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After a Strong First Half, Potential Is for More Gains in 2H

With the half year mark fast approaching, it's as good a time as any to take stock of the first six months for U.S. equities, and, more importantly, to see what, if anything, that means for the market's potential in the back end of 2019. We'll get a jump on the sell side, which will dutifully put out its forecast reports after June 30.

Where is this over ten-year old bull going? Will it trot on or begin to wobble, wheeze and fall? I remain convinced the bias is to a higher level by year end—but that doesn't appear to be the market's view, egged on by bad news headlines.

I'll grant you that there's plenty of skepticism to make you believe a bear market is around the corner. Yes, this is the second oldest bull market in history. There's the on again, off again trade talks between the U.S. and China, with the market rising and falling on every seeming movement. The global economic news isn't so great, nor even in the U.S., too.

For example, this week, blaming trade tensions, the Conference Board said its consumer confidence index dropped 9.8 points to 121.5 this month, the lowest since September 2017, from a downwardly revised 131.3 in May. And Tuesday also brought news that new home sales dropped 7.8% to a seasonally adjusted annual rate of 626,000 units in May, the lowest in five months. Jobs growth has been soft of late.

In the middle of this news, and after the market's big first half run up, it's easy for the clouds to obscure the positive factors. As we have noted in a recent reports by Tom Lee on cyclicals, the U.S. Treasury bond 10-30 yield spread has been widening, leading to a steepening yield curve. That's salutary for both the economy in general and cyclicals in particular. And I think that despite the red hot trade rhetoric, ultimately, cooler heads will prevail. I know I've said this before, but both countries need a deal, and President Donald Trump needs it badly, as the 2020 elections are a little more than a year away.

It also happens to be a bull without much investor enthusiasm. Nowhere is there exuberance. That's a contrarian point in favor of the bull trotting on.

As of June 25, the Standard & Poor's 500 index is up 16.7% for the year, and 24.1% from the lows of Dec. 24, 2018. Not bad. The market's price/earnings (P/E) on 2019 EPS is about 17.8 times consensus of about $167 and 15.6 times the consensus of about $187.

Here's some interesting data from Bespoke Investment Group (BIG). The performances of stocks and bonds this year has bucked the typical trend of this bull market, that is, bonds and stocks generally moving in opposition. Both asset classes are up. In 2019, long-term treasuries, as measured by the Bloomberg Barclays U.S. Treasury Total Return index, have rallied around 11%.

Since 1980, there have only been nine years where both asset classes were up over 5% through the end of June, according to BIG. In those instances, the S&P 500's average second half return was 11.3%, (median: 12.40%), with positive returns in all but one period. That's twice the average return for all second halves since 1980. Of course, past performance doesn't guarantee the future performance, but I find it interesting.

Another subtle market factor is one from our technical strategist, who's pointed out that defensive sectors are not showing the kind of strength that would indicate that investors are truly convinced a bear market is coming.

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Analysis not Opinions

For all the defensive positioning of institutions, our technical analyst Robert Sluymer points out that utilities and staples are at price highs but they actually haven't performed well compared to the broad market. For example, in the chart below it's clear that when the broad market weakened by 7% or so in May and utilities rose, but the sector then made a lower relative high compared to the previous high in the December 2019 drawdown.

Sluymer says the utilities weekly momentum has peaked with the relative performance in a longer term downtrend. It is continuing to negatively diverge, with lower highs underway. That suggests there isn't a lot of conviction behind the defensive positioning in the market. The consumer staples sector, another safe haven sector, shows a similar technical pattern.

S&P 500 Utilities - Weekly

Weekly momentum has peaked with relative performance in a longer-term downtrend
AND continuing to negatively diverge from price with lower highs underway

Source: FS Insight, Bloomberg, Optuma

Where could I be wrong? Going into May I thought that the U.S. and China would reach some sort of trade agreement. That didn't happen and the market didn't like that at all. Talks have resumed and both Trump and China's Xi Jinping will meet at the upcoming G-20 meeting in Japan. In any event, a full out "trade war" alone would not bring on recession, but the serious sentiment deterioration from such a prospect could hurt stocks almost as much as an actual economic contraction itself. The Middle East remains a political powder keg that can blow at any time, but this would likely be temporary setback for stocks, though not for people involved.

Bottom Line: More zig zag action into the third quarter but ultimately a higher finish.

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