Second Quarter 2019 Commentary

We are barely six months removed from the pain and tumult of the stock market's rout in the latter part of 2018, but it now seems like a distant memory. The S&P 500 index continued its upward march in the second quarter of 2019, advancing 4.3%. Tacking that onto its first quarter gains means that the market is up 18.5% for the first six months of the year and that the S&P is now higher than it was when it peaked last September. The Dow Jones Industrial Average, with its lower exposure to the hot tech sector, showed more muted gains: after advancing 3.2% in the second quarter, it has now returned 15.4% for the first half of 2019.

The Economy Turned Upside Down

As we have written before, the stock market and the economy do not move in tandem in the short term (i.e., one or two years), but they are inextricably linked over the longer haul. Of late, the U.S. economy has continued its steady climb. GDP growth has been clocking in at a robust 3% or so, unemployment is at its lowest reading in decades, annual wage growth has been accelerating, and corporate profits are high and rising.

All these signs seem to indicate that the economic engine of the United States is humming along nicely. Indeed, some of the recent tweets from our President have directed our attention that way. On July 2 he stated, "The Economy is the BEST IT HAS EVER BEEN!" On July 9 he said, "Very good numbers on the economy. Much potential for growth." And on June 15 he crowed that "we have one of the best Economies in the history of our Country."

Normally when the economy is operating as well as ours seems to be, the Federal Reserve begins to raise interest rates. Think of interest rates like the accelerator pedal on your car. When things get sluggish or even begin to slow down, like they did so memorably in 2008-09, the Fed really needs to step on the gas to get things going again. This is done by lowering rates, which they did in a big way, taking short-term rates basically to zero and keeping them there for several years.

If you're driving down a highway, there is a certain zone of acceptable speeds. You want to get to your destination in a reasonable amount of time, but you don't want to endanger yourself or other drivers by going too fast. Economically speaking, once our national engine begins to gain traction, the Fed will want to begin raising interest rates. Otherwise, we run the risk of driving too fast and thereby increasing the odds of a crash.

However, our President does not subscribe to such orthodox economic thinking. On June 24 he tweeted, "Federal Reserve … doesn't know what it's doing – raised rates far too fast … now they stick, like a stubborn child, when we need rate cuts & easing." The "sticking" that he refers to there is in reference to the Fed's decision to leave interest rates unchanged when it met in June.

The Stock Market is Topsy Turvy

The stock market seems to be on Trump's side when it comes to the topic of interest rates. The 20% swoon we experienced in the final months of 2018 came against a backdrop of a rise in the short-term Fed funds rate: from 1.9% in September to 2.4% by year-end. In recent weeks, it seems like any day on which the prevailing thinking is that the Fed will lower interest rates, the stock market responds by going up. Conversely, if market participants seem to agree that the Fed will maintain or even raise interest rates, then the stock market goes down.

This set of circumstances can lead to some topsy turvy results. For instance, on July 5 the Bureau of Labor Statistics released a fairly healthy monthly Employment Situation Summary (or, as it is more commonly referred to, a jobs report). Expectations had been that we would have increased the country's aggregate non-farm payrolls by 165,000, but actual results showed an increase of 224,000.

That seems like good news, right? The economy is growing, more people are able to participate in its success than previously, and more people are participating than we had expected. So how did the market react to this news? It went down!

According to the financial pundits, the market's thought process seems to go something like this: the economy is doing better than we expected, and that will lead the Federal Reserve governors to be averse to cutting interest rates in the short term, which will cause financial assets to cost more, which will cause investors to demand a higher return on the assets they own, which therefore means that stock prices must fall.

In other words, good economic news produces bad results in the stock market, and bad economic news produces good results in the stock market.

Focus on the Trees

If you focus on this roundabout way of thinking too much, it's enough to make an investor's head spin. We, of course, have the luxury of ignoring all of this. Whether next month's report shows a gain of 165,000 or 224,000 jobs, whether the Federal Reserve raises or lowers short-term interest rates at its next meeting, whether the President tweets about the stock market or not … these things are not important to us as stewards of your capital. We concern ourselves with other questions, such as will GEICO sell more auto policies five years from now, will Starbucks sell more coffee five years from now, or will U-Haul help more people move and store things over the next decade?

In other words, we focus more on the trees than the forest. That's not to say that we ignore the forest completely. While we do tend to ignore the day-to-day or even month-to-month noise related to the zigs and zags of our nation's economy, we rest well in the knowledge that—over the next five or ten years—the American economy will continue to do well, and that rising tide will help lift GEICO and Starbucks and U-Haul and other companies that you own to higher heights.

Thank you once again for entrusting your hard-earned money to our care. We look forward to reporting to you again in October.

Sincerely,

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