Market Perspective: Second Quarter 2019

HAPPY 1OTH ANNIVERSARY, U.S. ECONOMIC EXPANSION!

Depending perhaps on your profession, avocation, and personal experiences, the bottoming of the U.S. economic recession a decade ago in June 2009 may seem like either distant history or an altogether too fresh bad memory. Fortunately, all manner of dire predictions about global economies and financial markets in the period immediately preceding the 2009 upturn (and, indeed, for several years thereafter) did not come to pass. For investors, the most recent 10 -year period produced ample financial rewards. Such has been the case so far in 2019, with most asset classes producing portfolio returns that have exceeded consensus expectations at the start of the year. Recent U.S. and global data, however, are beginning to suggest that both the economy and financial markets might expect a “bumpier ride” across the balance of 2019 and in 2020.

RECENT ECONOMIC TRENDS

U.S. government policies, economic trends, and evolving monetary policy continued to drive prices in global capital markets during the 3-month period ended June 30, 2019. On the policy front, Trump Administration trade posturing with China and Mexico created growing economic concerns, with a possible widening and more expensive set of tariffs with the former and a short-lived plan to penalize the latter potentially creating havoc with critical cross-border supply chains. The resulting operating uncertainties have begun to adversely affect business’ confidence. Additionally, a weaker Chinese economy (itself a leading “engine” of global growth since 2009) contributed to slowing growth rates across much of the globe. There was only cold comfort that the U.K. has continued to experience even greater political dysfunctionality than the U.S. That country has yet to find a politically acceptable means of executing on its June 2016 BREXIT vote, hopes to choose a new PM that can do so this summer, and has until October 31 to craft policies acceptable both to its politicians and to the EU.

Reports on the U.S. economy’s growth across the year’s first quarter were favorable, with GDP growing at a +3.2% annualized rate (up from +2.2% in the final quarter of 2018). The underlying data, however, was somewhat mixed: strong exports (perhaps partly fueled by concerns about future tariffs) and private investments (in structures) masked tepid consumer spending. Although inflation (+1.6%, core) stayed under control and unemployment (3.7%) remained at 50-year lows, data showing lower purchasing manager activity and reports of eroding business and consumer confidence led most analysts to reduce their estimates of economic growth across the balance of 2019. Current consensus estimates are that U.S. GDP grew at a +1.8% rate in the Second Quarter, and that growth will be +2.5% across all of 2019 (versus +2.9% in 2018). Globally, growth is also slowing; notably, the German and Japanese economies logged sub-1% annual growth rates during the year’s first quarter.

This evolving economic environment was – and is – the backdrop for on-going deliberations by the U.S. Federal Reserve as to its next monetary policy steps. You may recall that, as recently as December, the Fed’s outlook was for continued strong growth and attendant more restrictive monetary policy (i.e., a Fed

Funds Rate that would peak at over 3.00% by December 2020). Given growing concerns about the pace of economic growth, capital markets began anticipating that the next move would be a lowering of the Fed Funds rate from its current level of 2.50%. In his testimony before Congress in mid-July, Fed Chairman Powell paved the way for a possible late-July cut, noting that "uncertainties about the outlook have increased in recent months".

BOND AND EQUITY MARKETS

The trend toward lower U.S. bond market yields that began during the year's first quarter continued during the most recent three months. Yields on 10-Year Treasury bonds, for example, fell a further -41 basis points to 2.00%. As recently as November 2018, they yielded 3.24%. The "shape" of the yield curve became even more inverted: 3-Year bonds now yield -40 basis points (-0.40%) less than 3-month Treasury Bills. Although the higher bond prices that created these downward yield movements produced the highest six-month total return (+6.1%) on taxable bonds since 2011, a return to low yields is likely foreshadowing future economic weakness (see discussion that follows). These trends – high YTD investment returns and a less rosy outlook – also apply to the tax-exempt bond market. Lower yields and continued strong investor demand last quarter pushed muni bond total returns to +3.9% YTD. But going forward, low yields portend a period of low total returns – approximating the 1.6% to 2.5% current yields in the tax-exempt and taxable segments of the U.S. bond market, respectively, across the next 5 years.

CURRENT BOND MARKET METRICS AND RECENT TOTAL RETURNS

	Yield to	Total Returns, Periods Ended 6/30/19		
Market Segment	Maturity	3 Months	YTD	12 Months
Taxable Bonds	2.49%	3.1%	6.1%	7.9%
Tax-Exempt Bonds	1.60%	1.6%	3.9%	5.5%

U.S. equity markets were more volatile during the most recent quarter but finished the period with a positive total return (+4.1%, Russell 3000 Index). The strong advance that began in late December drove prices higher through late-April before giving way to growing concerns about the potential impact of trade policies on the pace of economic growth. U.S. stocks declined nearly -7% in May. But an about-face on Mexican tariffs and prospects that the U.S. and China would re-start trade negotiations gave equity prices a lift in June. By month-end (and, into early July), major U.S. indices had fully offset their year-end 2018 collapse and were setting new all-time highs.

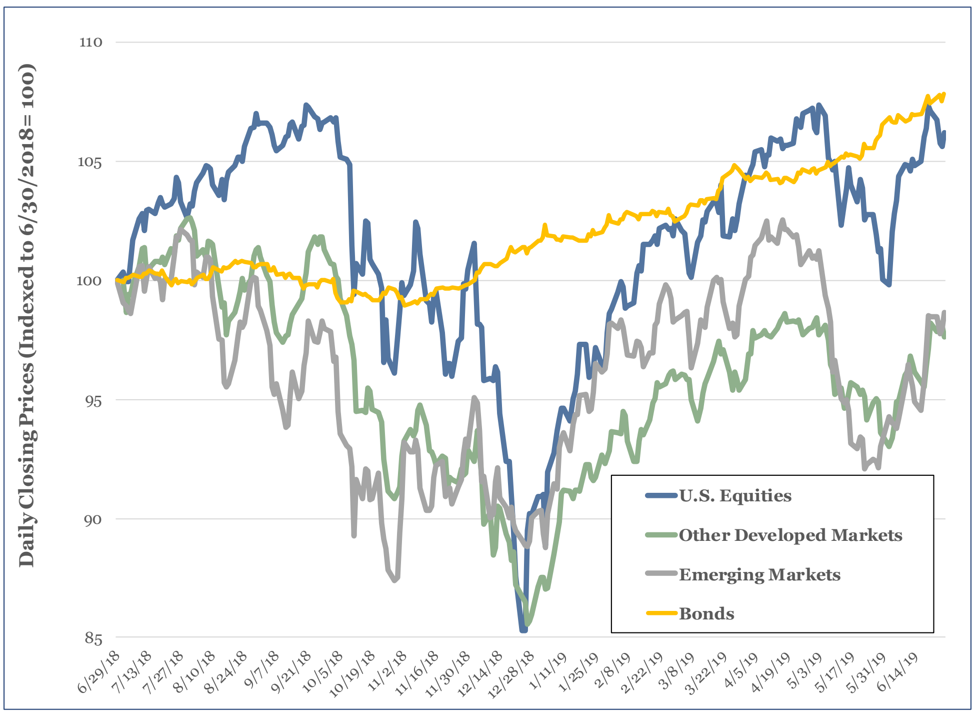
CURRENT GLOBAL EQUITY MARKET METRICS AND RECENT TOTAL RETURNS

	Total Returns		Valuations	Dividend
Equity Markets	3 Months	YTD	(Price/Est. EPS)	Yield
United States	4.1%	18.7%	17.1	1.96%
Developed Europe	4.7%	15.8%	13.1	3.96%
Japan	0.9%	7.8%	12.6	2.49%
Emerging Markets	0.7%	10.6%	12.6	2.99%

source: Bloomberg

Prices in equity markets outside the U.S. generally followed the same trends, though they bounced-back less dramatically than domestic markets through April and some emerging markets (particularly China) experienced sharper pullbacks in May. On balance, the U.S. Dollar was mixed against most major currencies; notably, China's currency declined about 2.5% versus the USD, somewhat dampening the economic impact on China of tariffs levied on many of its exports to the U.S. For the quarter, European equity markets topped the U.S., while Pacific equity markets lagged modestly and China (-4.4%) dragged down outcomes in the broader Emerging Market equity universe. Relative to U.S. equities, non-U.S. stocks continue to sell at a large discount (lower P/E) and offer higher dividend yields than domestic stocks.

CURRENT EQUITY AND BOND MARKET PRICES, JUNE 2018-JUNE 2019

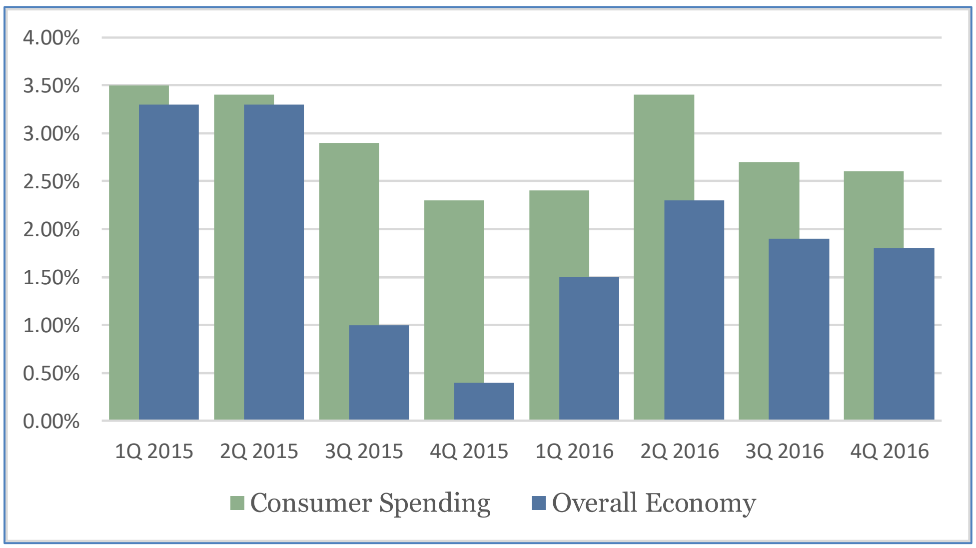


SLOWDOWN OR RECESSION?

The financial press generally – and the investment industry in particular – continues to speculate about how much longer the current economic expansion can or will continue. Read enough research reports on the economy and you are likely to see several references to the cliché that "expansions don't die of old age". This is a shorthand way of making two divergent points: expansionary periods do eventually end but the current expansion could well continue into its 11th year and beyond. Some combination of events or developments ultimately upend optimism. When consumers – and more critically, businesses – lose confidence that the economy will continue to grow and react by constraining spending and hiring, an economic slowdown can occur.

The current expansion has gone through some "soft patches" across the last 10 years, most notably between June 2015- June 2016. Economic growth slid from a strong +3.4% year-over-year rate across the prior 12 months to just +1.3% (and barely grew in the final quarter of 2015). Consumers mostly continued to boost the economy but a big decline in private investment (equipment and buildings) and shrinking exports (-1.5%, partly a consequence of a much stronger dollar) put the expansion and accompanying 6-year long equity bull market at risk. At the time, we discussed how concerns about Greece's potential default and exit from the European Union, and about China's economic slowdown and implications for the broader global economy, were both rattling capital markets. We wrote that, closer to home, "*the greatest threat to the 80-month long U.S. equity bull market may be a leveling-off of corporate profits*". Substitute BREXIT for Greece and the big-picture economic stories of mid-2019 look very similar to those of mid-2015.

QUARTERLY RATES OF ECONOMIC GROWTH, 2015-2016



Historically, it has taken a crisis (surging oil prices in the 1970's; home price collapse and banking industry instability in 2007-2008) or overly-aggressive monetary policies to tip an economic slowdown into a recession (negative economic growth). Neither "necessary condition" for triggering a recession exists presently; even inconsistent and uncertain U.S. trade policies do not seem likely to produce that tipping point. And we are not yet convinced that interest rates (having only been increased to levels well-below historical norms for periods of economic expansion) need to be lowered appreciably to keep the expansion going. Accordingly, we believe the odds that the economy muddles through a period of slow growth across the next 12 months are greater than it experiences its first-in-a-decade recession.

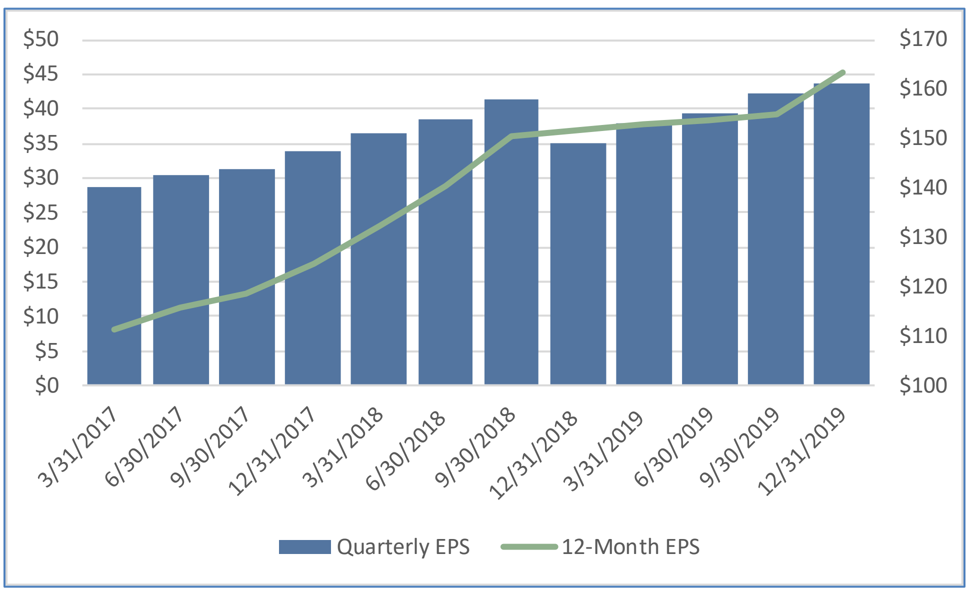
CAPITAL MARKET IMPLICATIONS

Although there are a few disconcerting capital market parallels to periods immediately preceding past economic contractions (e.g., Initial Public Offerings of unprofitable technology-related companies at high valuations), there does not yet seem to be any similarly misplaced consumer or capital markets euphoria.

For example, 10-years into an expansion consumers in 2019 are choosing not to shoulder increasingly large debt burdens, and U.S. stock market valuations – though again modestly above what we consider to be "fair value" – have not come close to approaching the absurd multiples (i.e., a P/E over 29x on the S&P 500 Index as was the case in mid-1999) that signal a wholesale disconnect with economic reality.

If growth rates in the U.S. and global economies do slow meaningfully, then less robust corporate earnings and dividend growth will be an issue that capital markets and investors confront in the periods just ahead. After achieving, in aggregate, all-time high profits during 2018 (e.g., EPS of $152 per share for the S&P 500 Index), companies' earnings are currently forecast to have grown only about 3% across the first half of 2019. According to Bloomberg, more than 80% of the S&P 500 Index companies that have recently communicated updated earnings forecasts for the just completed quarter have lowered their earnings projections. Additionally, the pace of share buybacks (companies using surplus cash to repurchase their shares and, consequently, boost per share earnings) has slipped modestly, suggesting more balance sheet caution on companies' part. The combination of earnings uncertainty, YTD total returns that have exceeded expectations, and valuations (price/current earnings) that are now on-par with the 18.1x level immediately prior to last fall's sell-off suggests that building on these market gains will be a challenge across the second half of 2019.

S&P 500 INDEX: ACTUAL AND PROJECTED EARNINGS PER SHARE- 2017-2019



INVESTMENT STRATEGY TEAM
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