Quarterly Commentary

U.S. Equity

The books are now closed on a tumultuous first half of 2019 that saw volatility surge thanks to trade war fears. U.S. equities advanced strongly in the quarter, despite heightened geopolitical tensions, as the Standard & Poor's 500 index climbed 4.3% in U.S. dollar terms over the second quarter. Year to date the index is up a stellar 18.5%. In Canadian dollar terms the respective change was 2.2% for the quarter and 14.5% year to date. The loonie gained 2.1% during the second quarter and it has increased by 4.1% so far this year.

The long bull market in the U.S. has now passed its tenth birthday and the recent run-up in U.S. stock prices may seem surprising for those who have been waiting quite a long time for a market reversal. Certainly there is no shortage of things that can go wrong with the long running global expansion which has been led by the U.S. For example, the world's two largest economies are locked in a trade dispute that tests competing visions of national economic management; the UK is lumbering toward a decision on exiting the Eurozone as the politicians relentlessly push the hard decisions further and further into the future; reforms in France have sparked protests; and leadership contests in Italy, Brazil and Mexico have lent support to various populist extremes.

In the U.S., the political system appears to be dysfunctional and the government will face challenges as a new fiscal year begins in the fall with the pressing need to fund ongoing operations. Paying for all these services will require that the government debt ceiling be raised once Treasury Secretary Mnuchin has run out of tricks to keep the government funded. Despite all the negative tidings, there is the potential for deals to get done and in particular the global economy may arrive at a net improvement in trading relationships, with better protection of intellectual property rights and increased openness of Chinese markets. That being said, global trade growth is likely to be slower than in its heyday before the Great Recession.

Investors seem to believe the Federal Reserve is correct to keep interest rates unchanged for now, with expectations that rates may move lower later this year to sustain economic expansion. Fed Chair Jerome Powell deserves credit for preaching patience to an administration that seems to expect immediate results. This honeymoon could linger for a while yet but the trade war means there will be an inevitable uptick in prices for manufactured goods coming from overseas. So far though, inflation has been kept at bay as firms are reluctant to raise prices. They are afraid of losing business but have been able to keep a lid on labour costs by finding a surprisingly large number of new workers. More people are getting jobs than policymakers once thought possible and wages and prices aren't spinning out of control the way some had predicted.

Beyond the slack in the labour market, forces like technology and globalization may also be keeping prices down as consumers with Amazon in their pockets can easily avoid overpaying. In fact the Fed's chairman has called weak inflation "one of the major challenges of our time." Some policy makers think there is room for a rate cut while inflation remains stuck below the central bank's 2% target. That could further stimulate the economy, helping to create more jobs and boost wages without pushing prices too high. But lowering rates is posing a challenge for the Federal Reserve as keeping rates low could also hinder the central bank's ability to manage the economy when the next downturn occurs.

The U.S. equity market continues to show signs of late cycle angst but, while trade disputes may generate negative headlines, there may be light at the end of the tunnel. China and the U.S. will be driven to reach an agreement as the threat of not doing so becomes increasingly evident. In the meantime the underlying strength in the economy and a healthy earnings outlook should be supportive of U.S. equities.

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