KayneCast
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Episode 76

Market Review First Quarter 2019

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Intro: Hello, you're listening to Kaynecast, a podcast that provides commentary on the economy and financial markets every quarter by the Kayne Anderson Rudnick investment management team.

Jordan: Hello, this is Jordan Greenhouse, Managing Director with Kayne Anderson Rudnick, and with me today I have Doug Foreman, Chief Investment Officer here to discuss the first quarter of 2019, as well as a Market Outlook moving forward. Doug, first and foremost, thank you for taking the time today to discuss the first quarter of 2019 with us. Over the last six months we have seen quite a market reversal take place. Can you walk us through some of these key drivers that took place in the moves from the end of the fourth quarter last year going through the first quarter of this year in 2019?

Doug: Hi Jordan, Happy to be here today.

Doug: Well it's been quite a volatile six months, since really early September of last year if you will, and let's talk about what caused the volatility and the downdraft in the fourth quarter of last year and then walk through why that's been reversed in the first quarter of this year. One of the principal problems in the last quarter of 2018 was that the Fed was still bent on raising interest rates in an environment where growth rates were clearly slowing, both globally and in the U.S. What the market was looking at was a slowdown in Europe that had been going on really since the beginning of 2018. China had been decelerating fairly rapidly over the course of 2018 as well, which put some downward pressure on emerging markets and even in the U.S. areas that were sensitive to interest rate increases like Autos and Housing saw a major downdraft in their business activity in the first half into the third quarter of 2018. So the market was concerned about the sustainability of growth and the possibility of a recession and wanted the Federal Reserve to back off on interest rate increases. The Fed was somewhat reluctant to do this in the fourth quarter of last year and culminating in their December meeting where they still insisted on doing at least two rate increases in 2019. So the market was not prepared for this, wasn't ready for this, didn't believe that the Fed was doing the right thing and was very concerned about the Fed potentially pushing the U.S. economy even into a recession over the next year or two given the interest rate activity that they were talking about. So that was the first and biggest problem.

The second problem was that trade issues were still dragging on a lot longer than we and other investors thought and really no resolutions were being made in the fourth quarter of last year. It wasn't getting any worse in terms of trade but it certainly wasn't getting any better and this has had a downward and deleterious effect on global economic activity as well, which further exacerbated slowdown fears.

And then the third thing was what third quarter earnings were reported in the October/November time period it was pretty apparent to investors looking closely to the numbers like we do that business activity was slowing even in the U.S. So the robust activity that we saw in the first half of 2018, while activity was still ok, it clearly was slower than what we saw in the first half of the year, further adding to fears about a global slowdown and even a slowdown in the U.S. and U.S. economy.

So the reason the market rebounded in the first quarter of this year so strongly was that these three factors really went the other way. So what you saw in early January was the Federal Reserve completely backed off on the two rate increases for 2019 and basically said we're going to do none in 2019. We're going to be data dependent, we're going to pause, we're going to be patient, we're going to wait and see. Look at whatever terminology you want to look at but the bottom line is the bet was on hold. So this was good and in line with what the market was hoping and thinking that the Fed should be. So that really united the rally that we saw and started the rally in the first quarter that started in early January. The second thing that happened is that trade issues, which had been getting not worse but not better in the fourth quarter of last year, are actually starting to get better in the first quarter of this year where it became apparent that both sides, President Trump and China both wanted to reach a deal and were willing to start to work towards doing that. So while this deal hasn't been consummated, we still have some kinks to work out, I think and there still will be some headwinds along the way. The fact is at least the talks are headed in the right direction and we made some major improvements, it appears in the first quarter. That also helped improve business confidence and the confidence in the sustainability of the outlook for corporate earnings going forward. And the last thing we saw was fourth quarter earnings which were largely reported in the late January through the middle of March time period. Fourth quarter earnings, while they weren't great in absolute terms, they were certainly better than what people had been fearing given the slow downs that we saw in these various markets and so corporate profitability is continuing to hang in there very very soundly even in a lower growth environment that we're clearly in today. So those are the principal reasons that we saw such a large rebound after a big sell-off in the fourth quarter and such a large rebound in the first quarter.

Jordan: Doug, on a global level can you take us through some of the changes you're seeing, specifically related to the slowdown we are starting to see in China along with the ongoing concerns related to the Brexit situation?

Doug: As I mentioned earlier, Jordan, China definitely slowed down during the course of 2018 and the country has taken some fiscal and monetary measures to try to at least stabilize growth here in 2019 and we think they are starting to become successful at doing that. But I think it's really important to keep China in perspective. The slowdown in China has turned their GDP from growing at a high 6% rate to a low 6% rate according to most economists, forecasts. That's still an enormous growth rate for an economy of China's size which is the second largest economy on the planet these days. So China in many absolute sense is still doing extremely well. In fact, every year they are producing the equivalent of a new Netherlands in terms of GDP within their own country. So this is an area that is still growing by any absolute standard, although clearly the growth rate itself did slow last year. As I mentioned earlier what we're seeing this year is we're starting to see some stability. It's too early to call it a meaningful recovery but it's entirely possible that given the easy comparisons we're going to see in the second half of 2019, that business activity may actually start to accelerate in China over the next 12 to 18 months from here. But it looks like at least we're in for a period of stability and with that type of growth rate, as long as it's stable, that should be pretty good for global markets.

Brexit on the other hand has continued to drag on. It's been two years plus in the making. It looks like now it's going to be delayed even further into 2020 possibly. But my point about Brexit is when even bad news hits on Brexit almost daily, it has almost zero impact on the U.S. market and it's having very little impact even on the U.K. market these days. So anybody that's concerned about Brexit is long gone in the equity market so I think there's minimal risk from that whatever that ends up doing and I think the risk of a hard Brexit continues to be extremely low and even if the hard Brexit occurs, companies now have had enough time to prepare their businesses and all have contingency plans in place on what they're going to do if in fact that happens. So I think that helps mitigate the downside even if that worst case does materialize, which as I mentioned before I think is highly unlikely anyway.

Jordan: Doug, my last question relates to a conversation we've had in the past related to the inverted yield curve. During the first quarter we did see parts of the Yield curve go inverted. What I hoping to do is get your perspective on why investors may need to pay attention to this and if there are specific things that investors should consider if and when this were to continue to occur?

Doug: Well, an inverted yield curve is clearly a negative for the equity markets and for future of business activity. And the reason I mention to most of the clients that have heard me speak at some of these client events before is that nobody is going to borrow money at say 3% and loan money out at 2.5% and take credit risk. And so when the yield curve inverts and short-term interest rates are higher that long-term interest rates, that's the proposition that lenders are faced with. So of course they shut their lending doors and ultimately that has a negative impact on business activity as people, small businesses and others that are relying on credit for working capital and starting businesses gets shut down and unable to take funds. So many fixed income pundits will talk about the technical reason the yield curve's inverted and why that doesn't mean anything because it's all technical, to me it misses the whole point. The point is, if in fact the yield curve is inverted, lending is going to slow, business activity will slow. It takes time, it doesn't happen overnight. It usually takes about 12 to 18 months to actually be felt in the real economy. But it is a leading indicator to be very concerned about if in fact it inverts. Now what we saw at the end of the first quarter was the 3-month T-Bill, which is what the Fed controls, was higher than the 10-Year Treasury which is controlled by the marketplace. So that's a negative sign but remember the 3-month is largely controlled by the Fed. So if this persists and if this continues I think the message of the market is that the Fed is still not where it needs to be in terms of interest rates and it should lower rates even, a quarter to a half point so that the yield curve starts to steepen back up and get more normally-shaped so lending and business activity can continue unabated.

So time needs to pass. It's gone in and out of inversion a few times over the last six months. But I think the key is the Fed is not likely to cut rates unless this persists for three, four, five months in the future and that's debatable whether that's going to happen or not. So it's something to keep any eye on but it's not the end of world as of right now.

Jordan: Once again, I've been speaking with Doug Foreman, Chief Investment Officer of Kayne Anderson Rudnick on his thoughts for the First Quarter of 2019 as well as the overall Market outlook. Thank you Doug for your time and valuable insight you bring to our KayneCast listeners.

Doug: Well thanks for having me today Jordan.