Economic & Market Commentary

Financial assets continued to grind higher in the second quarter, furthering the "worst to best" trend that began with the Federal Reserve Board's pivot in January. While not as good as the first quarter, second quarter equity market performance registered a gain of 4.3% for the S&P 500, bringing the year's first half in at plus 18.5% (including dividends). It was the best first half performance for the S&P 500 in a dozen years. It prolongs the decade long surge and surpassed the prior peak of the bull market that began in March 2009. In the process, stocks have recouped the dramatic losses experienced in the final quarter of 2018 and have exceeded the old high set in October of that year. Ironically, this follows a survey taken in December by the American Association of Individual Investors showing that 47% of those surveyed believed stocks would decline over the next six months (only 25% believed they would increase), one of their most bearish readings in years. The major sector contributors to the market's rise for the quarter and the 6 months were Information Technology and Communications Services, as well as Consumer Discretionary. Industrials and Financials were also positive contributors for the year-to-date. Reversing the first quarter's positive rebound in oil prices, the Energy sector was negative for the quarter and underperformed the index for the six months.

Although not as good as equities, bonds produced attractive positive returns across the yield curve. For example, the ten-year Treasury, after reaching a yield of 3.25% in October, ended June at 2.00%. Other than a handful of food commodities, most economically sensitive commodities ended down, reflecting the heightened fear of slowing economic growth, indicated by the Fed's more dovish stance. With most other central banks around the globe signaling stimulus, international equity markets followed the U.S., with only 28 of the 73 countries tracked by *The Wall Street Journal* showing negative results in dollar terms.

The sector performance trends that have been in place for a long time carried into the first half of 2019. Growth dominated value, as it has for the better part of the past ten years. Likewise, large cap dominated small cap. The breadth of the equity market diminished somewhat during the quarter with 5 of the 11 S&P 500 sectors topping the index, leaving only 4 of 11 doing so for the six months. The FAANGs (Facebook, Apple, Amazon, Netflix, Google) plus Microsoft, which have been dominating factors in the past few years, were less so into 2019. Only 3 of these outpaced the index during the quarter and, in fact, Google (Alphabet) was down. In aggregate, they contributed just over 20% of the index performance for both the quarter and the six months.

As this is written, the U.S. stock market continued to broach new highs, with the S&P 500 approaching 3000. It has been a ten-year bull market, coinciding with the now longest economic expansion in our history. The expansion has just started its eleventh year, and while it is our longest expansion, it is also our weakest period of ten-year growth. First quarter real

GDP growth of 3.2% was well above the prior quarter's 2.2%. However, looking beneath the headline reveals a less robust result. Net exports, inventory build, and government spending were above normal, while business investment and residential investment experienced slower growth. The consumer, which is the lion's share of our economy, has been stable, supportive, and is expected to continue to be so. With the Chinese trade situation not yet resolved, the anniversary of last year's tax cuts, and the continuation of lackluster results from the several parts of the economy mentioned earlier, we expect the second, and subsequent quarters to be less robust than the first. For some time, we believed we were in a +2% GDP world, and we remain in that camp today. The many factors in place coming out of the events of a decade ago pointed in that direction, and still do. The subdued pace of growth, and the policies put in place in the past few years have led to a protraction of this moderate growth path for the near-term. The U.S. consumer is in better shape, with wages finally rising, savings at a high point, and a willingness to spend. Inflation is well controlled, fiscal stimulus is easing, yet monetary policy (after the Fed's "pivot") remains accommodative. Most economists see few signs of dramatic economic slowing and expect the current path to continue until late 2020 or 2021. We have no reason to disagree with that conclusion. We do not expect a dramatic resolution of the trade situation with China, but rather see a continued kicking of the can down the road with the potential for side deals, which will keep the process moving. So, for policy purposes we will remain in the 2% world we have been in, unless there are major changes in future policies either in the U.S. or geopolitically.

As mentioned earlier, the U.S. stock market has also been on a ten-year run. Half a generation of investors have not been through the throes of a bear market. While we broached bear territory in the fourth quarter of last year, it was only six months later that we had recouped and reached new highs – "buy the dip" would have paid off nicely! As we approach 3000 for the S&P 500, we can say that the market is not cheap. Depending on whose earnings forecast is used, the S&P 500 is selling at 17.5-18.0 times this year's estimated earnings. This is not yet "bubble" territory (as it was in 1999-2000), but it gets our attention. Second quarter earnings reporting season is starting this month. Expectations have come down throughout the first half and most investors are looking for aggregate earnings to be flat to up/down modestly, over the next two quarters. Revenue growth is subdued, margins are at their highs, labor costs are increasing, so earnings surprises could be many and lead to greater volatility. We will be watching this closely. There are however signs of "bubble" like exuberance among certain parts of the financial asset world. Fixed income, for example, comes to mind. U.S. rates have been low for the better part of the decade, and in the past six months have reversed what was thought to be a "normalizing" trend on the part of the Fed. As previously mentioned, the U.S. Treasury 10 Year Note traded at 3.25% last year and has recently traded below 2.00%. Globally, the situation is even more pronounced. The bonds of most of the countries in the European Union

have been pushed to negative interest rates (i.e. you lend and, at maturity, receive less than you lent). Most of the central banks in those countries have adopted this policy in an attempt to incentivize spending and discourage saving in the hope the growth will continue and inflation accelerate. In total, close to $13 trillion of sovereign debt around the globe trades at negative interest rates.

The other area that has a "bubble" feel is the initial public offering (IPO) space. Our analysis shows that so far in 2019, 168 companies have come to the market with IPOs - 65% of these have no earnings. These are primarily in today's world called Unicorns – they have no earnings, and most have no competition. Typically, they are new businesses, spawned by the digital age, that are disrupting existing business structures. Companies that have no earnings and no competition (yet) are beyond economic analysis, and therefore very difficult to value. Yet, they are being gobbled up by traders with excess liquidity and starved for return.

In our view it is this liquidity that is keeping financial assets afloat. Recent actions have emphasized this. The Fed "pivot" in January and the resultant equity market rise, and the decline in interest rates (rise in bond prices) were the most telling example earlier this year. More recently it is evident that any indication of the Fed lowering rates is greeted by a rise in stocks and bonds. Conversely, any indication of the Fed increasing rates is greeted by the reverse. Clearly, the financial markets are dancing to the Fed's music, as contrary as that may seem. (Usually when the Fed lowers rates it signals a weakening economy, and an increase signals a strengthening economy). Excess liquidity has been a global fact for most of the last decade. Savings rates are high, asset prices are high, consumers are spending, but corporations are wary of making long-term commitments with global uncertainty so high. With most of the central banks around the world stepping on the monetary gas pedal, it's hard to see these circumstances changing drastically. Barring major geopolitical issues (China, Iran, North Korea), and as long as our economy keeps growing moderately, we think the U.S. stock market can grind its way upward in an increasingly volatile fashion. We like the way our client portfolios are positioned and the companies we own; we feel they have significant unrealized value. We hope the trend toward recognizing this value, which began in the first half will continue, and that company economic fundamentals will become important once again.

Fixed Income

U.S. fixed income securities led a global bond rally for the second quarter of 2019. Unlike the rally in the first quarter which focused on recovery and a telegraphed Fed policy change to "patience", this bond rally was not directly due to economic data reports, but rather trade tensions, global weakness, and the Federal Reserve.

The Bloomberg Barclays US Aggregate Bond Index returned 3.08% for the quarter, surpassing

the 2.94% return in the previous three months. The entire yield curve shifted down as rates declined. Treasury yields declined 28-52 basis points (bps). The yield on the two-year Treasury fell from 2.27% to 1.75%. The yield on the ten-year Treasury closed the quarter at 2%, falling 40 bps.

The yield curve continued to remain inverted, however, the inversion is between the six-month Treasury Bill and the ten-year Treasury Note. Economists note that inversions typically precede recessions, however the cited inversion has historically been between the ten-year and the two-year. Inversions following quantitative easing and quantitative tightening may not be predictive of future recession, as yields have not had an extended period of normalization since the massive intervention from the financial crisis.

Trade policy has been a major theme this quarter which has contributed to lower yields and a dovish Federal Reserve. There were many significant events which took place, principally the May 10 escalation of tariffs on imported Chinese goods, and how this action is having an impact on the economy. A trade deal or an imposition of more tariffs (25% on the remaining $300 billion of Chinese imports), have created a climate of economic uncertainty. In early June, an added threat of tariffs on Mexico further pushed the markets into unchartered territory and uncertainty. Expectations around the G-20 meeting, the use of tariffs as a negotiating tool, and predicting the impact on future economic activity contributed to a market reaction which anticipates multiple Federal Fund interest rate reductions by year end.

In the first quarter, Chairman Jerome Powell of the Federal Reserve noted concerns about global growth and uncertainties surrounding trade policies. This combined with low inflation allowed the Federal Reserve to be, "patient" in determining policy adjustments. Powell, in the second quarter signaled that the Fed would be open to cutting rates if necessary, during a speech to the Chicago Fed. "We are closely monitoring the implications of these developments for the U.S. economic outlook and as always, we will act as appropriate to sustain expansion, with a strong labor market and inflation near our symmetric 2% objective." The Federal Open Market Committee met at the end of June and kept interest rates unchanged. While monetary policy is based upon trade policy and weaker economic conditions the financial markets are predicting two interest cuts before the end of the year. Federal Reserve members are split in their expectations. Seven senior officials are expecting the Federal Funds Rate to be lower by 50 bps at the end of the year, while eight expect no change.

Economic data has been mixed. The U.S. economy added 224,000 jobs in June, a rebound from the May jobs number. Strong growth in job creation definitely moderates expectations for cuts, however slowing wage growth combined with below target inflation data could still strengthen the case for a 25 bps reduction in rates.

Global growth has continued to slow. Mario Draghi of The European Central Bank has moved bank monetary policy to a dovish stance. European economic forecasts indicate current growth at an anemic 1.1%. As global rates were low to begin with, this move pushed bond yields to record lows, and even pushed four countries into negative yield territory for their government issued debt.

We continue to position our fixed income portfolios shorter in duration to their respective benchmarks. We continue to overweight our corporate exposure after strong performance in the first half of 2019 sent yields to two-year lows. Dovish monetary policy, less new bond issuance, and strong balance sheets support the corporate credit sector. Aggressive market expectations of Federal Reserve cuts seem excessive and we will continue to be cautious.

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