July 29, 2019

Mid-Year Update

By the time some of you have read this, the Federal Reserve will have already acted by reducing interest rates 0.25% or 0.50% from their current historical lows (remember the Fed's stated goal in January 2019 was to further increase rates three times throughout this year). Artificially low interest rates and record low borrowing costs have been the lynch pin to keeping equity and bond valuations at this current all-time high level. The Fed's reasoning behind their "change of heart" is that trade tensions and global uncertainty are damaging our economy. Furthermore, inflation is running below the Fed's 2% target. Whatever the merits of those arguments might be, cutting rates now seems out of step with what the Fed has done in the past.

This month marks the longest expansion ever for the U.S. economy – 10 years with no recession. The bottom line - the economy is slowing but not nose diving. The jobless rate is low, inflation is modest, the housing market continues to be fairly strong, and consumer confidence has not yet wavered.

We don't think a recession is imminent but a slowdown is in the works. The global economy is really ailing and our economy doesn't appear immune to a recession the way it did a few months ago.

Persistent weakness in manufacturing since the start of this year has been caused by a weaker global economy, the ongoing trade war with China, and a strong dollar. Export demand for U.S. goods continues to weaken. The bond market is telegraphing an economic slowdown. We are now experiencing an inverted yield curve- where the two-year treasury yield is paying a higher rate than the 10-year treasury bonds. Nearly a quarter of the firms in the Russell 2000 Index don't even make enough money to service their debt much less pay back the debt.

How is the lower interest rate policy in the U.S. going to affect the global economy? The simple truth is that asset prices globally are far too overvalued and debt levels far too onerous for a few rate cuts to make much of a difference. Right now there is zero room left in Europe and Japan to make additional rate cuts. Further manipulation of interest rates will just create more imbalances within the global economy. Currently, there is $13 trillion worth of sovereign debt that is yielding negative returns (i.e. it would cost the investor 0.64% for the German government to hold their money in the form of a German government bond).

So, where do we go from here? At least for the short-term the Fed's reversal of policy should keep U.S. stock and bond prices elevated. While our economy may continue to slow we don't see it falling off a cliff in 2019. Continuing volatility is all but certain, stocks may end the year little changed from their current level although they may oscillate between short lived rallies and selloffs along the way. We feel that the sectors of government bonds, utilities, consumer staples, real estate, and gold will continue to provide defensive protection while paying good income.

In summary, from an investment standpoint we want to continue playing defense with the portfolio allocations and continue to use extra caution. The second half of this year promises to bring with it much uncertainty and a few unanticipated twists and turns.

As always, we at Kapusta Financial Group would like to thank you for the trust and confidence you place in our team.