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Investment Commentary - Second Quarter 2019

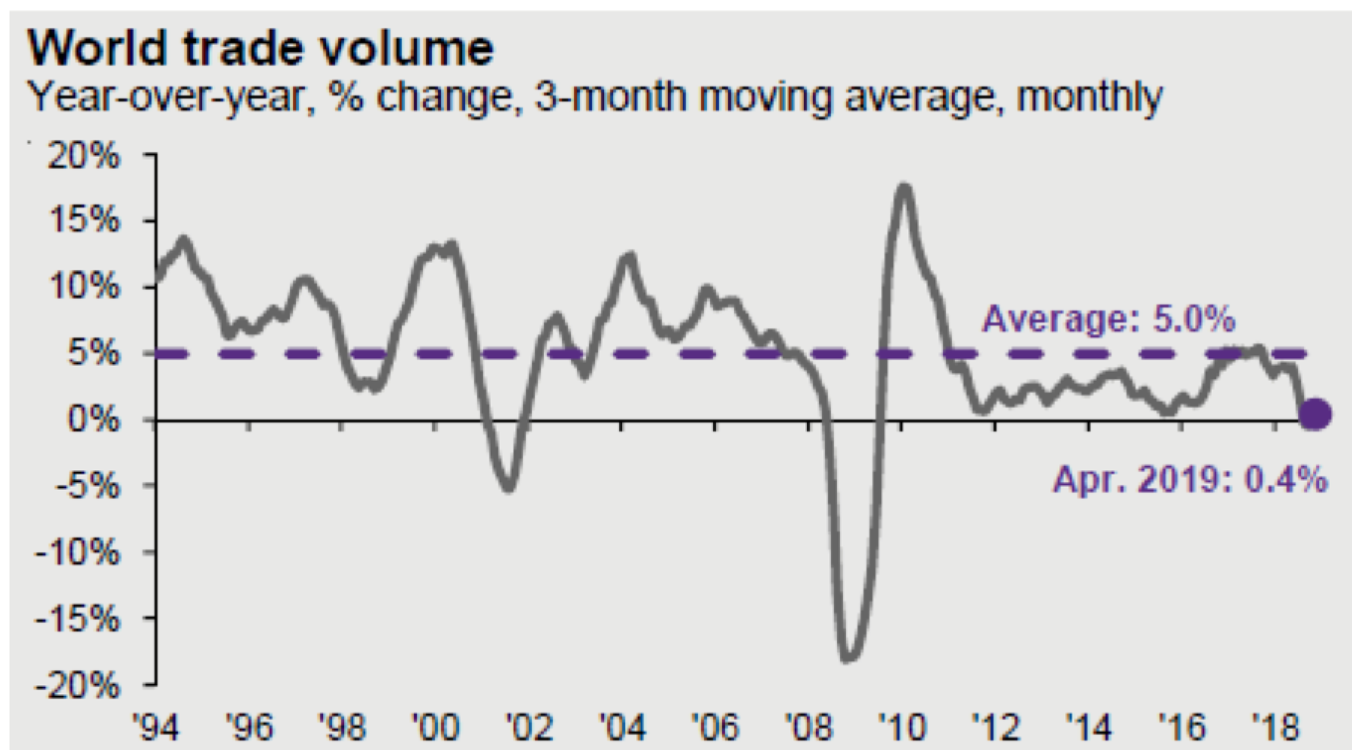
- U.S. stocks have best start to the year since 1997
- Bond yields tumbled on expectations for interest rate cuts
- Global trade slowed on uncertainty

The stock market ebbed and flowed but finished the quarter higher. Wavering prospects for trade negotiations and softer economic data were outweighed by expectations of lower interest rates from the Federal Reserve. Bond prices also rose on the anticipation of interest rate cuts. The first half of the year is off to a strong start. For the second half, investors will continue to watch how trade negotiations and the Federal Reserve's interest rate policy impact the economy.

Economic Review & Outlook

The current economic expansion is now in its 120th month, tied for the longest expansion in U.S. history. While first quarter GDP growth came in stronger than expected at 3.1%, more recent economic data has softened. A recent Wall Street Journal survey of 60 economists expects the economy grew at 1.6% for the second quarter. Manufacturing activity has been slowing, the housing market has softened, and consumer confidence has fallen. The uncertainty caused by the ups and downs of trade negotiations appear to be making a tangible impact on many business decisions.

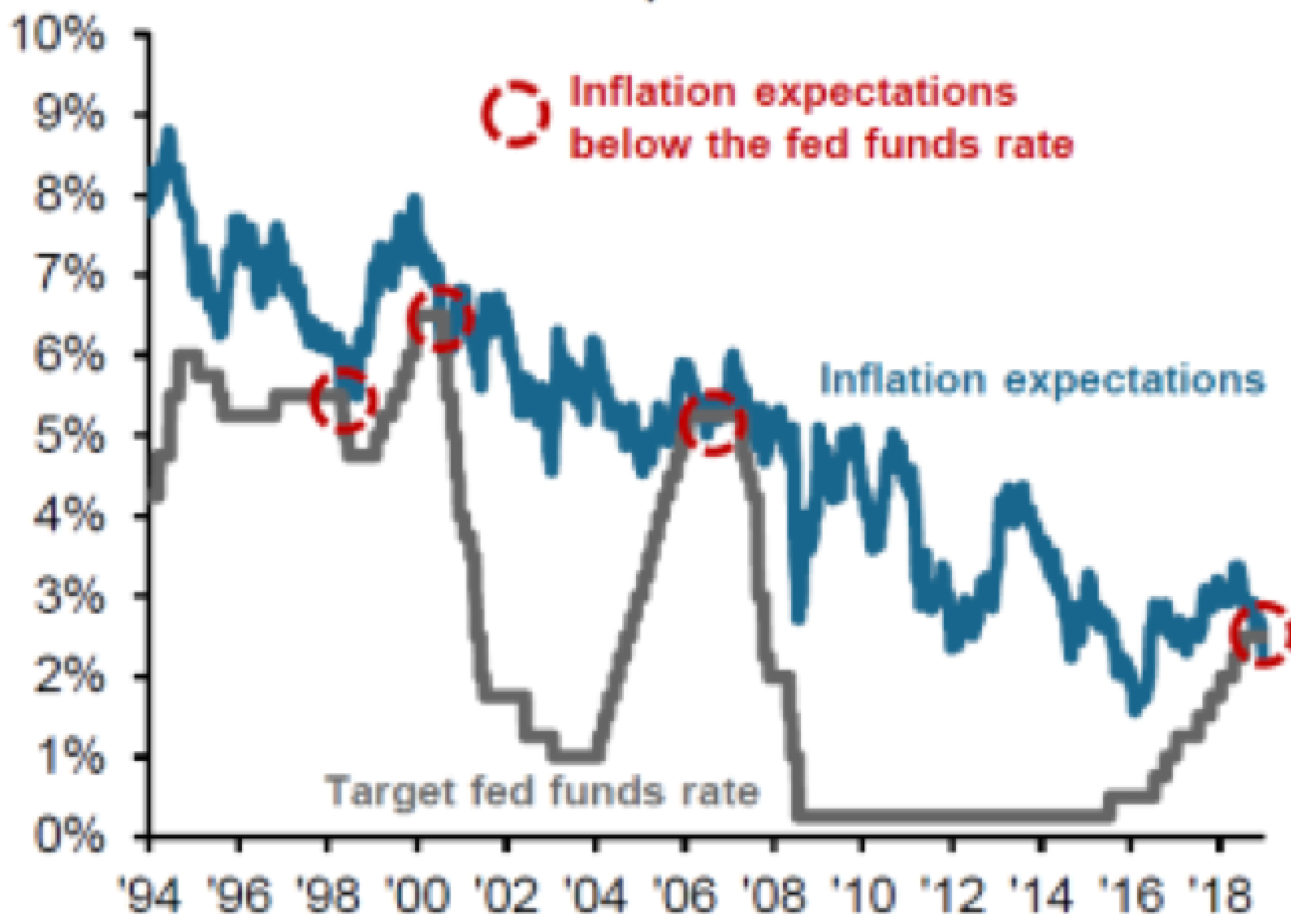
Growth is slowing more internationally than in the U.S. A leading indicator of economic health is the Purchasing Managers' Index survey, which has been trending down for both manufacturing and services. World trade volume has also turned down in recent months as shown in the chart below.



Source: J.P. Morgan Asset Management; Markit

With slower growth overseas, signs of slowing in the U.S., and continued ambiguity around trade negotiations, the Federal Reserve has strongly hinted at cutting interest rates in the coming months. Some economists are arguing for multiple rate cuts to battle both the ongoing trade war and falling inflation expectations. A recent chart released by J.P. Morgan (see below) shows the target Federal Funds rate is now above long-term inflation expectations, leading many to suggest the Federal Reserve should cut interest rates immediately. This hasn't happened since prior to the credit crisis, which lends support to economists suggesting a rate cut is justified. The Federal Reserve chose to forego a rate cut during their June meeting, but odds have been as high as 100% that a rate cut is coming in July. The housing market would be one expected beneficiary of lower rates. With mortgage rates having already dropped nearly a full percentage point since the year began, the summer season could see a nice turnaround for the housing market as potential buyers rush to lock in

lower rates.



Source: J.P. Morgan Asset Management

Bond Market Review & Outlook

Longer term interest rates continued their descent during the second quarter with the benchmark 10-year U.S. Treasury Bond falling from 2.41% to 2.00%. Bond prices move inversely with interest rates, so the broad bond market gained 3.1% for the quarter, pushing year-to-date returns up to 6.1%. Bonds have rebounded strongly following 2018, when the broad bond market was flat and corporate bonds were down.

The current dilemma for bond investors is the flatness of the yield curve. The yield difference between investing in 2-year Treasury Notes versus 10-year Treasury Bonds is a mere 0.25% as of June 30th. This means an investor only earns an extra 0.25% per year to loan the U.S. government money for 10 years instead of 2 years. Why would an investor do that?

This conundrum exists because investors expect the Federal Reserve to cut interest rates soon. If that proves to be the case, long-term interest rates will likely be lower after the rate cuts, so investors can lock in higher rates by purchasing longer dated bonds now. From our perspective, forecasting interest rate moves is extremely difficult. We have confidence in our bond managers to navigate this unique environment and position their portfolios accordingly.

Stock Market Review & Outlook

The second quarter was a roller coaster for the stock market, but it ended up higher. Stocks staged a dramatic rally to begin the year, propelled by the Federal Reserve's dovish U-turn. The S&P 500 surged to new all-time highs in April, fully recovering from last year's 20% correction. The stock market reversed course in May as trade talks between the U.S. and China broke down and economic data showed slowing global growth. After one of the worst months of May, stocks finished the quarter on a high note, recording one of the best Junes in history. Stocks were bolstered by optimism that the Federal Reserve would cut interest rates soon and that trade talks between the U.S. and China could get back on track.

For the quarter, the S&P 500 returned 4.3%. Small caps were up as well, rising 2.1% as measured by the Russell 2000. Technology stocks continue to remain market leaders, as evidenced by the strong 3.6% return in the NASDAQ composite. International stocks rebounded some during the quarter as the MSCI EAFE returned 3.7%, in line with the other major indexes. Despite the heightened volatility over the past six months, investors who have been able to control their emotions and stay invested have been rewarded.

Growth stocks continued to outperform value stocks across all market caps. In general, larger companies outperformed smaller ones as investors' appetite for the mega cap names continues to show no signs of waning. This thirst for large cap stocks pushed the S&P 500 to its best six month start to a year since 1997.

Alternatives & Hybrids Review & Outlook

Alternatives, as measured by the Morningstar Multi-Alternative Fund Category, rose 1.1% for the quarter, driving year-to-date returns up to 5.2%. Alternatives helped provide defense in the tumultuous month of May, falling only 1.8% while the S&P 500 fell 6.4%. For the quarter, hybrids, real estate and managed futures were the best performers, while market neutral strategies and broad commodities lagged. Global oil prices retreated after rising aggressively earlier in the year. Gold prices surged amidst global volatility, rising 8.7% in the second quarter. Hybrid funds, which allocate across stocks, bonds, and other assets, enjoyed strong returns as both equity and bond markets performed well.

Conclusion

Despite the sense of comfort many investors have developed, the time will come when portfolio declines will last longer than a couple of months. Being prepared for this inevitable outcome by accepting this reality separates successful long-term investors from those who panic when financial market concerns arise. Over the past year, a diversified portfolio of stocks, bonds and alternatives has delivered solid returns despite a never-ending barrage of economic, geopolitical and domestic concerns being thrown at it. Patient investors who stayed the course despite all the headlines were rewarded, and ignoring the daily noise remains our best advice.

Stocks could move materially higher in the second half of 2019, especially if some of the current concerns regarding trade negotiations, economic growth, or the housing market improve. Conversely, any of these could take a turn for the worse and temporarily sink financial markets. For our clients, we strive to position you in a way that allows you to steer through either of these outcomes and still reach your long-term plans. Thank you for entrusting us with the responsibility to navigate your financial well-being during these uncertain economic times.

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