Rochester Financial Services

Fee-Only® Financial Management Services

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Dow Jones	S&P 500	NASDAQ	Russell 2000	10 yr Treas	Earnings Yield (S&P)	Gold	Crude Oil
25,332	2,803	7,527	1,509	2.12%	6.06%	$1,331	$53.04

Investment Strategy Report

Stocks Suffer First Down Month of 2019. Will Today's Advance Reverse the Downturn?

After a strong 4 month start to the year, stocks suffered a severe pull back in May. The S&P 500, which had been up 18.2% through the end of April, was down 6.4% for the month. It was followed by the Dow, down 6.7%, and the Nasdaq and Russell 2000, both down 7.9%. Not a fun month. As a result, investors, who had begun to feel pretty good as stocks hit new highs, reversed course and began reaching for the panic button. The level of fear rose significantly.

So what caused these substantial declines so soon after hitting record highs? The blame was first thrown at the China tariffs, as the trade war with China heated up and hope for a quick resolution faded. Threats of tariffs on Mexican goods at the end of May didn't help matters. However, we have faced trade war fears for quite a while now, and these concerns had not derailed the market advance. What really spooked investors in May was most likely the somewhat scary drop in interest rates. The 10 year Treasury yield hit a low of 2.08% yesterday. The yield began the year at 2.7% and was at 2.5% at the end of April. Was the precipitous drop an indication of a global slowdown?

Low interest are, in general, good for the economy. With lower interest rates, loans are easier to get which spurs business investment, and mortgage rates drop, encouraging home buying. What appears to have happened is that while interest rates were dropping, the Fed showed no signs of moving from their hawkish stance on the Fed Funds rate. With that rate at 2.40%, it is materially higher than the 10 year Treasury yield. This is what is referred to as an inversion of the yield curve. With a 10 year yield of 2.1%, the Fed Funds rate should be significantly lower, not higher. A Fed Funds rate of 2.0% or 1.75% would be much more accommodative. Since an inverted yield has signaled (if not caused) recessions in the past, investors took their cue and decided to lighten up.

The good news is that we saw stocks spike higher today, with the major averages up from 2.1% to 2.7%. There were several reasons for this. 1) We heard some favorable remarks about the trade war from the Chinese ministry today. 2) We also heard from a Mexican foreign minister saying that he felt that there was an 80% chance that the dispute with the US will get resolved. But the most likely spark for today's rally came from 3) Fed Chairman Jay Powell who said that he is monitoring the trade wars and will act as appropriate to sustain the expansion.

This latter statement is similar to what the Fed said in January, the almost apologetic statement about being too restrictive in December. This led to the dramatic advance of stocks in January and might have been the key to today's rally. This and the fact that investors had gotten too negative. While the threat of a global slowdown still exists, the fundamentals point more to continued growth and an almost goldilocks economy.

There is plenty of good news about the economy that investors seem to be ignoring. In Fritz Meyer's latest economic update (5/14), he pointed out that 1) the 1st quarter 3.2% GDP growth was way above forecasts, 2) as was the 3.6% productivity growth. 3) The May jobs report was very strong (263,000 new jobs) while inflation is 1.5%, below the Fed's target of 2%. Based on S&P 500 earnings estimates, he forecasts that the index should hit 3,000 in 2019 and 3,400 in 2020. We are experiencing strong growth with low inflation, an ideal set up. Fritz quoted Fed Chairman Powell's statement from the last FOMC meeting "There is no reason to think that this cycle can't continue for quite a while". Fritz added that the Fed has engineered every recession. So unless the Fed blows it, we should be OK.

Also in the bull camp is Bob Brinker. He issued a strong stock market buy recommendation on May29th, saying that the S&P 500 is very attractive in the 2700s. *Jeff Feldman*

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