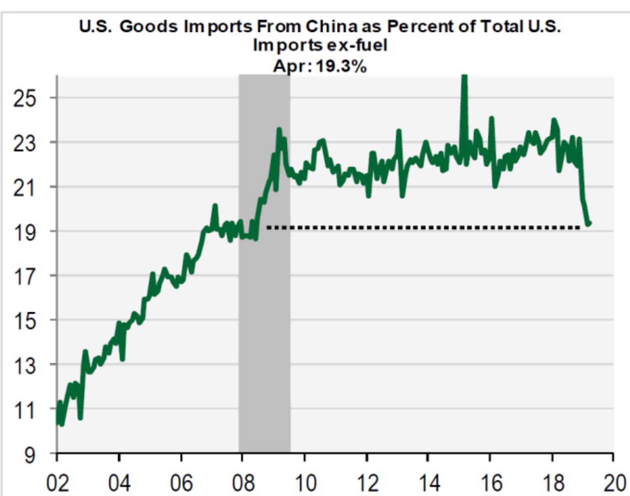
The second quarter of 2019 delivered more gains for investors, (2018 seems like a distant memory when cash outperformed every major asset class!) with the Standard & Poor 500 Index (S&P 500) reaching a new record high of 2,954 on June 20th. While impressive, in order to get there, investors had to endure another bout of volatility:

- Last December's -9.2 percent decline in the S&P 500 was the second worst December loss in over 90 years.
- May's -8.2 percent loss was the seventh worst May performance in over 90 years.
- June's +6.9 percent gain in the S&P 500 was the strongest June in 64 years.
- Overall, the first six months of 2019 experienced the strongest gain since 1997.

President Trump's tariff tweets have created uncertainty and have taken their toll on the global economic outlook due to a 180 degree reversal on the prospects for a trade deal with China in early May. To add fuel to the fire, the president banned US companies from selling any components into China's largest technology company, Huawei. To top it off, he threatened a series of escalating tariffs on imports from Mexico if the Mexican government didn't stop the flood of immigrants into the United States, and then recanted the threat a week later. Trump's stance softened on Chinese trade talks and the Huawei ban following meetings at the G-20 summit, but the damage was done.

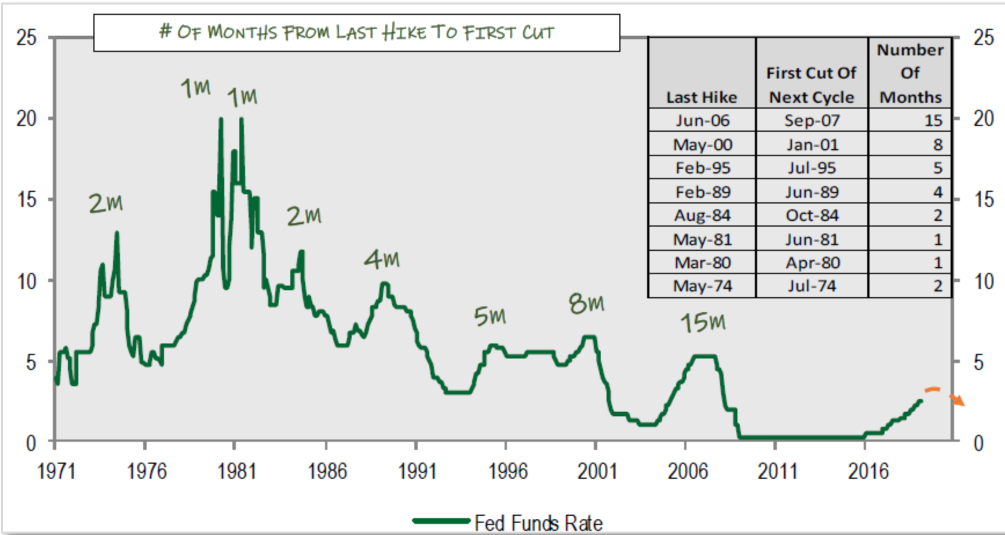
President Trump's tariff tweets created significant uncertainty as tariffs raise costs for US businesses and consumers, disrupt supply chains, invite retaliation, and slow business investment because companies are trying to avoid geographies which are high cost. This thirst for low-cost manufacturing is what caused the mass exodus out of the United States and into China over the past 25 years. However, the labor arbitrage that attracted manufacturers to move their facilities there to begin with is nearly gone when factoring in transportation costs to ship the finished goods to their ultimate destination. After adding the potential for up to 25 percent tariffs on nearly every good exported from China to the US, you have the makings of a mass exodus from that country.

As you can see from the chart below, goods that have been imported from China have taken a precipitous decline this year.



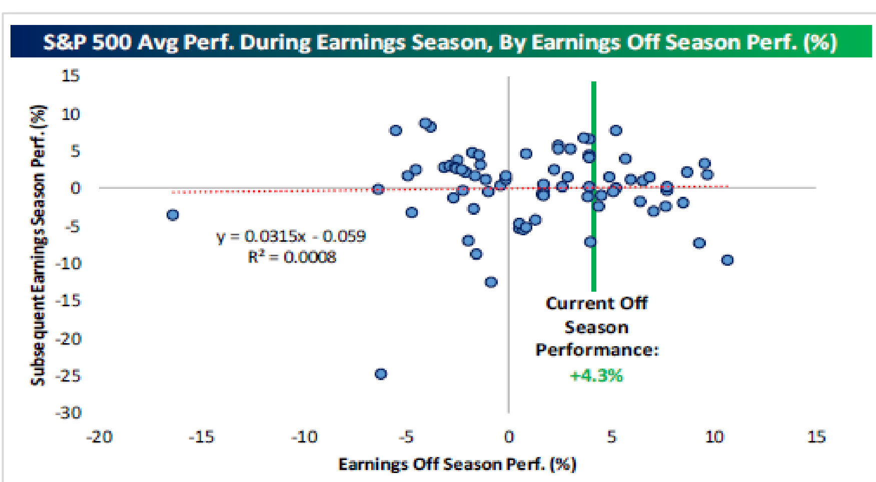
As suggested earlier, the Federal Reserve has come to the rescue of the financial markets. The Fed has indicated that they will be accommodative and lower interest rates as early as their July meeting. What a difference a year makes. Last year at this time, Chairman Powell was on schedule to increase interest rates three more times in 2018, and up to another four times in 2019. Earlier this year, they pivoted and told the markets that they were done tightening.

If the Fed does what's expected and lowers rates this month, then the time from last hike to first cut will be seven months which is par for the course.



With stock prices reaching multiple record highs, we have had many conversations asking whether the gains since June are 'borrowing' from the future, setting the stage for a disappointing earnings season. That could very well end up being the case, but from a historical perspective, there is not evidence indicating strong performance during the earnings offseason has any impact on performance during earnings season.

- The chart below compares earnings season performance (y-axis) to earnings offseason performance (x-axis) going back to 2002. There is virtually no correlation between the two.
- In the 11 earnings off-seasons where the S&P 500 was up between 3 percent and 5 percent since 2002, the Standard & Poor 500 Index's median gain during earnings season was 1.4 percent with positive returns 64 percent of the time.



Moving on to the fixed-income markets, the 10-year Treasury yield continued to decline from its multi-year high of 3.2 percent last October, dipping below 2 percent following the Federal Reserve's June meeting. This was a near three-year low and ended the month at 2 percent. Mounting expectations of a Fed rate cut, persistent low inflation and negative global interest rates (please see chart below) have contributed to this recent decline in yields. In this environment, fixed income advanced across the board with the Barclays Aggregate Bond Index and Barclays Municipal Bond Index each with very strong first half returns, 6.1 percent and 5.1 percent.

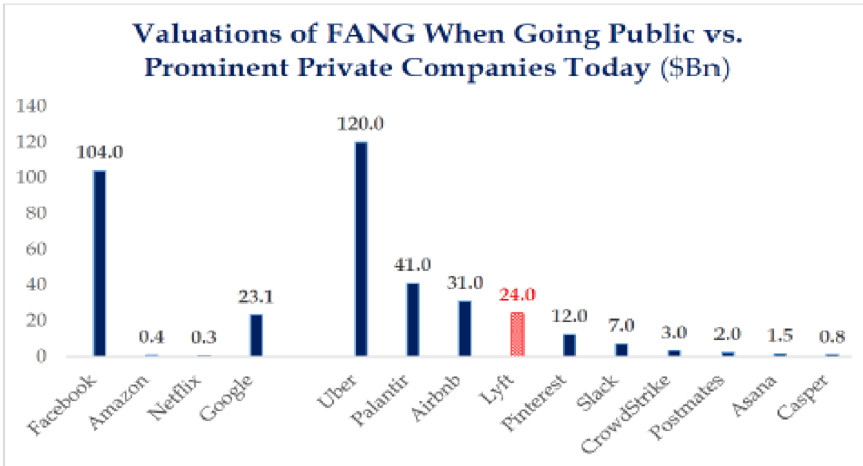
Why are we skeptical of predictions? As further evidence of the consistently poor track record of market forecasters, the consensus of 69 economists and analysts surveyed in January by the Wall Street Journal was that the 10-year Treasury yield would rise to 3 percent by mid-year. None of them predicted the yield would fall below 2.5 percent this year, let alone down to 2 percent!

@CharlieBilello	The Negative Bond Yield Matrix												
Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-0.70	-0.90	-0.90	-0.88	-0.88	-0.80	-0.76	-0.72	-0.73	-0.64	-0.33	-0.17	-0.03
Germany	-0.68	-0.74	-0.77	-0.74	-0.68	-0.64	-0.59	-0.50	-0.45	-0.37	-0.15	-0.01	0.23
Netherlands		-0.72	-0.70	-0.67	-0.60	-0.51	-0.45	-0.36	-0.30	-0.21	-0.01	0.04	0.25
Japan	-0.19	-0.20	-0.22	-0.24	-0.24	-0.25	-0.26	-0.24	-0.19	-0.16	0.50	0.20	0.34
Denmark		-0.73	-0.71		-0.63			-0.44		-0.29			1.02
Austria	-0.60	-0.68	-0.63	-0.57	-0.50	-0.43	-0.32	-0.28	-0.21	-0.10	0.21	0.30	0.62
Finland		-0.65	-0.64	-0.62	-0.55	-0.49		-0.27		-0.10	0.16		0.46
Sweden		-0.57			-0.50		-0.24			-0.01	0.17	0.48	
France	-0.63	-0.67	-0.67	-0.64	-0.56	-0.46	-0.37	-0.27	-0.19	-0.10	0.25	0.48	0.82
Belgium	-0.62	-0.59	-0.65	-0.59	-0.55	-0.45	-0.31	-0.21	-0.16	-0.03	0.24	0.54	
Slovakia	-0.35				-0.28	-0.55		-0.09	0.07	0.13			
Ireland	-0.55	-0.45		-0.48	-0.52	-0.29	-0.20			0.06	0.42		0.98
Slovenia	-0.13	-0.49			-0.33		-0.23			0.13			
Spain	-0.47	-0.41	-0.40	-0.30	-0.19	-0.11	-0.02	0.10	0.21	0.33	0.82	0.84	1.33
Portugal	-0.42	-0.45	-0.34	-0.23	-0.22	-0.02	0.10	0.20	0.33	0.44	0.81	0.99	1.33
Malta	-0.20		-0.17		-0.10					0.52		1.14	
Bulgaria	-0.18		0.02		0.20		0.38			0.50			
Italy	-0.10	0.09	0.51	0.74	0.97	1.19	1.27	1.46	1.48	1.74	2.08	2.40	2.67
United States	1.99	1.87	1.82		1.84		1.93			2.05			2.55

A Picture Is Worth A Thousand Words

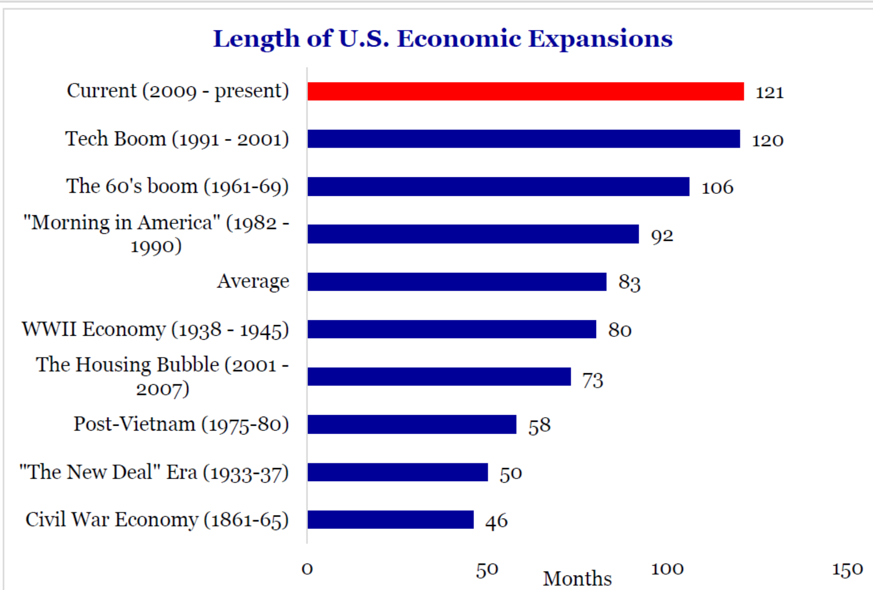
In order to provide you with a shorter read, as everyone's time is valuable, we have included some compelling charts with a bullet point of explanation as to why we think the graphic is important.

So far 2019 has been a big year for Initial Public Offering's (IPO), particularly for companies like Uber, Lyft & Pinterest, to name a few. Unfortunately, many of these IPO's haven't fared well as a publicly traded company. I guess valuations do matter after all.



Source: Strategas Research

The current economic recovery since the Great Depression now has the honor of being the longest and slowest recovery on record.



Concluding Thoughts

As the third quarter gets underway, Wall Street continues to wrestle with forecasting the severity of future ongoing economic softness offset by the likelihood of new policy support in the near future. Financial markets have already posted impressive year-to-date gains and thus may be due for a breather in the near-term, but the much larger risk of the economy falling into recession and driving stocks into a bear market has likely been reduced for now, assuming there is another round of monetary stimulus on the way.

At Next Generation Wealth Management, we continue to execute long-term thinking, patience, and discipline to see how the battle between central banks and economic weakness plays out. In the meantime, we will continue to look for opportunities across all asset classes.

We appreciate your trust and confidence in our team, and are readily available to discuss our thoughts in a personal conversation. Please contact us at (414) 257-4248 to schedule an appointment or visit our website for company news and reports at www.ngwealth.com.

Respectfully,

David

David A. Massart
President

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