Current economic events

U.S. stock markets broke psychological levels and records last week when the Dow Jones Industrial Average moved past 27,000 and the S&P 500 exceeded 3,000. Market momentum since the beginning of June appears to be attributable in large part to a dovish pivot from the Federal Reserve (Fed) toward easier monetary policy rather than an uptick in fundamentals. That continued to be the case last week. Much of the market’s rise came Wednesday morning in response to Fed Chair Jerome Powell’s statement to the House Financial Services Committee, when he cited “uncertainties” weighing on the global economy. Across the pond, the European Central Bank’s (ECB) minutes were even more blunt, noting that policy makers are in “broad agreement” that the bank should “be ready and prepared to ease the monetary policy stance further by adjusting all of its instruments.” This includes cutting already-negative rates or restarting its quantitative easing (QE) bond-buying program. Markets are hoping that central banks can finally put a floor on the synchronized global slowdown without too much pain for earnings-dependent equities. However, with data continuing to slow, it remains to be seen whether they can pull it off. The Organization for Economic Cooperation and Development’s (OECD) composite of leading indicators signal that they perhaps can. In its May report, the OECD changed its stance on developed world growth from “easing growth momentum” to “stabilizing growth momentum,” showing it believes growth may soon reach its nadir. However, the indicator continues to drop and is frequently subject to revisions, so the language change should be taken with a grain of salt.

Although our evaluation of data shows downward trends, it is striking that the Fed is poised to cut interest rates, considering that data most watched by “Main Street” remains at solid levels. Just last week the Job Openings and Labor Turnover (JOLTS) survey showed job openings continuing their trend downward, yet they’re still near all-time highs. The National Federation of Independent Business’s (NFIB) small business optimism survey was similar — down but still near all-time highs. Inflation data appears to be just about on target, with core consumer price growth a tick above the Fed’s 2 percent goal and headline consumer and producer inflation slightly below. All this while the U.S. gross domestic product (GDP) growth clocked in at a solid-but-not-too-hot 3.2 percent year-over-year in the first quarter and the most recent payroll report showed gains of more than 200,000 jobs in June. It is likely the Fed is increasingly focusing on the more cyclical parts of the economy, which have typically led the much larger labor and consumer sectors. This view
is confirmed by our proprietary U.S. “Health Check,” which recently fell to its lowest level in nearly three years on continued weakness in manufacturing and more recent softness in the services sector, with data trending down at its fastest rate in more than a decade.

Sentix, a survey provider, did not mince words regarding the economic health of Germany, where it believes “a recession … seems inevitable,” with its overall index at a 10-year low. The largest European economy has been increasingly troubled by the growth slowdown and a trade war. Recent hard data, including contractions in industrial production and exports, has reflected this softness. Adding insult to injury was the news that Deustche Bank, the country’s largest bank, will cut 18,000 jobs over the next few years. The broader eurozone economy hasn’t fared much better. Last week the Sentix overall index for the eurozone fell to its worst level in nearly five years and industrial production slowed into further contraction. Japan industrial data also provided little comfort, with production slowing to a faster contraction and machine tool orders contracting a stunning 38 percent, though growth in retail sales did tick higher. Our Health Check sees foreign developed economies, in aggregate, as the softest since the beginning of 2015, though trending down less sharply than the United States.

Emerging market economies have shown some signs of stabilization in recent survey data that hasn’t yet been confirmed by harder data. For example, the OECD leading indicator continues to show stable growth momentum in China and mixed directionality across the other major markets. Sentix’s headline reading appears to be trending flat or up in the three emerging regions while the major developed economies trend strongly downward. However, hard data from China indicates caution is warranted, with exports falling back into contraction, foreign direct investment slowing and loan growth dropping to its lowest rate since August 2018. Industrial production growth in India and Mexico echoed this sentiment, both slowing in May. United States/China trade tensions also continue to cause collateral damage, with the highly trade-dependent Singaporean economy showing basically stagnant year-over-year GDP growth in the second quarter, its slowest since 2009. Because of this lack of confirmation of survey numbers, we see emerging markets at their weakest point in four years, though with more stability in trends and momentum than the developed world.

**Equity markets**

U.S. equities continue to march higher, with the S&P 500 closing at an all-time high of 3,013 on July 12, up 20.2 percent year-to-date. Restrained inflation, low interest rates and moderate earnings growth are providing valuation support while serving as the basis for advancing equity prices. Strength last week was largely attributed to Fed Chairman Powell’s dovish comments, fueling expectations for a looming rate cut in an otherwise quiet week of trading. This week, investor focus is expected to quickly shift toward second quarter corporate results. S&P 500 companies are slated to begin releasing results, with 12 percent announcing this week and another 30 percent in each of the next two weeks. The S&P 500 ended last week roughly 1 percent below 3,050, the upper boundary of our 2019 year-end price target range. We intend to review our assumptions and price target in early-August, after the bulk of S&P 500 companies have released results and offered forward guidance.

- Powell, among other Fed officials, noted last week that the case for lowering interest rates is getting stronger amid soft inflation expectations and business investment. Lower rates provide valuation support for equities while lessening the appeal for fixed income as an attractive alternative. Equities have drifted higher on this dovish outlook, consistent with the adage, “don’t fight the Fed.” The next Federal Open Market Committee meeting, when rates could be reduced, is scheduled for July 30-31.

- Earnings releases are likely to dominate headlines beginning this week and over the next three weeks. Roughly 85 percent of S&P 500 companies are scheduled to release results between now and close of the week of August 9, according to Bloomberg. On balance, expectations are low, with consensus estimates reflecting a 2.7 percent decline year-over-year, according to FactSet, arguably setting the stage for upside surprise. While
early, with only 4 percent of S&P 500 companies having released results so far, sales and earnings are modestly exceeding estimates, up roughly 1 percent and 5 percent, respectively, over expectations, according to Bloomberg.

- Our published single-point year-end 2019 price target for the S&P 500 of 2,970 is under review with upside bias. To a large degree, equities appear priced-to-perfection with a narrow margin of error. In addition to being up 20.2 percent year-to-date as of Friday’s close, approximately 75 percent of S&P 500 companies are trading above their 50-day moving averages, implying mounting excitement. Our published 2,970 target is based on a multiple of 18 times 2019 earnings of $165 per share; the upper-end range of 3,050 is based on a multiple of 18.5 times earnings of $165. We anticipate upside to our price targets to be driven primarily by modest multiple expansion, rather than earnings acceleration. We intend to review our assumptions and price targets in early August, toward the end of the second quarter reporting period and after having gleaned company forward guidance.

Fixed income markets

Powell’s testimony before Congress made it clear a rate cut later this month is highly likely and inflation data was stronger than expected. These factors contributed to falling short-term and rising long-term Treasury yields. Minutes from the Fed’s June meeting also indicated most voting members favor cutting rates in July. Market pricing is implying high odds of three rate cuts this year and another cut next year, for a total of 1.00 percent of policy easing by year end 2020. Risks to Treasury yields are biased higher (which means prices would be lower) in our view, given aggressive market assumptions around rate cuts. Because of this view, along with the flatness of the yield curve, we suggest slightly lower-than-benchmark duration exposures in non-taxable portfolios. Only slightly lower, due to the strong trend of lower rates and additional global central bank accommodation.

Economic data released last week supported riskier bond valuations. Yield spreads to comparable maturity Treasuries (a gauge of compensation for incurring credit risk) remain tight. Spreads have only been tighter (meaning lower compensation for your investment) 30 percent of the time in the last 15 years for investment-grade and high yield corporate bonds. Investment grade non-taxable municipal bonds are also expensive by historical comparisons but are still the best choice for investors in high tax brackets. We recommend bond portfolios be comprised primarily of high-quality debt due to its historical diversification characteristics versus other portfolio holdings. We remain wary of riskier high yield corporate bonds due to worsening credit fundamentals and price sensitivity to changing investor sentiment.

Real assets

Publicly traded real estate investment trusts (REITs) and other defensive sectors were mixed last week, trailing the broader market by roughly 0.5 percent, depending on the sector. Infrastructure was the best-performing sector, gaining 0.5 percent, while REITs and Utilities were both flat. A generally “risk on” (aggressive) tone in the market, combined with an increase in 10-year Treasury rates, were the catalysts for defensive stocks to take a breather. In the absence of lower interest rates, it’s hard to get excited about the defensive sectors of the market for now.

Crude oil prices, as represented by West Texas Intermediate (WTI), rose 4.7 percent last week. For the year, WTI is up more than 32 percent. Price action was once again helped by a massive decline in domestic inventories. Over the past month, domestic crude inventories have fallen by 30 million barrels to just slightly more than the five-year average. Geopolitical tensions and a tropical storm in the Gulf of Mexico were additional catalysts for a substantial upside move. With the Iranian situation still unresolved, it is hard to be bearish on oil prices — especially if demand can hold up.
Midstream infrastructure companies were beneficiaries of the positive move in crude prices, with the Alerian MLP Index rising 1 percent. Recent market action has been positive and has moved the index above all the daily moving averages we follow. However, these stocks have now reached an area of stiff resistance. The current level has not been breached to the upside all year. In the absence of a larger catalyst to push prices higher, we believe the market probably remains rangebound. However, fundamentals in the sector are improving and the assets trade cheaply.


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Past performance is no guarantee of future results. All performance data, while obtained from sources deemed to be reliable, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for direct investment. The S&P 500 Index consists of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 actively traded blue chip stocks and is the most widely used indicator of the overall condition of the U.S. stock market. The Alerian MLP Index is the leading gauge of energy master limited partnerships (MLPs) and is a float-adjusted, capitalization-weighted index, whose 50 constituents represent approximately 75 percent of total market capitalization.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Investment in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in high yield bonds offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer’s ability to make principal and interest payments. The municipal bond market is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issues of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes, but may be subject to the federal alternative minimum tax (AMT), state and local taxes. There are special risks associated with investments in real assets such as commodities and real estate securities. For commodities, risks may include market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties (such as rental defaults).

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