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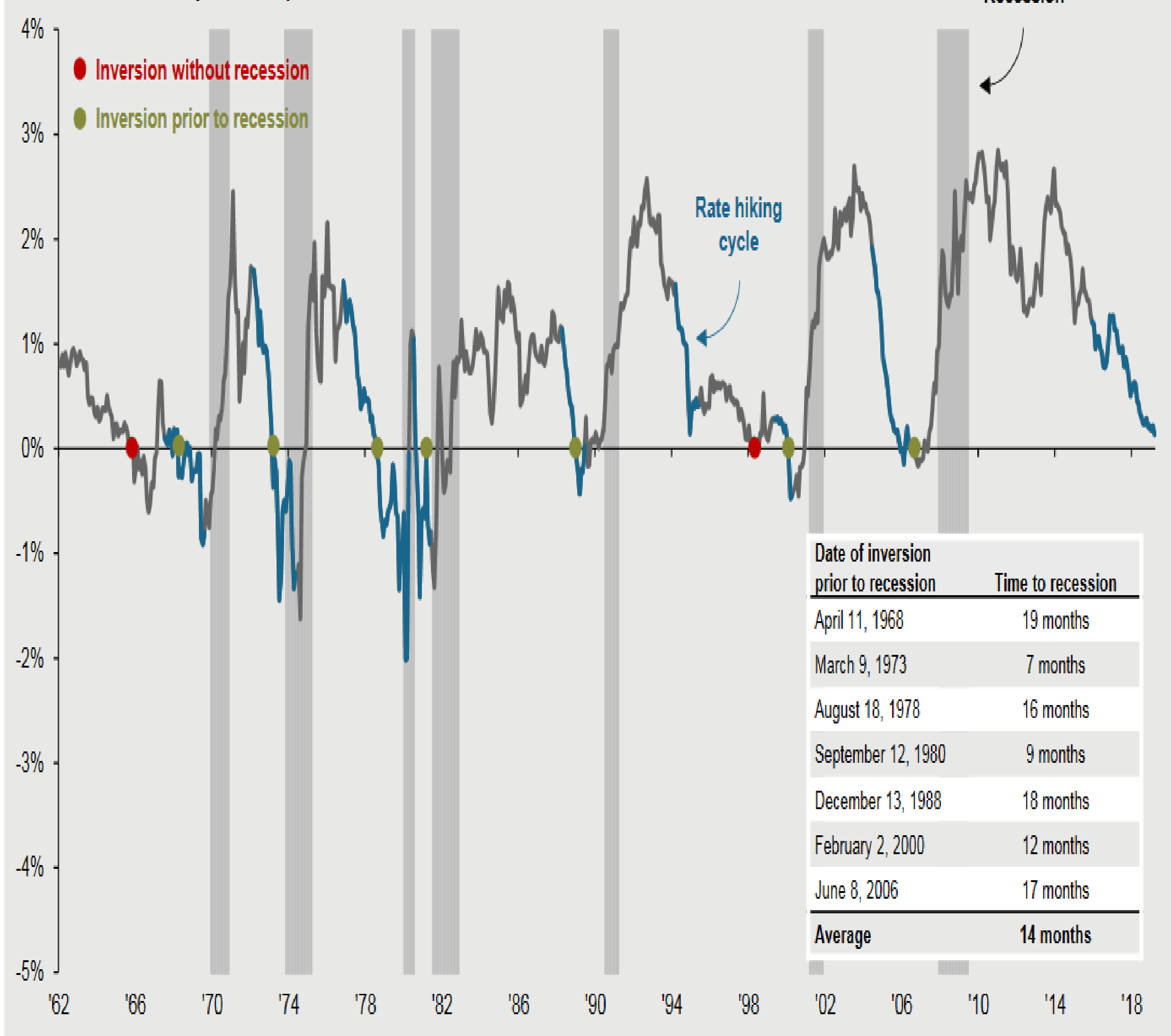
Q2 2019 Market Commentary-
Federal Reserve Pauses Interest Rate Hikes and the Market Rallies

After a large sell off last year, the equity markets have rebounded nicely in the first quarter. Many factors affect the equity markets including trade, tariffs, taxes, political infighting in Washington, and corporate earnings, but the biggest factor affecting stocks has been interest rates. We mentioned in our last commentary that we believed the Federal Reserve had raised interest rates too far, too fast and it was beginning to harm the economy. We believe that the steady stream of nine interest rate hikes helped create an interest rate inversion (a very negative economic indicator) this year, and that the Fed's back peddling on interest rate policy this year is the leading reason for the market's advance. In this commentary, we discuss the interest rate inversion, as well as some issues that we think will affect the market later this year including the large number of IPO's (Initial Public Offerings) slated for this year. We also discuss the upcoming presidential elections and the uncertainty it will bring.

An interest rate inversion is a situation where short term rates are higher than long term rates. In a normal market, short term rates are lower than long term interest rates because investors expect to be paid more if their capital is tied up for longer periods of time. On March 22nd this year, for the first time since mid-2007, the three month U.S. Treasury interest rate moved higher than

the 10-year U.S. Treasury rate which created an interest rate inversion. Worth noting is the fact that this the longest stretch of time since the early-1960's without an inversion (JP Morgan Asset Management).

The reason that Wall Street pays so much attention to interest rate inversions is that interest rate inversions have predicted all nine U.S. recessions since 1955. The primary reason that interest rate inversions have been such a powerful forecasting tool is because they affect the profitability of bringing new capital into the economy. When shorter-term rates are below longer-term rates (a normal curve), banks can lend profitably as they earn the spread by borrowing at the short end and lending at the long end. As a review, banks borrow money from individual depositors who keep checking and savings accounts at the bank. The banks pay a low interest rate to these savers, and then take their savings and lend it long term for items like cars loans and home loans at higher rates. However, if the banks have to pay more money to their depositors than they can make on their long term loans, the absence of profitability leads to compressed lending; with the resultant tightening in credit conditions contributing to a recession. The longer that the inversion lasts, and the steeper the imbalance between short and long term rates, the worse the situation becomes. The average span between inversions and subsequent recessions has been 14 months, with a range of five months to 19 months (Charles Schwab Research).



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. *From January 1962 to May 1976, short-term bond is U.S. 1-year note, and from

The problem with interest rate inversions is that we only have a limited history of economic data, and there have been "false positives". On such false positive of an inversion was in 1998 during the Asian Currency Crises. The interest rate inversion in 1998 was caused by the Asian Currency Crises, and the implosion of heavily leveraged hedge fund Long Term Capital Management. During that time period the markets experienced a steep sell off, not unlike late last year, and a recession was avoided by the Federal Reserve stepping in to

help unwind the derivative portfolio of Long Term Capital Management and lowering short term interest rates to undo the interest rate inversion.

At the Credit Suisse Asian Investment Conference in Hong Kong last month, former Federal Reserve Chair Janet Yellen said that the inverted yield curve could merely signal that the Federal Reserve needs to cut short term rates. Indeed, that is what the futures market is pricing in as Eurodollar futures point to an interest rate cut this year (Credit Suisse). If short term rates were to drop by an interest rate cut, or if economic conditions were to improve and long term interest rates were to rise, the yield curve could go back to a normal situation.

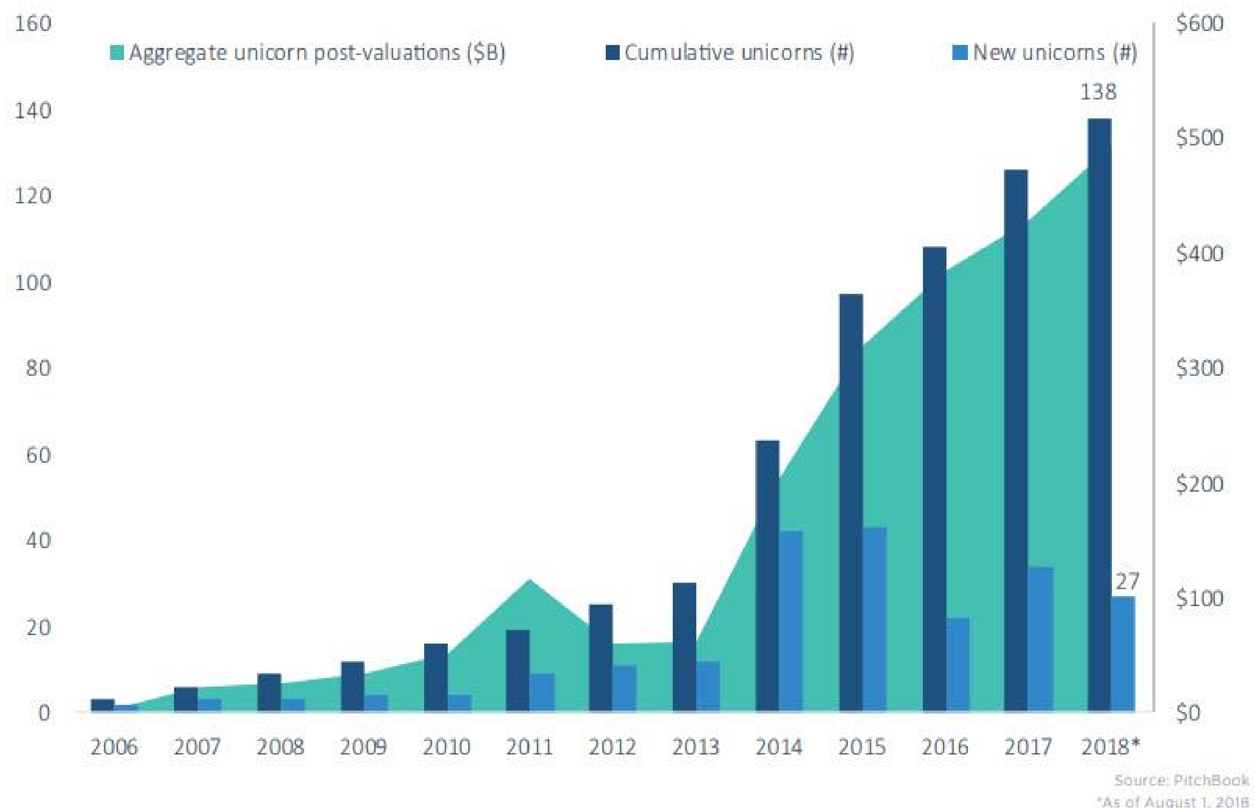
We agree with Janet Yellen that the inversion could mean that the Fed raised short term rates too fast. As we mentioned in our last commentary, we think a large reason for the 20% pull back in the market in the final months of last year was because the Federal Reserve raised short term rates too far too fast. Investors expressed their displeasure by selling securities and raised cash for they could see the economy clearing slowing with each rate hike. In fact, the yield curve would not be inverted right now if the Fed had not raised rates in December. Moreover, auto and home sales as well as other interest sensitive industries would not have experienced a decline in sales last year and this year if the affordability of those products was not negatively affected by higher interest rates.

That being said, we do commend the Federal Reserve for reversing course this year on interest rate hikes when they too realized that they probably raised

rates too quickly and that their own rate hikes were hurting the economy. We also understand that Fed saw the strong economic growth early last year and low unemployment as a catalyst for future inflation, so they wanted to raise interest rates to prevent inflation. U.S. GDP Growth slowed steadily last year from 4.2% growth Q2 2018, to 3.4% Q3, to 2.2% Q4. (Bureau of Economic Analysis). However, much of the growth last year was due to tax cuts. According to Goldman Sachs, over half of the earnings growth last year was attributed to the lower corporate tax rate. That tailwind for earnings and economic growth will be gone this year, so the rate hikes were not needed. So we do not think it is a coincidence that the Dow Jones opened the year with its worst start since the year 2000, and then abruptly turned course and rose 747 points on January 4, 2019 after Federal Reserve chair Jerome Powell said that interest rates would not rise this year. The market has been recovering last year's losses ever since that announcement.

Unfortunately, the stock market will be facing some headwinds later this year as a large supply of new stock hits the market and as the Presidential Election begins to heat up. Renaissance Capital predicts that up to a 100 billion dollars of new IPO (Initial Public Offerings) will take place this year as well known brand names like Levi Strauss & Company, the jean's maker, and a host of new tech companies like Lyft, Uber, Postmates (the grocery food delivery company), Airbnb (the home rental site), slack technologies, zoom video, and Pinterest go public. This number is only a fraction of the estimated 138 unicorn companies (private companies worth a billion dollars or more) which are waiting to go public. In a public offering private companies sell part of their

ownership to the public, the founders of the new companies get big paydays, and the companies themselves get working capital to expand their businesses. From an economic prospective, new IPO's are good and bring excitement to the stock market, and more importantly the IPO's bring money to the fastest growing parts of the economy to allow them to grow. In fact, one of the leading reasons the American economy has been so dynamic for so long and one of the fastest growing economies on earth over the last hundred years is that the IPO process allows the country to fund the new, growing companies efficiently.

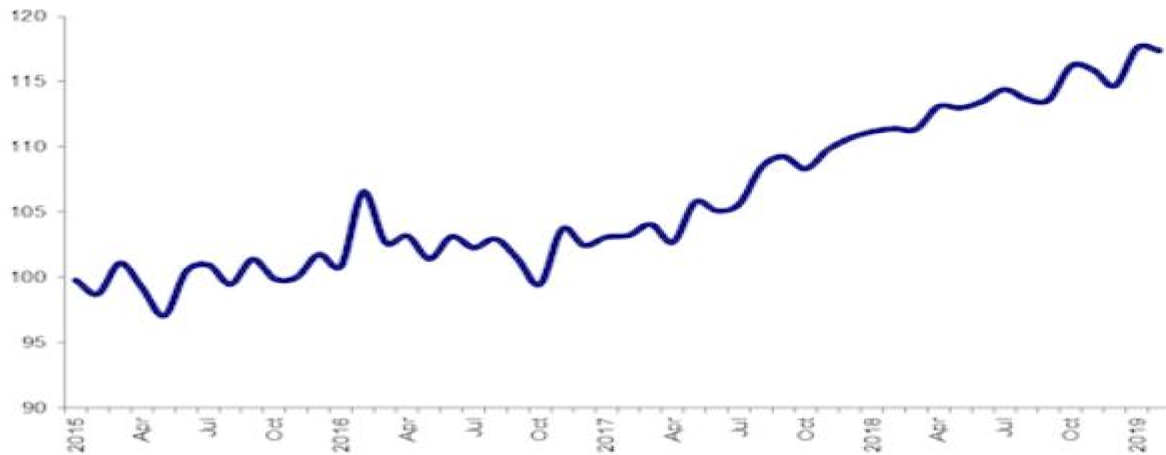


From a stock market prospective new IPO's are not as good as it creates a lot of new supply on the market. In order to buy all of these new IPO's, portfolio managers have to sell positions in existing stocks, or investors have to

put new money into the market to come up with the money to buy these new securities. Whereas corporate buybacks and mergers are good for the stock market in the sense that they reduce stock supply, new IPO's add stock supply and create a headwind from the market to work through as they add supply (new stock). Historically, large numbers of IPO's dilute near term price appreciation of the overall stock market.

We are also concerned by the upcoming presidential election as dozens of candidates' and the President's campaign across the country with vastly different economic agendas. The range of economic policies of these candidates is quite large. With such a wide range of different economic policies from the candidates, it is very possible that many investors will take a wait and see approach to investing as the election gets closer. Since the markets have already started the year strongly, we think further price appreciation may be more subdued as the year progresses.

In conclusion, even though we see that the economy has slowed from over 4% growth early last year to about 2% this year, we still do not think there will be a recession, at least not in the next six to nine months as corporate profits continue to hit new highs, unemployment levels are at 50 year lows, and as rail and truck traffic are still at all-time highs.



American Trucking Association Truck Tonnage index hit a level of 117.4 in February. This is 17.4% higher than in 2015.

Longer term we are still concerned about rising debt levels and unfunded government and corporate liabilities. As a result, we continue to focus on brand name, large capitalization companies, with strong balance sheets, providing goods and services that consumers need to use on a daily basis and who are returning cash to investors through dividends and share buy backs.

As always, we thank you for your continued support.

Sincerely,

William H. Schnieders Principal	James F. Schnieders, CFA Principal	John C. Schnieders, CFA, CFP® Principal