GAMBLE JONES | CAPITAL MANAGEMENT
A Division of Gamble Jones Investment Counsel

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It is said that patience is a virtue; the stock market certainly appears to value it as such. Following its worst December since 1931 due in large part to fears that the Federal Reserve would raise interest rates too aggressively amid rising economic uncertainty, the market sharply reversed course in the first quarter on the heels of the Fed doing the same. As recently as December, the Fed had projected two more rate hikes in 2019 and indicated it saw little reason to end the steady reduction of its $4 trillion bond portfolio that has been used to provide additional stimulus to the economy since the Great Recession. However, in fairly short order, the Fed has since pulled an about-face, stating it "will be patient" in determining future changes in rates and hinting that no rate hikes are now on the horizon this year. It also now plans to end the bond portfolio runoff in October, leaving the Fed with a much larger balance sheet than it anticipated when it began shrinking the holdings in late 2017. The market certainly appreciated the gesture, as the resulting decline in long-term rates helped the S&P 500 to its best quarter in a decade.

Of course, a key reason the Fed has become more patient is because it recognizes that the economy has cooled off a bit. Coming off a year in which it achieved GDP growth of 3% for the first time since 2005 due in part to the tax cuts put in place at the beginning of the year, the U.S. economy is now showing signs of weakening as the fiscal stimulus fades. In addition, the economy is also facing a headwind from slowing growth overseas, with particular weakness in Europe and China. The economic soft patch has led some to conclude that the U.S. economy is in danger of slipping into a recession.

Concerns over a potential recession were amplified by the recent inversion of the yield curve. A yield-curve inversion takes place when long-term bond yields fall below that of short-term yields, an unusual occurrence given that investors are typically rewarded with higher yields for locking up their money for longer. In this case, the yield on the 10-year Treasury note fell below that of the 3-month T-bill for the first time since 2007, just before the start of the last recession. An inverted yield curve is a sign that investors are anticipating that the Fed's next move will be a rate cut, which would most likely occur due to pronounced economic weakness. Forecasting future economic developments is always a difficult task, but an inverted yield curve is seen as the most reliable indicator for recessions, having preceded each of the past seven. A recession typically begins six to eighteen months after an inversion, though it can take as long as two years to emerge. The stock market can also continue to rally long after an inversion takes place. In the most recent case, the yield curve initially inverted in August 2006, 14 months before the market peaked and 16 months before a recession began. And while an inverted yield curve has generally been an accurate predictor of recessions, it is not a perfect indicator, with an inversion taking place in both 1966 and 1998 without an ensuing recession. In addition, the massive amount of Treasury bonds still held by the Fed has artificially flattened the yield curve in recent years, potentially making it a less reliable signal.

The economy has certainly slowed a bit over the past few months, and the recent inversion of the yield curve has served to reinforce that. And with the current economic expansion on track to become the longest in history in a few months and undoubtedly now in its later innings, it would not be a big surprise if a recession were to occur in the next couple of years. However, with the economy still supported by a strong labor market and a healthy consumer, we don't think a recession is imminent.

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Tracking the path of the economy, corporate earnings growth is also expected to slow this year. Boosted by tax cuts, earnings were exceptionally strong last year, with S&P 500 firms delivering EPS growth of 24%. With the economy slowing and the benefit of tax cuts now having faded, EPS growth is expected to be a far more moderate 4% this year. Still, we expect the economic environment to be sufficient for a number of companies to produce solid results.

Following the recent rally, we view the market as a whole as fully valued at current levels. We would not be surprised to see heightened volatility in the coming months as the market sorts through a number of issues, including Brexit, the ongoing trade dispute between the U.S. and China, and the state of the economy. In spite of the turbulence that these short-term macro issues may cause, our focus remains centered on building durable portfolios of quality stocks that will perform well over the long-term, through a number of economic cycles.

Sincerely,

Alison Gamble, President
Gamble Jones Capital Management