AF CAPITAL MANAGEMENT
Registered Investment Advisor

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Perspectives

As a student of the market, I'm fascinated by what's going on in both the stock and bond markets. As an investment advisor and investor of my own funds, I'm starting to get nervous for the first time in over a decade. I don't expect a recession within the next six months, but the probability has risen for an economic slowdown to begin in 2020. While the US unemployment rate is close to historic lows, inflation is tamer than the Fed would prefer. Tariffs are often blamed for the recent economic slowdown, not only because the increase in costs for goods, but also because of the uncertainty the rhetoric has caused for businesses that are having a hard time planning for future projects.

The next recession is coming, but when? "Yield curve inversion" were the buzz words that swept business news and nightly news when the stock market dipped in August and prompted calls that the next recession had already begun. The narrative was that the yield (think interest rate) on the 10-year Treasury note falls below the yield on the 2-year Treasury note before a recession, so everyone should hold onto their hats and be ready for another disaster. Of course, media needs to sell these headlines to keep eyeballs on their screens, but most news anchors left out a key part of the story. While the yield curve does invert before recessions, this signal can be as long as two years before a recession begins, which makes it irrelevant for now. Since the average bull market lasts four and a half years, it's hard for the signal to be wrong given a window open long enough. As one commentator put it, if the S&P 500 finishes on an even number two days in a row, we'll get a recession within the next few years. In other words, it's a static event that has no bearing on how to invest this year.

The same voices that yelled for recession were quiet when data turned more positive. Once the mini panic of August ended, the S&P 500 pushed higher in September before cresting only a few points shy of its all-time high reached in July. Although the yield curve inversion is moot for now, it doesn't mean the coast is clear from other challenges. Manufacturing reports indicate a contraction. The US is in a trade war with China and is adding Europe to our trade opponents in a few weeks with new tariffs scheduled. Our president is facing an impeachment inquiry and we have a major election in 13 months. The markets hate uncertainty and uncertainty is what we have on the schedule for the foreseeable future.

What we do know is that the US economy is growing much better than the economies of Europe and Asia. Our growing economy and higher interest rates have created demand for the US dollar. A stronger dollar hurts exporters because our goods cost more for those buying our goods using weaker currencies. Typically, importers benefit from a stronger dollar since it means we have to use fewer dollars to buy foreign goods, but the growing tariff costs have muted that benefit and even turned it into a negative. Parts of Asia and Europe began lowering their interest rates years ago to stimulate their economies. Once these interest rates hit zero and offered little to no stimulus to their economies, their central banks turned rates negative. Negative rates mean that investors have to pay to have their money invested versus being paid to loan money to the government. As a specific example, investors who buy German Bunds lose 0.79% each year on the 2-year notes.

Some vocal critics of the interest rate path taken by the Federal Reserve believe US interest rates should be lower to compete with other countries' negative rates. This stance is logical since lower rates tend to stimulate the economy, however interest rates face a point of diminishing returns. A CEO who is reluctant to invest in a new factory while rates are close to 1.5% in an expanding economy with low unemployment is not more likely to make that investment if rates were 0.5% lower. The decision not to expand operations comes down to predictability in the economy more than interest rate levels and with the issues cited above, little in the economy is predictable over the next 12 months.

Based on the results from the negative interest rate "experiments" other countries have attempted, many economists believe negative interest rates do more harm than good. Rather than stimulating investment, banks are less likely to loan money at negative rates because their profit margins are minimized while the risk of defaults is boosted during weaker economic conditions. The second part of the argument against negative interest rates in the US is that while growth has slowed, unemployment is extremely low and the economy continues to expand. With the unemployment rate at 3.5%, the economy has little room to improve with additional stimulus. If we move to negative interest rates during a growth period, the Fed will have few other tools available when, not if, we reach the next recession. Lowering rates much further could provide a short-term boost to stocks, but the easy money will set us up for a deeper recession when the economy reverses.

The question becomes, why are stock prices so close to all-time highs in the face of such constraints? This is where it gets more interesting. Thanks to low interest rates, corporations have been able to refinance debt at lower levels and reduce their costs. Some of this low-cost debt is used to buy back their stock shares, which reduces their dividend burden and cuts costs even further. At the same time, stock buybacks also help to put a floor on falling prices when the markets face a correction because the corporations continue to buy when other buyers flee the market.

Individuals have used lower interest rates to refinance mortgages and to buy houses that have continued to provide price appreciation. Lower interest rates allow monthly payments to remain level while the size of loans increases. Investors who need income from their investments during retirement are forced to buy dividend paying stocks instead of bonds. At the same time, bond yields are pulled lower by foreign investors who are searching for yield outside of their own countries' negative rates. (Bond prices and yields move inversely.)

All of this activity works until it doesn't. At some point, like every previous bull market, the risk of investing will outweigh the potential reward. The trigger for each collapse changes every cycle, but it will hit the markets again. Until then, investors should remain diversified (possibly with shorter duration bonds versus more volatile longer-duration bonds), not invest more than they can tolerate losing before the next positive business cycle begins, and remember that when the next bear market surfaces that it will reverse again and a new bull market will begin after the froth is worked out of the system.

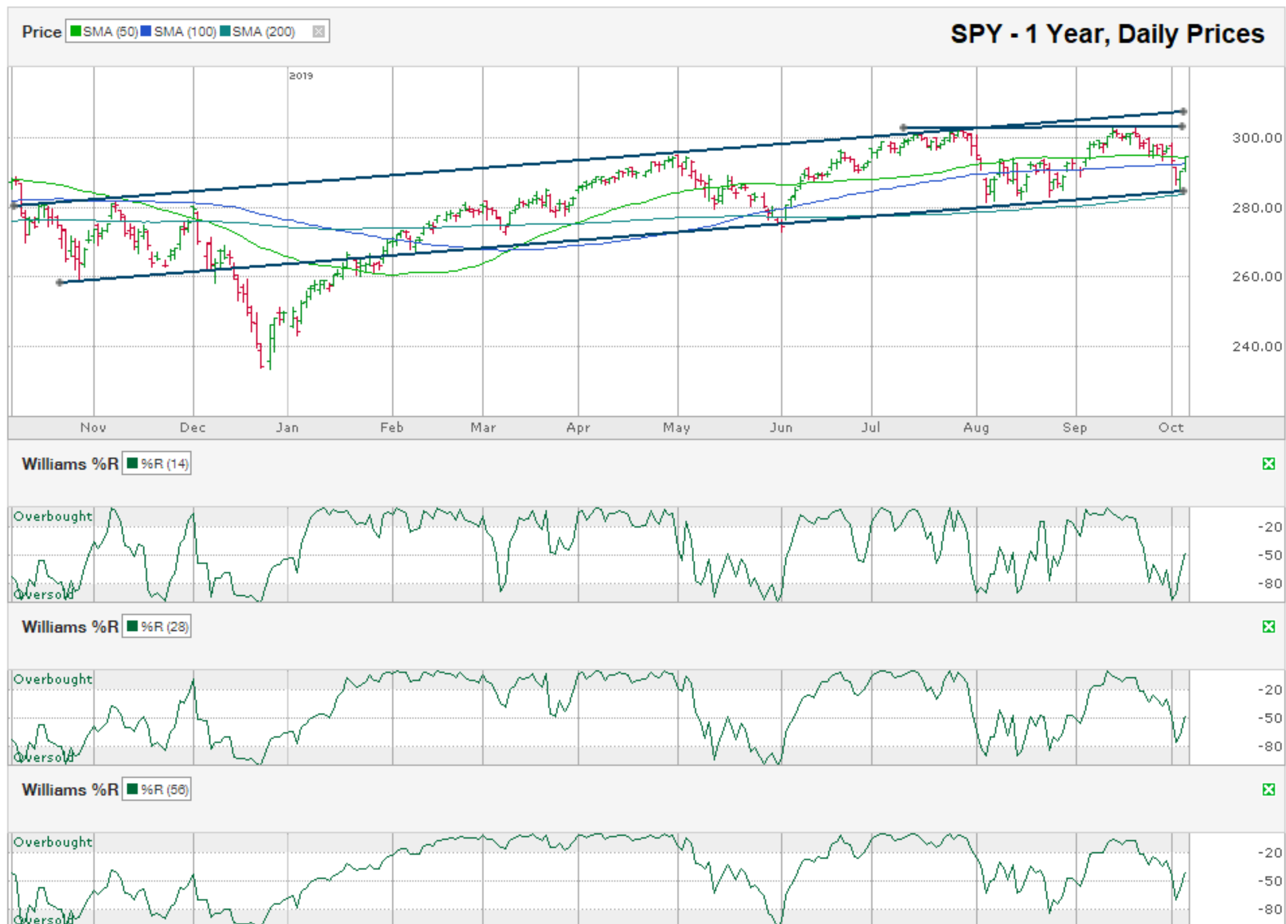
Many investors expect a trade deal in the first quarter to set up a strong rally into the election. The contrary view is that a deal that removes such a major hurdle for the economy could be the catalyst that pops the current bubble and ends up being a "sell on the news" event. Removing some riskier investments before the bubble bursts in favor of stronger cash positions now could serve investors well in the long-term.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	10/4/2019	16.06	2.23	16.25	12.04
NASDAQ Composite	10/4/2019	20.30	1.31	14.70	12.27
Russell 2000	10/4/2019	12.49	-7.54	8.03	7.80
S&P 500	10/4/2019	19.59	3.83	13.39	10.70
S&P MidCap 400	10/4/2019	15.96	-2.27	9.22	8.63
Global Stock Indexes					
MSCI Emerging Markets	10/4/2019	3.19	-1.37	2.86	-0.01
MSCI World, Excluding US	10/4/2019	11.46	-1.36	5.80	3.26
Bond Indexes					
Core Bond	10/3/2019	9.09	11.50	3.13	3.53
Intermediate Core Bond	10/3/2019	6.63	9.36	2.58	3.14
Long-Term Core Bond	10/3/2019	19.06	22.01	5.20	6.01
Short-Term Core Bond	10/3/2019	4.53	6.00	2.14	1.91

Index Chart & Analysis



The chart above shows the daily prices for SPY, an S&P 500 ETF, after closing the week at $294.35 on October 4, 2019. SPY has traded in a defined trading channel for the past year, except for the brief and harsh correction that hit stocks last December. Once stocks recovered from the panic selling, the large-cap index remained in a tight range for the next eight months and appears to have fought off the most recent attempt to push it below its trend line of higher lows.

This trend line of higher lows closely follows SPY's 200-day moving average, which aided in offering support for falling prices. After finding support and bouncing off the intraday low on Thursday morning, SPY charged past its 50 and 100-day moving averages before the week of trading ended. Some of this rally was due to the increased probability for another interest rate cut that some traders still believe will benefit stock prices. Part of it was buying by algorithms and short covering triggered by the technical support noted above. The rest of the cause can be attributed to the idea that we might not be as close to a recession as some feared and traders didn't want to miss out on further gains.

A retest of the 200-day moving average and the trend line of higher lows is possible before SPY pushes to new highs, but until these technical indicators break support, bulls don't need to join the selling frenzy. If SPY can remain above its 50 and 100-day moving averages this week, it will begin to climb towards its trend line of higher highs and then repeat the pattern until one side breaks out.

Just as in August, SPY's Williams %R indicator did not signal that the ETF reached a complete capitulation last week. The 14-day indicator reached deeply enough into the oversold section for a technical reset of sentiment, but the 28 and 56-day indicators left technicians wanting more clarity. This lack of clarity is not a negative for stocks, but it's not a positive either. It only leaves an opaque view of what could come next.

Traders should continue to follow the trend lines for guidance and remain ready to act quickly in either direction when the trend lines, moving averages, and the Williams %R indicators align again. All trading patterns and price trends come to an end eventually. Until that day, traders have little reason to abandon what has worked so far.

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