Economic Review & Outlook

THIRD QUARTER 2019

Interest Rates – What They're Telling Us and Why They Matter

Most of us are aware that interest rates have been very low for the past decade, and we've been prepared that they were likely to go up at some point. When rates rose last year and bond returns suffered, few clients were surprised, and some wondered why we would choose to hold bonds in the first place. Now that bonds have rallied and the markets expect the Fed to lower future rates, there is more optimism around fixed income investments. But should there be? What are the markets telling us about future interest rates and potential bond returns?

In this quarter's Economic Review & Outlook, we take a deeper look at interest rates – what drives them, where they currently stand, and what they tell us about future market expectations. We also share how this information drives our portfolio construction process. As you can imagine, short-term interest rates can be very unpredictable, and sometimes reading too much into expectations can harm the long-term diversified approach we recommend.

First, we will review key economic events and market performance for the quarter.

Economic Review

Trade Still Dominating Headlines

Trade negotiations between China and the U.S. have been going on for well over a year with no end in sight. While April saw promising trade talks and hopes of compromise, President Trump announced an increase in tariffs from 10% to 25% on $200 billion worth of Chinese goods in May. China retaliated by increasing tariffs on certain U.S. goods. Both sides spent the rest of the quarter trading barbs; the U.S. banned Chinese technology firm Huawei from purchasing from American companies, and China released a white paper criticizing the U.S.'s trade negotiation tactics and protectionist policies, even implying that the U.S. was a dangerous place for Chinese citizens to visit.

These actions can cause market volatility and increased uncertainty in the short term, but the long-term risks of slower economic growth and inflation are of greater concern to us. We continue to believe that freer trade, cooperation, and mutual respect between these two global superpowers is the best path towards long-term prosperity.

Growth Expectations Declining

Trade war concerns are starting to take a visible toll on the economy as the latest data have pointed towards slower economic growth. Since last quarter, we have experienced softening wage growth, slower job creation, and lower future GDP estimates. We have even seen decreasing positive sentiment in investor and small business owner surveys.

While we are nowhere near crisis levels, things are heading in the wrong direction. We cannot point to trade wars as the only culprit – we are in the late stages of an extremely long expansion, and market valuations are high; however, it's hard to argue that trade is beginning to have a noticeable impact on both current data and future sentiment.

Interest Rates Fall as Fed Considers Policy Shift

Another side effect of trade tensions and slower growth has been a sharp decrease in bond yields. This flies in the face of recent Fed policy, which has been to gradually move rates up by increasing the Fed funds rate (the interest rate banks charge each other to lend reserve funds overnight.) Because of the drop in longer-term yields, slowing economic growth, and trade war concerns, market forecasters are now overwhelmingly expecting the Fed to not only cease hiking rates, but also begin cutting rates this year.

We will discuss this potential policy shift and its implications in greater detail in the next section.

Asset Class Performance

January	February	March	April	May	June	Q2	YTD
Emerging Market Stocks 8.8%	Commodities 4.0%	U.S. Stocks 1.9%	U.S. Stocks 4.0%	Diversified Bonds 1.8%	Gold 8.0%	Gold 9.0%	U.S. Stocks 18.5%
Commodities 8.4%	U.S. Stocks 3.2%	Diversified Bonds 1.9%	Int'l Developed Stocks 2.9%	Gold 1.7%	U.S. Stocks 7.0%	U.S. Stocks 4.3%	Int'l Developed Stocks 14.5%
U.S. Stocks 8.0%	Int'l Developed Stocks 2.6%	Commodities 1.0%	Commodities 2.4%	Int'l Developed Stocks -4.7%	Emerging Market Stocks 6.3%	Int'l Developed Stocks 4.0%	Commodities 13.3%
Int'l Developed Stocks 6.6%	Emerging Market Stocks 0.2%	Emerging Market Stocks 0.9%	Emerging Market Stocks 2.1%	U.S. Stocks -6.4%	Int'l Developed Stocks 6.0%	Diversified Bonds 3.1%	Emerging Market Stocks 10.8%
Gold 3.1%	Diversified Bonds -0.1%	Int'l Developed Stocks 0.7%	Diversified Bonds 0.0%	Commodities -6.7%	Commodities 4.2%	Emerging Market Stocks 0.7%	Gold 10.0%
Diversified Bonds 1.1%	Gold -0.5%	Gold -1.6%	Gold -0.8%	Emerging Market Stocks -7.2%	Diversified Bonds 1.3%	Commodities -0.4%	Diversified Bonds 6.1%

Source: FactSet. Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

The second quarter saw a bit of a reversal from earlier in the year, as commodities went from the highest returning asset class to the lowest (-0.4%) and gold went from the lowest to highest (+9.0%). This shift was likely in part due to slowing growth expectations and trade war concerns. On the equity side, U.S. stocks led the way (+4.3%), with emerging markets lagging (+0.7%). Bonds benefited from declining interest rates and gained 3.1% during the quarter.

Year-to-date, the first half of the year has seen solid gains across all markets, which is a welcomed sight after a difficult 2018. While U.S. stocks have led the way, all major equity markets are up strongly so far this year. Bonds, while not up as much, have still seen a respectable return of 6.1%.

Our Perspective

Why has the Fed been raising rates?

During the Financial Crisis a decade ago, the Fed cut rates to historically low levels to help stimulate growth and heal the economy. While we have been in a low-rate environment ever since, most believe that rates will increase back to normal levels. In recent years, the Fed has been working to get back to that point, first by ceasing its purchasing of long-term treasury bonds in 2014 and by beginning to raise the Fed funds rate in 2015.

Since December 2015, the Fed has raised rates nine times, increasing the Fed funds rate from zero to a target level of 2.25-2.5%. The frequency of these rate hikes has been increasing steadily, with the expectation that, barring an economic collapse, rate hikes would continue for several years. Recently, slower growth, trade concerns, and increased volatility have led many to believe the Fed will change course and begin cutting rates, something few would have imagined a year ago.

What do markets expect the Fed to do?

For the past several years, it has not been a question of if the Fed will raise rates, but when. That expectation has changed over the past year. Seen below, markets are not only expecting one cut, but multiple rate cuts with a probability of 94%. This is a complete reversal from where things stood a year ago, when the markets only gave a 2% chance for that scenario. In fact, at that time, it was viewed as more likely than not that the Fed would be raising rates at least once this year.

Market Probabilities for 2019 Fed Rate Changes

Action	Current	One Year Ago
Three or More Hikes	0%	8%
Two Hikes	0%	18%
One Hike	0%	31%
No Change	0%	28%
One Cut	6%	13%
Two Cuts	31%	2%
Three Cuts	40%	0%
Four or more cuts	23%	0%

Source: FactSet. Probabilities based on Fed funds rate futures contracts. Data as of 6/30/19.

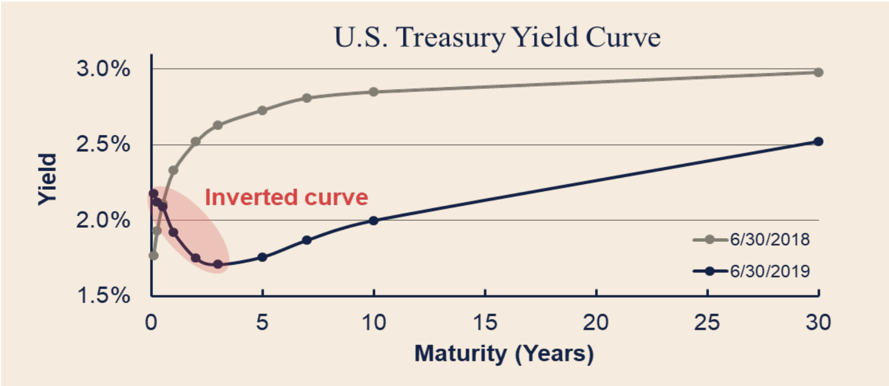
What has caused such a drastic shift in expectations? While we cannot know what truly drives market participants to act, we do know that we're seeing signs of slowing economic growth; just a year ago, growth and corporate earnings were accelerating. Another likely contributor is concern over the trade war with China, discussed in a previous section above. By shifting expectations, the market is in part factoring in the potential for lower long-term growth as a direct result of more restrictive trade policies.

Finally, part of this may be more market-driven than economic. Some believe the Fed will do everything to avoid causing a large market correction by pumping the brakes on rate increases during periods of increased uncertainty, including uncertainty driven by large-scale trade negotiations or periods of market volatility like we're seeing today.

In any case, the market has clearly communicated to the Fed that it expects to see multiple rate cuts in the near future. It will be interesting to see if those indicators factor into Fed policy going forward. If the Fed surprises the markets and tightens its policy, we could see elevated market volatility.

How has this impacted current interest rates?

So far, we've talked about what could happen to the Fed funds rate (an overnight rate,) but how does that impact those with longer-term bond investments? Below is a chart showing yields on treasury bonds now, compared with one year ago:



Source: FactSet.

Very short-term yields have increased year-over-year as the result of two Fed rate hikes, yet yields on treasuries with maturities over six months have fallen in some cases by nearly a full percent. At the same time, the short end of the yield curve is inverted, meaning that yields go down as maturities increase. An inverted yield curve indicates that markets are expecting slower growth, and by extension, lower interest rates in the future. The fact that this is only occurring for short-duration bonds is an important detail. Our conclusion is that the market is concerned about economic growth over the next few years and expects the Fed to cut rates to help avoid a potential recession. However, in the long run, the markets acknowledge that rates are still low and will need to increase eventually to get back to normal levels.

In terms of what to expect going forward, the Fed is expected to begin cutting rates during their next meeting in late July. Longer-term rates will likely adjust based on how Fed chairman Jerome Powell frames expectations around the timing of additional rate cuts. While it is important to understand market expectations and forecasts, it's equally important to acknowledge that outcomes are uncertain, and expectations are constantly shifting to account for new information.

Our Investment Strategy

What does all this mean for your portfolio? There is good and bad news here. The good news, as you saw in the Performance section, is that bonds have had strong returns over the past 12 months because of falling rates (bond yields move inversely to bond prices). If rates continue down from here, it will continue to positively impact bond prices. However, higher bond prices today can mean lower returns tomorrow.

Lower return expectations can also be challenging to our time-based strategies' performance goals. To address this, we find areas of the market with greater return potential. One example is corporate bonds, which pay a higher yield than treasuries. While this extra yield isn't free (it compensates investors for increased credit risk), layering on a reasonable amount of high-quality corporate bond exposure to a portfolio can help increase both yield and diversification. This is an approach we are taking in our fixed income-based portfolios.

Bonds are not the only asset class to have lower future return expectations, as equity market valuations are also stretched from years of strong returns. As a result, we lean into markets that have the best combination of price and future growth potential. Value stocks have not had the same run-up as large cap U.S. equities over the last decade, so they are priced more attractively than normal. International equities, especially emerging markets, are also attractive as they currently have higher growth expectations. While we believe these areas are priced for more attractive long-term relative performance, outcomes are uncertain. This is why diversification, patience, and a sound financial plan are all paramount.

While it can be tempting to look at this data and try to time the markets based on the latest forecasts, we maintain a disciplined process that emphasizes long-term return drivers, diversification, and making sure our clients' money is there when they need it. Markets can turn unexpectedly, so trusting in a single potential outcome is a dangerous game if you get the timing wrong. If markets were wrong once, they can be wrong again.

In Conclusion

For the past several years, we have grown accustomed to hearing that interest rates are going up, so the increase in yields from 2017 to 2018 wasn't a big surprise to most. However, recent economic and market developments have caught many by surprise, leading the Fed to ponder changing course and cutting rates back to low levels. Interest rates are always the result of market expectations, and expectations can change. A year ago, markets expected growth to continue accelerating and that the Fed would hike rates. Now, they are concerned about slowing growth and expect rate cuts on the horizon.

These uncertainties serve as another example of why you should always be somewhat leery of any market or economic forecast, no matter how likely it appears. We just can't know what the future will hold, and the only protections against uncertainty are diversification, not overpaying for investments based on rosy projections, and having a sound financial plan with plenty of margin built in. If you can persevere through uncertain times like these by remaining patient and sticking to a process, we believe you should be well on your way to reaching your financial goals.

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