“We’re going to need a bigger boat”

Capital Markets Review
Second Quarter 2019

The beginning of July is one of our favorite parts of the year. Summer is in full swing. That means family vacations, parades, cookouts and of course, blockbuster movies. For some of us, the summer movie of all summer movies, was Jaws. In 1975, the movie, and that shark, captivated the country. People wouldn’t swim in pools let alone dip a toe into the ocean. Perhaps one of the film’s most iconic scenes is the first time the audience gets its first full view of the shark, and those teeth. By this time in the film, we are scared out of our wits. Chief Brody is seen at the back of the boat, chumming with dead fish and blood, hoping to raise the shark. That’s exactly what happens as we first see this massive fish, its open mouth with sharp teeth filling the screen. Like all of us, Chief Brody is dumbstruck, knowing what the others don’t yet know, that they have a difficult task ahead. In that spirit he exclaims to his shipmates, “we’re going to need a bigger boat!”

Luckily, as investors, we don’t have to deal with sharks. We do have to contend with bulls and bears. The second quarter generated more frequent conversations about the likelihood of a bear market, if only because a downturn in the stock market seems extraordinarily overdue. The current bull market reached its 10th anniversary in March and on July 1, the US entered the 121st month of economic expansion—the longest on record. The returns for the first half of 2019 have made the downward volatility of the fourth quarter of 2018 a distant and forgotten memory. For the first 6 months of 2019, the S&P 500 has climbed 18.5%, led of course, by those same 6 companies (FANG 6 – Facebook, Apple, Amazon, Netflix, Google and Microsoft) which were up 28.9% during that same time period. The FANG 6 is like that massive shark in Jaws; relentless, awe inspiring. For the five year period ending June 30, these six stocks have annualized a return of 28.1%! It has been these stocks that have propelled the S&P 500 to a 10% return for that 5 year period. Consider this, in the last 18 months, the FANG 6 are up approximately 40% while all the stocks in the rest of the world together, are flat.

Still, we have seen, thankfully, a broader diversification of returns in the first half of 2019. For the first six months, developed market international stocks (MSCI) were up 13.6% and emerging market stocks (MSCI EM) were up 10.6%. Bonds have performed better as rates in the first half declined. The Bloomberg Barclays Aggregate Index and the US Municipal Bond index were up 6.1% and 5.1%, respectively for the period. Exposure to credit also did well in the first half of the year. High Yield bonds returned 9.9% for the period and Business Development Companies (BDCs) returned 18.9%. Even more broadly, and proving the benefits to diversification, MLPs, REITs and Infrastructure funds were each up 17.0%, 17.8% and 20.7%, respectively, through June of 2019. The first half of 2019 has been a rewarding time for diversification. Our clients have benefited from this diversification, as we maintain a slight underweight in our portfolios to US stocks.

The question on many minds is how long this expansion can continue. US Corporate earnings remained strong, even as their rate of earnings growth slowed in the first half. This slowing has curbed the Federal Reserve’s appetite for interest rate hikes. The odds appear to favor either a slowing in their previously stated desire to raise short term rates or, to now potentially even cutting those rates. The effect has been a renewed energy of this already mature bull market, at least for a while. Inflation, the prime motivator for the Fed's desire to raise rates, simply hasn't occurred.

While low interest rates and earnings growth are key to sustaining the continued market expansion, from our perspective, one big concern is the ability to find labor. Our economy needs workers to fuel our growth. Labor growth has expanded in each of the last 4 decades; '80's-1.2%, '90's-1.0%, '00's-1.3%, and '10's-0.5%. Notwithstanding the political rhetoric, those growth rates are almost equally distributed between native born and immigrant workers. Forecasts for labor growth for the next 10 years is for below 0.2% growth with the labor force expanding from immigrant labor at 0.15% and native born workers growing at just 0.01%! As Chief Brody might say again, "we're going to need a bigger boat." The US Bureau of Labor Statistics projects an increase in overall employment by 11.5 million for the 2016-2026 decade bringing the total employment in the US to 167.6 million. Unfortunately, the group with the largest increase to the labor pool is for the population group aged 55+. Also, the forecast is that 10.5 million jobs will come from the service sector while goods-producing (manufacturing) jobs will account for 0.1% of this job growth. Again, we see a lack of workers as a risk to continued expansion.

Still, summer is upon us. And the weather seems relatively clear. In the short term, we see no significant catalyst to derail the markets. US stocks, while slightly expensive on a forward earnings basis, are not outlandishly priced. Forecasting the weather, as with short term performance of the markets, is not an easy task. Rather, we work with our clients to develop a portfolio that can withstand inevitable changes. We do this by understanding our clients' return and risk objectives, along with a knowledge of their liquidity needs, taxes, and unique circumstances. We stand ready to continue our discussion with each and every one of you. As we do so, enjoy this time of the year with your families.