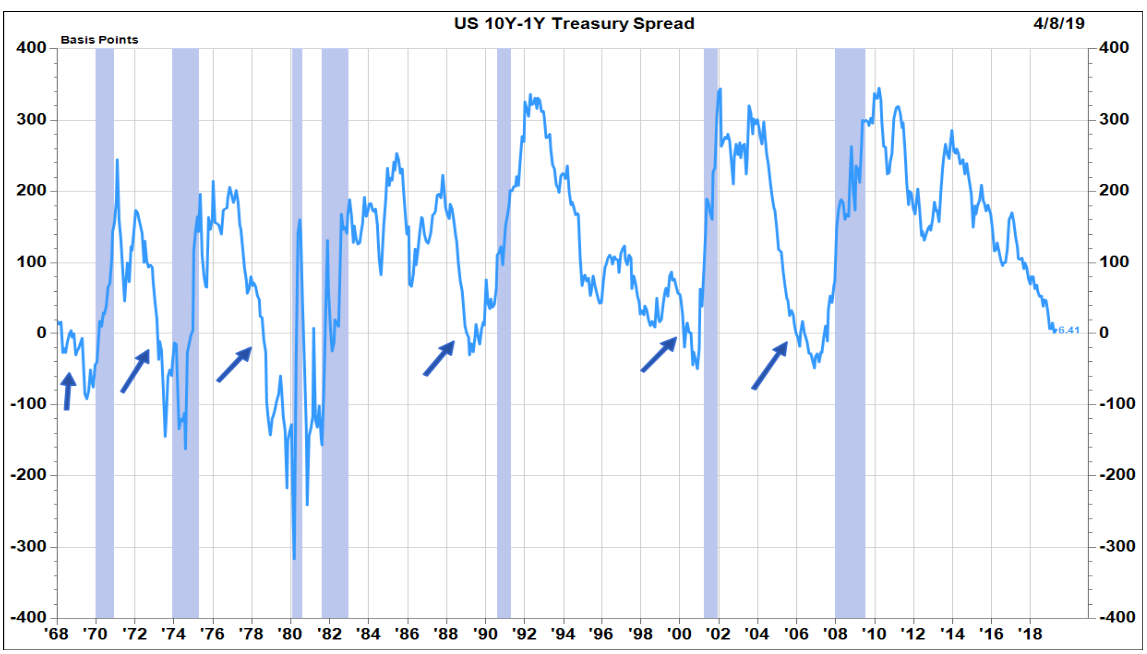
Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company
Investment Outlook, April 2019

The Standard & Poor's 500 Index provided a total return of 13.6% in the first quarter, the best start to a new year since 1998, and a complete turnaround from the fourth quarter of 2018 in which the S&P declined almost 14%. Clearly, volatility remains very much a fact of life in the current market environment.

On the surface, it appears that the stock and bond markets are discounting two entirely different economic outcomes.

Stocks are trading as if we were in the early stages of a new economic expansion with accelerating corporate earnings and improving jobs growth. The reality, however, is that earnings are expected to be flat-to-down for the first quarter and possibly for the next two quarters, as well. Non-farm jobs growth is slowing if one looks past the highly volatile monthly reports to the moving averages. The last three monthly job reports show gains in non-farm payrolls of 180,000 new jobs, on average, which is below the average gains of 233,000 for last year's fourth quarter and 200,000 for all of 2018. The unemployment rate at 3.8% has remained flat for eleven months, and wage growth has begun to slow slightly. At the same time, the stock market's forward price/earnings ratio expanded from 14 times earnings to nearly 17 times during the first quarter, and the percent of all stocks trading above their 200-day moving averages has increased from 9% to 66%!

The bond market, on the other hand, is behaving as if a recession was imminent. The yield on the 10-year U.S. Treasury has declined from 3.23% in December to 2.51% currently. The yield curve actually inverted briefly late in March when the 10-year yield fell slightly below the 1-year yield. This was viewed by many as significant, as every recession since at least 1970 has been preceded by an inversion of the yield curve. The chart, below, shows the last seven recessions (shaded areas), each preceded by an inversion of the yield curve, with the 10-Year yield minus the 1-Year yield below zero.



While an inverted yield curve has been a signal that equity investors have been watching for anxiously, and is now flashing yellow, we would add the following three points.

First, while it is true that inversions of the yield curve have commonly preceded economic recessions, such inversions have not, of themselves, *caused* economic recessions. Second, compared to the March inversion, all prior yield curve inversions were deeper (50-100 basis points or more) and persisted for longer periods of time, often for months. The yield curve was inverted for almost two years prior to the 1970 recession. The late-March inversion, by comparison, amounted to just 3 basis points and lasted just 3 trading days. We would need a monthly average inversion, or longer, for a more clear recession signal to emerge. And third, other reliable leading indicators of recession, such as money supply growth, unemployment, and jobless claims remain in neutral-to-positive territory.

The Federal Reserve sets short term interest rates, but the bond market sets long term rates, which have been falling in anticipation of lower economic growth and continued low inflation. If the Fed responds by reversing course and lowering short term rates back below market rates, the risk of a recession will go down. Previous recessions have not been caused by inverted yield curves, as we have said, they have been caused by the Fed continuing to raise short term rates even after the yield curve inverted.

The bond market has sent a clear signal to the Fed that it is time to reverse course. It is also clear that the stock market is discounting the eventuality that the Fed will ease in time to keep this expansion on track. We view these expectations as entirely reasonable in the total absence of any signs of over-heating on either the wage or inflation front. Stock market investors who have followed the adage, “Don’t fight the Fed” have generally fared well in good times and avoided the worst of the bad times. At this point, the reverse is also true - the Fed shouldn’t fight the markets.

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