JMK

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Private Wealth Management

Quarterly Investment Commentary

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Glorious Summer

The longest days of the year are already behind us. There is still plenty of summer left, but the daylight hours will start to fade at the edges as the Earth completes the back half of its annual orbit around the sun.

It remains to be seen if markets will fade as well. Thus far, financial markets and risk assets have enjoyed a somewhat bumpy but rather remarkable recovery from the winter of discontent felt late last year.

Federal Reserve Chairman Jay Powell channels Richard III

Then, investors worried about trade, monetary policy, Brexit, government shutdowns, and geopolitical risks.

These concerns are still with us, and global economic data has deteriorated since last year. But investors have opted to look on the brighter side of things, largely because of a significant change in the direction and outlook for monetary policy by the Federal Reserve and other Central Banks. Easy monetary policy has trumped trade concerns and restored glorious summer to markets, at least for a while longer.

Year-to-date, the U.S. stock market, as measured by the S&P 500 Index is up 18.5%. Non-U.S. stocks are up 13.6%, Emerging market stocks are up 10.6%. Bonds have also had a good year: high yield bonds are up 10% and the Barclays Aggregate Bond Index is up 6%. Even gold is doing well for a change, up 9.9% for the year. Against a barrage of conflicting economic and geopolitical news, investors have embraced risk-oriented assets and pushed markets higher. It's been a remarkably good year so far, at least with respect to market returns.

Where we go from here depends on several factors, but our central thesis is that markets continue higher into next year.

The largest factor is trade. We have already seen a weakening in economic fundamentals around the world, largely because of uncertainty regarding global trade. The major axis of conflict is between the U.S. and China, but these are the two largest economies in the world and there is a spillover affect that impacts almost every other economy. We can see this in the deterioration in manufacturing and services data around the world since the middle of last year.

It is hard to tell how much of the present weakness in global economic fundamentals is temporary, the result of uncertainty about trade and tariffs, and how much is a more enduring sign that the current economic cycle is drawing to a close.

Our sense is that it is more the former than the latter and that global economic growth can pick up if a lasting trade agreement – or at least a détente - between the U.S. and China can be reached. We expect that this is what will happen as it is in both sides' interests to de-escalate and postpone the thornier issues for another time. President Trump in particular, has a self-interest in maintaining a strong economy and stock market heading into the 2020 election.

With the threat of additional tariffs removed, at least for now, and central banks focused on supporting economic growth, the global economy has room to improve if allowed to do so.

In the U.S. we expect economic growth to slow and stabilize in the coming quarters. Growth last year got a boost from the 2017 tax reform, and also perhaps from businesses building inventory in advance of potential tariffs going into effect. These boosts have largely run their course and it is natural that growth would slow in their absence and revert back to a slower baseline level.

Meanwhile, business fundamentals are generally healthy. Unemployment is at 3.6%, its lowest level in 50 years, and there are few signs of inflation. Increases in wages continue to be offset by increases in productivity. The housing sector is in healthy shape and will likely rebound as mortgage rates decline. Corporate debt levels are high but manageable, especially with lower interest rates.

Typically, recessions are caused by significant economic imbalances, such as the housing and dot-com bubbles in 2007 and 1999, or a rapid increase in interest rates to counter inflation. For the time being, we do not see either of these preconditions in place and therefore think that the U.S. economy is more likely to chug along unless disrupted by a significant change in current conditions.

Outside of the U.S., China has started to ease credit conditions to boost economic growth. Much of this effort is aimed at stimulating domestic consumption, but it will have a positive spillover effect for Europe and Emerging market economies.

The stock market has rallied in part on the belief that some trade agreement will be reached and that the Federal Reserve has committed to a much more dovish monetary policy path. Markets have now priced in the expectation that the Fed will be lowering the Federal Funds rate several times this year. Given the strength of the underlying economy and the absence of inflation, it is hard to argue that the Fed needs to lower interest rates at all unless things take a turn for the worse. Current interest rates are not high enough to prevent any kind of sensible investment, or reasonable consumer spending. It is also questionable whether lower short-term rates have much productive impact on the economy. They drive prices of stocks and other risk assets higher, which helps overall sentiment, but they also increase systemic economic risk through higher levels of borrowing and higher valuation levels. They make the overall economy more vulnerable to external shocks.

And so, we are somewhat nervously optimistic for the time being. As long as current trade disputes can be put to bed, and no new ones are started, we expect global growth to pick up modestly in the U.S. and also in Europe and Asia. Supported by low interest rates around the world and improving economic fundamentals, the prices of risk assets including stocks and real estate should trend higher.

Eventually, we think that Central Banks will succeed at creating some actual inflation as excess productive capacity is used up and a scarcity of workers and other resources drives prices higher. At that point, the Federal Reserve and other Central Banks will have little choice but to step on the brakes and start raising interest rates. This will likely lead to both a recession and the next bear market. Just not today.

Current valuation levels for stocks are full but not extreme. Outside the U.S., valuation levels are more attractive but economic fundamentals are more challenging. We find Emerging markets and especially China more interesting and attractive than Europe, and with a lot more potential for long-term growth.

Given current valuation levels, as well as the risk that things play out differently than current expectation, we remain reasonably fully invested relative to our long-term allocation targets but are maintaining a layer of more defensive alternative and bond investments that can be redeployed into stocks when better opportunities present themselves. They almost always do.

We still favor global investments targeted on technology, life sciences, and emerging markets, and other areas of long-term growth, balanced by more defensive equity, alternative, and fixed income strategies to mitigate volatility and risk.

As always, we welcome your comments, questions and referrals.

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Based in the San Francisco Bay Area, Jurika, Mills & Keifer provides wealth management, planning and advisory services to a limited number of individual, families and foundations.

We combine a forward-looking view of the world with a deep understanding of our client's needs and aspirations to build and preserve wealth and financial well-being over time.

Over the years, we have built a reputation for independent thinking, sound judgement, and a high level of individualized advice and service.

We welcome the opportunity to discuss your financial priorities and goals and how we can help you achieve them.

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