What Happened to Risk Assets in the First Half of 2019?

Photo Source: Pixabay.com

Executive Summary

Increased concerns about **global growth slowing** and **downside risks from trade** resulted in **deteriorating macro-economic conditions** in the first half of 2019. As a result of the prevailing financial conditions, the U.S. Federal Reserve **signaled** it is open to **cutting interest rates** to stimulate growth and sustain the current economic expansion.

The S&P 500 index produced a return of **17.35%** in the first half of 2019, its **best first half since 1997**. In our view, the current year to date index returns in the U.S. are unlikely to continue at this rapid pace.

We continue to **advocate a globally diversified, multi-factor, multi-asset ETF.** Moreover, we strongly believe sticking with a long-term investing plan will increase the probability of accomplishing one's financial goals.

U.S. Federal Reserve

At its June meeting, the U.S. Federal Reserve Chairman, Jerome Powell, announced that the committee would **keep** the U.S. federal funds rate target range **steady** at **2.25-2.50%.** However, the Federal Reserve provided a **strong indication** that it is open to **cutting interest rates** in order to sustain the current economic expansion.

A significant number of the committee members now favor an interest rate cut of 50bps before year end. Seven members now see 50bps of rate cuts in 2019, one sees a 25bps rate cut, and eight members see interest rates on hold. That's a **significant shift** from the March FOMC meeting where eleven members saw rates on hold this year.

In our view, the Federal Reserve is **reacting to a weaker global growth environment**, rising uncertainty about trade policy, and negative sentiment about the global economic outlook.

Yield Curve

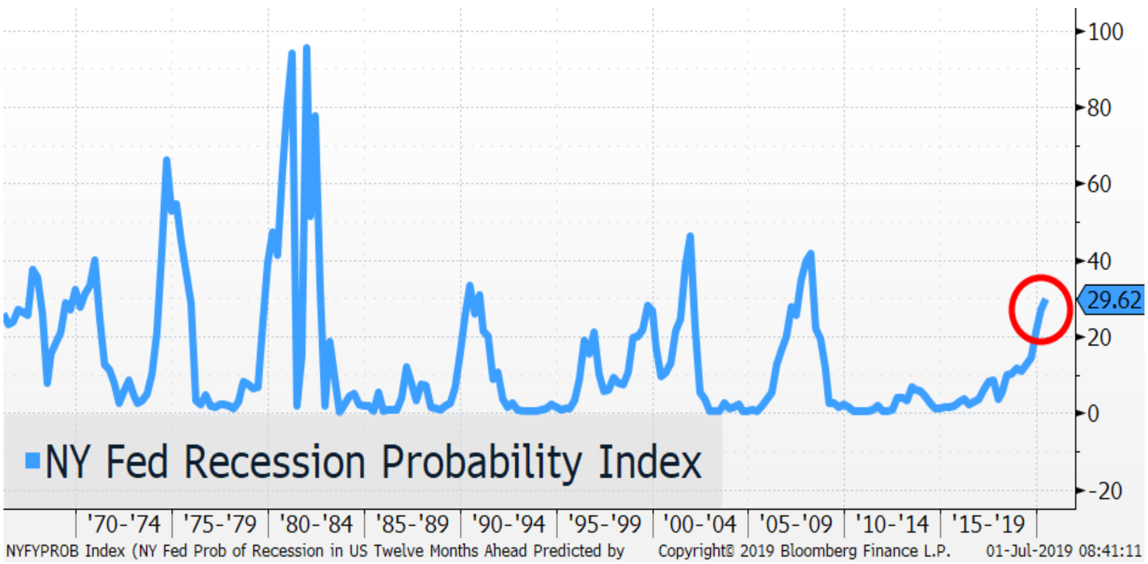
The **inversion of the U.S. yield curve** is a topic that the financial media continues to caution followers. Historically, a negative yield curve implies investors expect future short-term rates to be lower as the Federal Reserve eases policy in response to a potential recession. According to J.P. Morgan Research, **7** out of the **8** U.S. yield curve inversions **since 1960** were followed by a recession.

While the media has been focusing on the 3-month Treasury bill vs. 10-year Treasury inverted yield curve, not all parts of the U.S. interest rate yield curve are inverted. For instance, the 2-year vs. 10-year spread **remains positive** at **24.82bps** as of June 28, 2019. In fact, the 2-year vs. 10-year spread has historically been more of a bellwether for predicting economic recessions and has been **steadily steepening** since the 4th quarter of 2018.

Source: Bloomberg, Astoria Portfolio Advisors

According to J.P. Morgan Research, the number of months between the 2-year vs. 10-year inversion and the subsequent recession has increased (**17 months**) for the prior 3 yield curve inversions compared to the prior four inversions (**9 months**). Moreover, J.P. Morgan's Research group notes that there was a **22-month lag** between the time the yield curve inverted in 2008 and the subsequent recession.

The NY Federal Reserve Bank maintains a Recession Probability Index for the **next 12 months** ahead. As of May 31, 2019, the NY Federal Reserve's Recession Probability Index for 2020 stands at **29.62%** (see chart below).



Source: Bloomberg, New York Federal Reserve, Astoria Portfolio Advisors

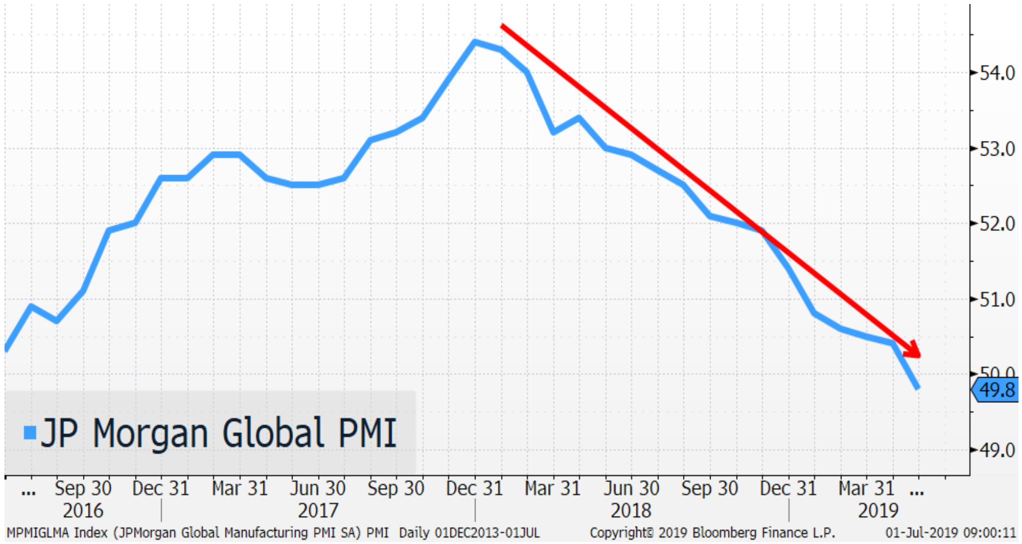
Tariffs

The G20 summit took place on June 28, 2019. The U.S. administration announced that it will **hold off** on 25% tariffs on the remaining US$300 billion U.S. imports from China. China announced that it would continue to purchase agricultural products from the U.S. Moreover, both countries announced it will roll back some non-tariff barriers such as restrictions on high-tech exports by U.S. companies.

The bad news is that uncertainty remains as there is no clear path towards a comprehensive resolution. From our perch, we believe that lingering uncertainty will continue to provide an overhang on the global economic outlook and trade and will lead a drag on global growth in the second half of 2019 and into 2020.

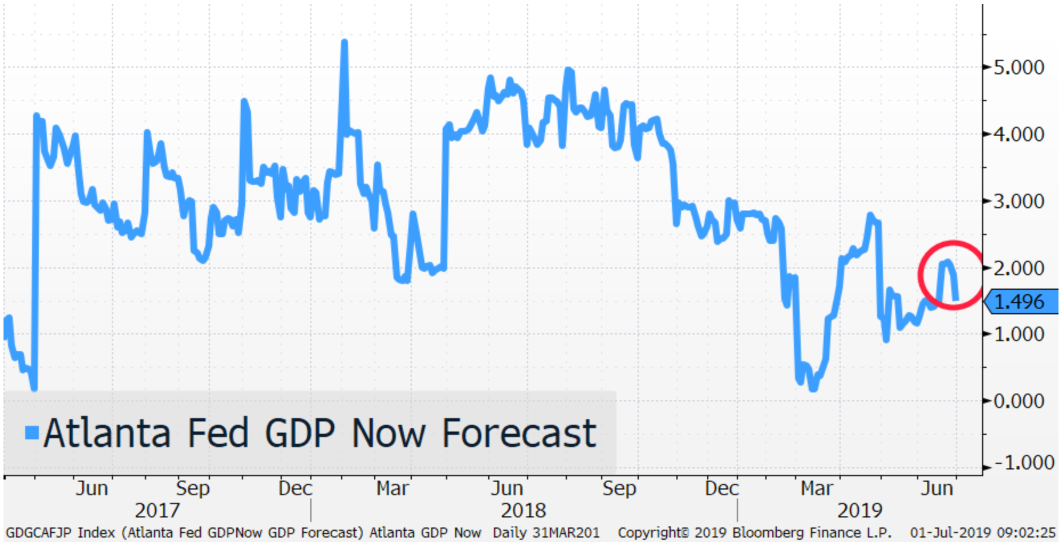
Economic Data, Valuations, and Portfolio Construction

Global economic data has **deteriorated in 2019.** The J.P. Morgan Global Manufacturing Purchase Managers Index, which is a measure of economic health for the manufacturing and service sector, **has steadily declined since early 2018** (see chart below). A slowdown in various economies globally along with trade concerns have been the key drivers behind the weakness in manufacturing data.



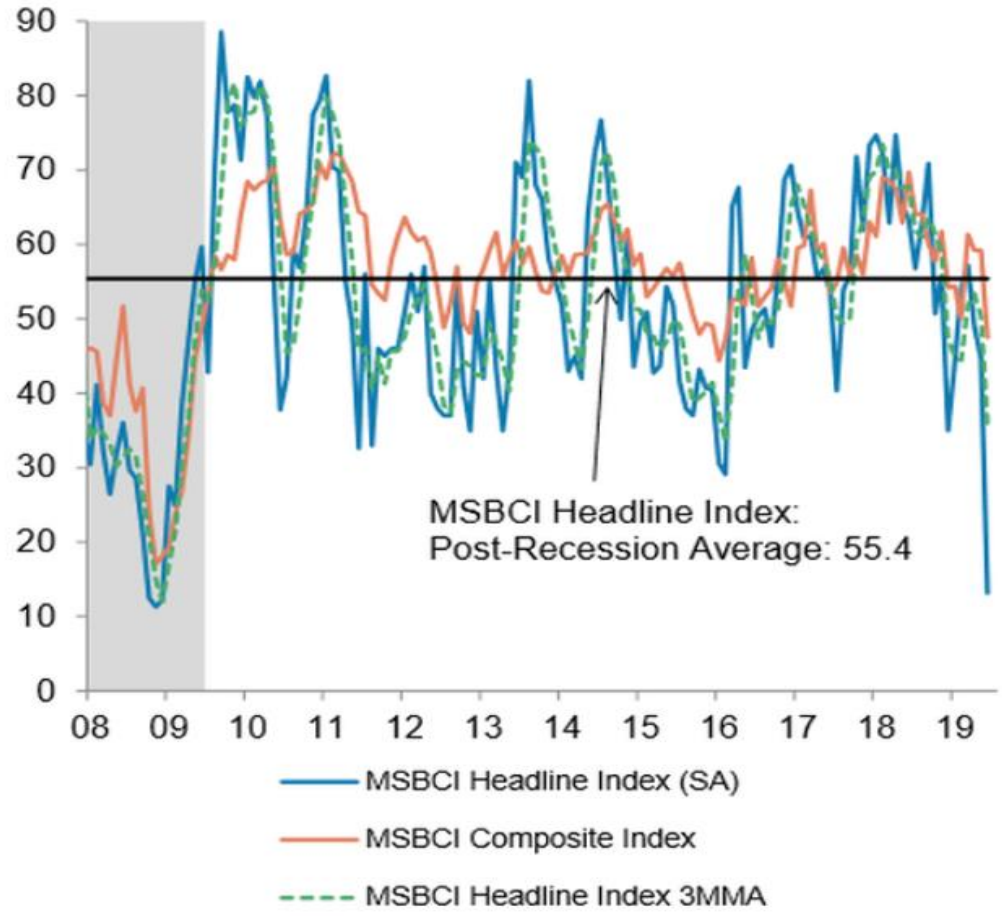
Source: Bloomberg, J.P. Morgan, Astoria Portfolio Advisors

The U.S. economy **isn't immune** to the global growth slowdown. The Atlanta Fed GDPNow Forecast Model is **1.50%** as of June 28, 2019. On August 1, 2018, this model was forecasting GDP to be **4.95%.**



Source: Bloomberg, Atlanta Federal Reserve Bank, Astoria Portfolio Advisors

Meanwhile, Morgan Stanley's Business Conditions Index recently had its **largest one-month decline** since 2002 and is **near its 2008 Great Financial Crisis level** (see chart below).



Source: Morgan Stanley Research

U.S. stock valuations are **neither cheap nor expensive**. According to FactSet Research Systems, the S&P 500 Index forward P/E ratio is **16.6x** as of June 28, 2019 and is slightly above the 5-year average (**16.5x**) and the 10-year average (**14.8x**).

From a long only ETF factor perspective, **Quality, Size, and Momentum** have outperformed the most thus far in 2019.

Factor *(as of 2019-06-28)*

Updated July 1, 2019		Live Daily*	1 Wk Return	YTD Return	1 YR Return	52 Wk Low	50 DMA 200 DMA 52 Wk Price Meter	52 Wk High	% Above (Below) 50 DMA	% Above (Below) 200 DMA
Momentum	MTUM	1.05%	-0.96%	18.92%	10.59%	$92.8		$120.45	3.05%	7.56%
Value	VLUE	0.59%	1.92%	12.85%	-0.01%	$68.64		$89.31	2.04%	0.77%
Size	SIZE	0.63%	0.20%	19.02%	10.04%	$72.15		$91.35	2.10%	6.05%
Quality	QUAL	0.83%	-0.53%	19.72%	11.24%	$71.91		$92.22	1.77%	6.36%
Dividend	DVY	0.18%	0.17%	12.45%	4.35%	$85.2		$102.32	1.26%	2.61%
Low Volatility	USMV	0.42%	-0.85%	18.23%	17.86%	$49.77		$62.47	2.38%	8.25%

Source: ETFAction.com, Data accessed on June 28, 2019.

International Equities

On the back of the U.S. Federal Reserve's more accommodative stance in the 1st quarter, International Developed and Emerging Markets equities posted **strong returns** in the 1st half of 2019. The Shanghai Stock Exchange Composite Index (China) **increased by 20.96%** (in CNY terms), the Euro STOXX 50 Index (Europe) **rose by 19.81%** (in Euro terms), the MSCI Emerging Markets Index **was up 11.06%** (in USD terms), and the Nikkei 225 Index (Japan) **increased by 7.53%** (in Japanese Yen terms).

Range 12/28/2018 - 06/28/2019 Period Daily No. of Period 182 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SHCOMP Index	CNY	19.45%	20.96%	1.15%	46.47%
2)	SX5E Index	EUR	16.31%	19.81%	--	43.69%
3)	MXEF Index	USD	9.58%	11.06%	-8.75%	23.41%
4)	NKY Index	JPY	6.30%	7.53%	-12.28%	15.66%
5)						
6)						

Source: Bloomberg

The Bloomberg Dollar Spot Index (BBDXY) **decreased** by **0.75%** in the 1st half of 2019.

According to ETFAction.com, the iShares MSCI ACWI ex U.S. ETF (**ACWX**) currently has a P/E ratio of **13.60x** based on 2019 analyst estimates. This is significantly lower than the SPDR S&P 500 ETF (**SPY**) which has a P/E ratio of **17.47x** based on 2019 analyst estimates.

In our view, Emerging Market equities (China in particular) **remain attractive** for long term investors as they are trading at a **substantial valuation discount** compared to the U.S. stock market. According to ETFAction.com, the iShares MSCI China ETF (MCHI) is projected to have **15.00%** EPS growth based on 2019 analyst estimates whereas the S&P 500 ETF (SPY) is projected to have only **3.75%.**

Fixed Income

U.S. interest rates **declined across various maturities** in the 1st quarter. Yields on the **2-year**, **10-year**, and **30-year** U.S. Treasury Bonds were **1.75%**, **2.01%,** and **2.53% respectively** as of June 28, 2019. Given that the **U.S. yield curve is relatively flat**, we believe ultra-short duration bond funds are providing investors with a more attractive opportunity compared to longer duration bond funds.

The Bloomberg Barclays U.S. Aggregate Bond Index is up **6.11**% as of the end of the 1st half. We continue to prefer owning **higher quality U.S. bonds** across our portfolios. We maintain an **overweight position** in **U.S. municipal bonds** and **U.S. mortgage-backed securities**, both of which are highly rated. In fact, between **75-80%** of our fixed income bonds across both Astoria's strategic and dynamic ETF portfolios are rated either **AAA** or **AA**.

Commodities

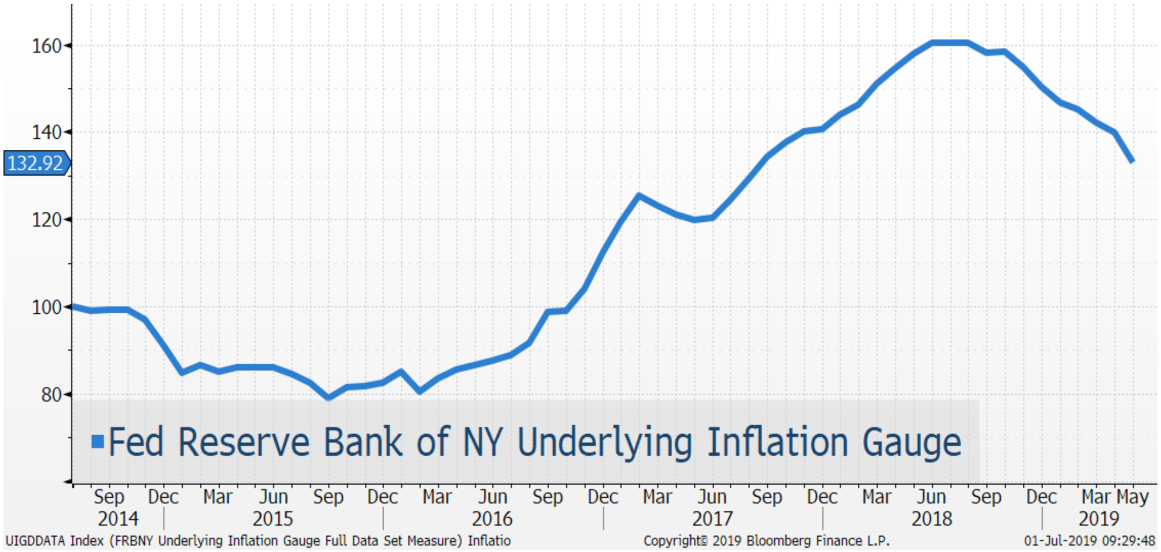
Along with stocks and bonds, commodities posted **positive returns** in the 1st half. The Bloomberg Commodity Index **increased by 3.83%** although, once again, there were notable divergences across the complex. The United States Oil ETF (USO) **increased by 24.64%,** Invesco the SPDR Gold ETF (GLD) **rose by 9.86%,** DB Base Metals ETF (DBB) **climbed by 0.71%,** and the Invesco DB Agriculture ETF (DBA) **declined by 2.18%**.

Range 12/31/2018 - 06/28/2019 Period Daily No. of Period 179 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	USO US Equity	USD	24.64%	24.64%	23.92%	56.69%
2)	DBB US Equity	USD	.71%	.71%	--	1.46%
3)	GLD US Equity	USD	9.86%	9.86%	9.14%	21.13%
4)	DBA US Equity	USD	-2.18%	-2.18%	-2.90%	-4.40%
5)						
6)						

Source: Bloomberg

We do not think **rising inflation is a major risk for the economy.** This is in fact a key reason why the U.S. Federal Reserve stopped raising interest rates. We are closely monitoring the New York Federal Reserve Underlying Inflation Gauge Index which has **steadily declined since June 2018** (see chart below).



Source: Federal Reserve Bank of NY, Bloomberg, Astoria Portfolio Advisors

We have written that **gold was attractive** in a multi-asset portfolio as it serves as a **valuable diversifier** during times of stress. As a reminder, our gold allocation helped soften our portfolio volatility in the 4th quarter of 2018 as gold **rose 7.53%** while the S&P 500 Index **declined 13.52%**.

Market Timing

Our long-standing view is that **timing the market top and bottom is extremely difficult** and that investors are incentivized to **stay fully invested**. The past 3 quarters have proved our point. The S&P 500 Index declined **13.52%** in the 4th quarter of 2018 and then rallied **17.35%** in the 1st half of 2019. We continue to advocate **not only to stay fully invested** but to **maintain a globally diversified, multi-asset portfolio.**

Best, John Davi
Founder & CIO of Astoria

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