The first half of 2019 unfolded in a way few predicted coming into the year. The equity market not only recovered to new all-time highs in the second quarter, but it approached and even surpassed levels that many prognosticators had predicted for the full year. Meanwhile, in the bond market, falling interest rates and expectations of future rate cuts helped the Bloomberg Barclays U.S. Aggregate Bond Index deliver its best total return over the first half of a year since 1995.

Given the surprises thus far in 2019, what should investors expect going forward? There are few, if any, scenarios in which both stocks and bonds continue to deliver the very high returns of the last six months. In other words, what is good for stocks in the short-term is likely to be bad for bonds and vice versa. Furthermore, since strength in both markets has coincided with increasing expectations that the Federal Reserve (the Fed) will cut short-term rates in the second half of the year, downside risk in both markets may have increased.

As surprising as the first half returns of the stock and bond markets have been, the environment in which the returns have transpired makes them even more surprising. The strong returns of the equity market came despite a significant slow-down in the growth rate of corporate earnings. After growing at a rate of more than 6% in each of the first three quarters of 2018, S&P 500® Index operating earnings expanded at a rate of less than 1% in both Q4 2018 and Q1 2019 and are currently expected to grow less than 1% in Q2 2019. Slowing growth appears to be primarily a corporate phenomenon rather than a sign of broader domestic economic deterioration.

The bond market environment has changed dramatically over the last six months. After their December 2018 meeting, the Fed had prepared the market to expect two rate hikes in 2019. Market seers who had forecast low to negative returns from bonds based on the Fed's outlook are, to this point, off by more than a country mile. The yield on the 10-year U.S. Treasury Note (the 10-year) has defied both the Fed and market prophets by briefly falling below 2% during the second quarter, a mark that put it within spitting distance of all-time lows. Moreover, at the end of Q2 2019, futures market prices for the Fed funds rate reflected a 100% probability of at least one rate cut this year, with the first likely to come as soon as July. Futures pricing also reflected rising probabilities of additional cuts by year-end. Falling rates and strong bond market returns occurred despite robust Q1 2019 GDP growth, strong employment figures and an elevated Conference Board Leading Economic Index.

Looking forward, continued economic expansion may be necessary to support a re-acceleration of earnings growth that would justify current market valuations and support a continuation of the robust equity market advance. However, this would likely put upward pressure on interest rates and lower the likelihood that the Fed could justify the multiple future rate cuts currently priced into futures markets. Similarly, significant progress on trade policy, specifically between the U.S. and China, may benefit stocks but would also likely alleviate some of the concerns about a global economic growth slowdown that may have contributed to expectations of future rate cuts by the Fed. Conversely, if economic data begin to conclusively show that the domestic economy is deteriorating due to tariffs, slowing global growth or some other phenomena, the bond market may continue to rally. However, any or all of these developments would be negative for the stock market.

While it is difficult to envision scenarios that would allow both the stock and bond markets to simultaneously continue their high returns, there is a scenario with the potential to trigger a simultaneous retrenchment in both markets. If the Fed is unable to deliver on the rate cut expectations currently reflected in bond futures market prices, both stock and bond markets could potentially give back a substantial portion of their recent gains.

Investors may be compelled to attempt shifting money to the winning horse when two have gotten out to a stronger than expected start. Gateway believes investors are best served by maintaining exposures that are consistent with their risk tolerance. Shifting portfolio allocation toward the asset class that is expected to do the best over the short term could result in exceeding risk tolerance, or unnecessarily lowering risk below tolerance. Gateway strategies, which combine equity exposure and index option-based cash flow to lower risk, are a potentially attractive middle ground for investors who see long-term opportunity in equities but shorter-term risks in both stock and bond markets.

The Chicago Board Options Exchange (Cboe®) Volatility Index (VIX®) ended the second quarter at 15.08. While this is below its long-term average, it is notable because the S&P 500® Index was above 2900 and near its all-time high. VIX® ended the second quarter significantly higher than its reading the previous times the S&P 500® Index made new highs above 2900. Specifically, VIX® was 28% higher than it was at the market peak on September 20, 2018 and 17% higher than the peak on May 3, 2019. The implied volatility represented by VIX® is the vital component of strategies that write index options to lower the risk of equity market exposure. Higher VIX® levels result in higher cash flow from index option writing. Higher cash flow has the potential to translate into greater returns if the equity market advance continues. Increased cash flow can also provide improved protection if downside risk materializes in the equity market.

Gateway strategies have a long history of utilizing cash flow from option writing to achieve a lower risk profile than the broader equity market. Investors seeking to maintain their historical risk profile while reducing direct exposure to the potential risks of stock and bond markets may find a useful role for Gateway strategies in their diversified portfolios.

IMPORTANT INFORMATION

Sources: Morningstar Direct℠, Bloomberg, L.P.

For more information and access to additional insights from Gateway Investment Advisers, LLC, please visit www.gia.com/insights.