MANAGED ASSET PORTFOLIOS

MAP VIEWS

Second Quarter 2019 Review
Third Quarter 2019 Preview

When good news is bad news, and bad news is good news

Six short months ago, the economy was enjoying its best performance in recent memory and the Fed was talking about raising interest rates three or four times in 2019. The possibility of higher interest rates spooked investors, sending stock prices tumbling. In the first half of 2019, growing concerns of a trade war between China and the U.S. put downward pressure on the economy, prompting the Fed to shift gears regarding interest rates. Instead of raising rates this year, there is increasing optimism that the Fed will actually cut interest rates this year. Prospects for lower interest rates have fueled a stock market rally, sending many of the major averages to record highs, while bond prices tumbled lower.

Globally, stocks pushed higher, despite the escalation of tensions between the U.S. and China. In the U.S., technology stocks led the way, allowing for domestic markets to enjoy their best first half of the year since 1997. Much of the rally in the U.S. was centered around a handful of large tech stocks. Microsoft, Facebook, Apple, and Amazon combined accounted for 19% of the S&P 500's total return during the first half of the year. These outsized returns, concentrated in a few tech names were also experienced in 2017 and for the first three quarters of 2018, until of course they took a nasty tumble during the fourth quarter of last year. These companies have reported impressive growth, even in the face of what has been a rather lackluster economic recovery. Accordingly, investors have gravitated toward these names, pushing them higher and higher.

Yields on the 10-year U.S. Treasury bond traded within a whisper of 3.25% in November of last year. Today, they are now approximately 2%. As meager as that sounds, it looks downright generous relative to other countries. Over $13 trillion of bonds around the world (mostly Europe and Japan) are trading with negative yields. In 1996, then Fed Chairman Alan Greenspan used the term "irrational exuberance" to describe lofty stock prices. Today, the same phrase could be used to describe bond prices. To provide an example of the insanity of the bond market, consider the government of Austria, which sold "Century bonds" with a 2.1% coupon nearly two years ago. A few weeks ago, Austria sold a second tranche of these bonds priced at 154.047, providing a meager yield-to-maturity of 1.171%. Keep in mind the maturity is September 2117! Should the yield on these bonds merely go back to where it was less than two years ago, investors would be looking at losses of around one-third of their investment. Upon examining the holdings of a large international bond fund, we found 18 of their 30 largest holdings carry negative yields-to-maturity, and represent nearly 40 percent of their total holdings.

For our Global Balanced Composite, we are keeping our mix between stocks and bonds relatively even, while maintaining short maturities. Our weighted average maturity for our portfolios is slightly below one year, and we are generally not purchasing bonds with maturity dates beyond three years (up from two). Given a dovish Fed, it is unlikely that rates will move sharply higher over the foreseeable future. However, given the flatness of the yield curve, the risk/reward ratio for extending maturities, in our opinion, is not favorable. To highlight this, let's compare the yields on US Treasuries. As of July 26th, the 20-year U.S. Treasury bond yielded 2.58%, while a one-year T-bill yielded just under 2%. We do not see the attraction of owning a bond with an additional 19 years to maturity (while taking on the corresponding interest rate risk) in exchange for just 60 more basis points of yield.

Despite stock indices near record highs, we are still able to find some stocks with valuations that we believe offer investors the potential for favorable returns. Selectivity is the word we would use to define what it will take to be a success on the investment front going forward. Given the strong stock market performance during the first half of the year, it would be surprising to see it continue at the same clip it enjoyed during the first half. However, with a dovish Fed and ECB, we do not foresee a bear market in the near-term. Stock valuations appear a bit rich, albeit not excessive. There are some names, such as recent high-profile IPOs that command valuations, which we view as exorbitant.

Assuming the U.S. and China can come to terms on a trade deal, we believe the U.S. economy can continue to chug along at a 2 percent clip. We do believe both sides will eventually agree to a deal, as both parties have too much to lose should an agreement not be reached. Failure to reach a deal would likely push the U.S. economy into a recession, something President Trump wishes to avoid, especially in light of the fact that November 2020 is right around the corner. President Xi, on the other hand, is grappling with a weakening economy coupled with civil unrest in Hong Kong, and therefore, would probably prefer to get a deal done sooner rather than later. As we have stated before, we believe the key to any agreement, from the U.S. perspective will be intellectual property protection. As we have addressed in previous MAPVIEWS, we view it as very difficult to bring manufacturing back to the United States. China is losing manufacturing jobs to Vietnam, as they have a lower cost of labor. It is very difficult to imagine the U.S. gaining much traction in the manufacturing space in such an environment given that we are far from being the low-cost producer. The crown jewel for the U.S. today is its intellectual property. Over the years, U.S. technology firms have lost literally billions of dollars to piracy and theft.

We hope everyone has a safe and enjoyable summer. Thank you for allowing us the opportunity to serve as your investment manager. Rest assured, we work diligently and ethically every day, seeking out the best risk-adjusted opportunities for our clients.

Managed Asset Portfolios' Investment Team

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