

2019 Second Quarter Review of the Markets

Index	2nd Qtr Return	YTD Return
S&P 500	4.30%	18.54%
MSCI ACWI Ex USA IMI	2.74%	13.33%
Barclay's Bond Index	3.08%	6.11%
Consumer Price Index	0.46%	1.02%

Investment Commentary

In a continuation of the first quarter rally, both global stocks and bonds registered positive returns in the second quarter. In the U.S., the S&P 500 rose 4.3%. The Russell 2000, which measures the performance of smaller company stocks, increased 2.1%.

Abroad, developed market stocks outperformed emerging market stocks. The MSCI ACWI ex USA IMI increased 2.7%. This occurred as the yield on the benchmark 10 year German government bond (bund) went negative for the first time since 2016. The yield registered a new historic low late in the quarter before ending the quarter at a yield of -0.31%.

U.S. bonds performed well as yields continued to decrease in tandem with falling global yields. The yield on the 2 year U.S. Treasury decreased more than the yield on the 10 year Treasury as the market priced in several rate cuts by the Federal Reserve. The Bloomberg Barclays Aggregate Bond index increased by 3%.

Economic Outlook

The two biggest influences on the horizon for equity markets are likely trade and The Fed. While equity markets finished the second quarter

higher, this increase was not without volatility. Markets started the quarter strong, increasing 4% in April. This was, in part, due to optimism about trade conflict resolution between the U.S. and China. Conversely, stocks fell when trade talks between the U.S. and China appeared to falter midway through the quarter. As we have mentioned in previous writings, this back and forth will likely continue for the foreseeable future due to the deeply entrenched nature of both sides.

The Fed is somewhat beholden to the issues created by trade disagreements due to their dual mandate of price stability (2% inflation target) and full employment. For starters, increased tariffs could allow room for price increases on domestically produced goods, causing inflation to pick up and surpass the 2% target. The Fed could mitigate this inflation by increasing rates, although we think this is unlikely in the near future. Market based inflation expectations continue to suggest that the Fed will fall short of their inflation target (10-year TIPS breakeven inflation rates ranged from 1.60% to 1.95% throughout the quarter ending at 1.7%). On the opposite end of things, cost pressures on businesses and overall uncertainty could slow hiring in the U.S., incentivizing the Fed to ease monetary conditions and cut interest rates.

With trade uncertainty likely to continue, we think it is likely the Fed will err on the side of easy, rather than restrictive, monetary policy. Overall, this should be good for riskier assets.

We mentioned earlier that the market is pricing in several rate cuts by the Fed in the second half of 2019. You may recall in previous reviews that the Fed is several years into a rate hiking cycle that began in December 2015 after many years of holding the Fed Funds rate at zero. One may question whether or not easing monetary policy 10 years into an economic cycle is properly timed. It is worth noting that the Fed easing cycle often occurs at the end of a market cycle either preceding or during a recession. In fact, the last time the Fed began an easing cycle was in the summer of 2007, and that cycle continued until the Fed Funds rate reached zero in late 2008. However, the market has made it clear that it believes the Fed should cut rates (hence the inversion on the front end of the yield curve) and the Fed has made it clear that they do not want to disappoint markets.

Ultimately, this situation is likely to resolve in one of two ways. Perhaps the Fed was overly aggressive in their previous expectation for the “neutral rate” and a slight rate cut (50-75 bps) gets the economy back to a state in which the Fed is neither accommodative nor restrictive and the cycle continues. This scenario can be termed a ‘soft landing’. Alternatively, perhaps the previous rate hikes were too restrictive (there tends to be a long lag so it is unlikely the effects have been reflected in the market at this point) or trade talks turn negative and this is the beginning of the end of the cycle. Under the second scenario, these first few rate cuts will be the first of many on the one-way street back down to zero. Historically the Fed has rarely been able to engineer a soft landing, but it has happened.

Abroad, China is now some ways into a stimulus plan that is aimed at reaccelerating growth and muting some of the effects of the ongoing trade tensions. In Europe, there has been a changing of the guard at the European Central Bank with Christine Lagarde, the current leader of the International Monetary Fund, taking over for the departing Mario Draghi. There has been some talk of further monetary and/or fiscal stimulus in the Eurozone which has been sideswiped by the ongoing trade battle between the US and China. This is all to say that the Fed is

certainly not alone in actively trying to ease policy and reignite growth and inflation.

Investment Strategy

We are by no means alone in our view that the Fed will remain accommodative. As mentioned previously, the market is anticipating the Fed will cut rates. Forward rate pricing suggests there will be two or three rate cuts over the next six to twelve months. Even though the yield curve is quite flat at this point, we still think that intermediate term Treasuries will prove to be helpful if market expectations are not met and the Fed does not decrease its target rate.

We wrote last year that investment grade bonds looked expensive relative to Treasury bonds. While valuations on these bonds began the year in line with their long term averages, they have become more expensive since then. This “spread tightening”, combined with falling rates for this longer duration sector of the bond market led investment grade corporates to be the best performing part of the Aggregate Bond index. We do not think it is wise to chase these higher valuations and may lighten our exposure to investment grade corporate bonds.

Our underweight allocation to emerging market stocks relative to their developed market peers continues to be additive. While EM stocks have increased this year, they have trailed developed markets. Valuations in this area have only slightly increased and we are likely to maintain our current position.

Unemployment ticked up very slightly in June. We continue to monitor this as a key indicator for the U.S. economy. While not quite the historic low unemployment rates of the early 1950s, April and June may well have been the low for unemployment for this cycle. If the upward trend continues, we will likely look at reducing equity risk in client allocations. As always, we encourage clients to continue open discussions with us to make sure that their portfolios are aligned with their long term goals.

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