



Market Commentary July 2019

Introduction

After an impressive first quarter, both stocks and bonds experienced more volatility during the second quarter but still ended up positive. Overall, the economic data in the U.S. has moderated from peak levels in 2018 but remains positive in many regards. The labor market has been a bright spot for the economy with the unemployment rate falling to 3.6% as of May. GDP growth is up 3.1% however is anticipated lower for the remaining quarters this year. Lastly, inflation has been somewhat muted with CPI up 1.8% year over year as of May. The Federal Reserve has recently mentioned the possibility of cutting short term interest rates to support this expansion in light of economic risks that exist such as the threat of further tariffs and data on slowing global growth. With equity markets continuing to move higher, we are taking a more conservative posture and reviewing the data to confirm where the economy is headed. As there is uncertainty as to whether the Fed will cut rates and to what magnitude, headlines such as tariffs, and geopolitical tensions between the U.S. and Iran are impacting market sentiment in addition to the economic data coming in softer.

Domestic Equities

Although U.S. stocks generated a positive return of 4.30% for the second quarter of 2019, this 3-month performance hides the volatility which took place intra-quarter. In fact, the S&P 500 returned 4.05% in April but significantly sold off in May falling -6.35% only to rebound and return 7.05% in June. The selloff in May can be predominantly explained by a heightening of trade tensions between the U.S. and its trading partners and fear of slowing global growth. Although tariffs would likely hurt foreign countries like China and Mexico more than it would hurt the U.S. due to a higher dependency on exports, U.S. companies would still feel some pain as a result of higher prices due to tariffs. After the selloff in May, investors found optimism in anticipation of a potential Fed rate cut which could occur in the back half of the year, hope for improved negotiations with China and the possibility that the Mexican situation is resolved for now. With earnings growth projected to be negative for Q2 2019, stock valuations more expensive, and a softer economic backdrop than what was experienced last year we recommend a neutral stance on equities.

International Equities

International developed equities and emerging market equities returned 3.68% and 0.61% for the second quarter, respectively, both lagging the S&P 500. Despite prolonged uncertainty in Europe after the United Kingdom failed to reach an agreement on Brexit in late March, GDP growth in the euro-area exceeded expectations as low inflation supported stronger household spending. Germany, the economic powerhouse in the Euro Zone, may have avoided a recession as manufacturing production stabilized and output accelerated, though the potential of auto tariffs from the U.S. remains a risk to their economy. Though growth was stronger than expected in Europe, weak productivity, high unemployment, and an aging population are likely to drag on growth over the longer term. The ECB President Mario Draghi has indicated a possibility of cutting interest rates to help support an already tepid economy.

Within emerging markets, trade tension continues to weigh on major emerging market economies such as China and other developing countries that are dependent on the Chinese economy. The U.S. raised tariffs in May on \$200 billion in imports from China from 10% to 25% bringing the total amount to \$250 billion. China's economy has continued to slow, with its manufacturing PMI falling into contraction territory in May to 49.4. Although Chinese economic data is moderating, the Chinese government has historically provided stimulus to the economy during bouts of weakness. Overall there are many uncertainties in international and emerging markets, but due to inexpensive valuations and the potential resolutions to the pending conflicts, there may be buying opportunities in the future. Despite mild economic data, both international and emerging market equities have performed well this year up 14.03% and 10.58%, however, still lag the S&P 500.

Fixed Income

Fixed income continued its strong run in 2019 to post positive returns in the second quarter of 3.08% as measured by the Bloomberg Barclays US Aggregate Bond index. Lower quality corporate bonds benefited from investors' continued appetite for risk while longer maturity bonds were supported by falling long term interest rates. The Federal Reserve adopted a more dovish tone, removing the word "patient" from their most recent commentary as well as introducing the possibility of rate cuts in 2019. As a result of the market's downward projections for interest rates, demand for longer duration securities increased and pushed yields down, with the 10-year U.S. Treasury yield ending the quarter at 2.00%, a drop of -0.40% from the beginning of the quarter. During the past two expansions, the Fed hiked rates by 3.5% and 4.25%, respectively; Since the Fed only raised rates to 2.50% during this cycle, we believe the projected path for interest rates will remain stationary in the near term, as the Federal Reserve has less room to cut rates than it did in the past and while economic data has slowed, it remains positive. Moving forward, we believe fixed income securities will provide significant diversification benefits to equities as economic and corporate growth slows.

Alternatives

Risk-reducing alternatives took a backseat to traditional return enhancing alternatives during the second quarter. Oil prices experienced increased volatility amid fears of oversupply and worries that slowing global growth coupled with rising crude inventories could potentially cause a supply glut. Specifically, the trade dispute between the U.S. and China clouded the outlook for oil demand. On the other hand, escalated tensions between the U.S. and Iran and the potential for further supply cuts from OPEC has bolstered oil prices. Overall, U.S. crude only fell -2.78% over the course of the second quarter to \$58.47 per barrel. The Morningstar Diversified Alternative index returned 0.83% for the second quarter underperforming the S&P 500 but with significantly less volatility (as measured by standard deviation).

Real Estate

The housing sector is on uneven footing as housing starts, a gauge of home construction, fell -0.9% in May from the prior month and new home sales fell -7.8%. The NAHB index, an index that tracks homebuilder optimism and a leading indicator for the housing market, fell to 64 this month from an unrevised level of 66 in May, as builders continue to report rising development and construction costs due to tariffs. However, building permits edged up 0.3% compared to April suggesting the housing market may be benefitting from the continued decline in mortgage rates. The average rate on the 30-year fixed mortgage ended the second quarter at 4.06% down almost -1% from its peak of 5.17% in November of 2018. Even with low borrowing costs, the demand for housing has decreased due to the changing demographics of the U.S.

Conclusion

The market managed to generate positive returns for Q2 despite multiple headlines impacting investor sentiment. With markets recently moving higher in anticipation of consecutive Fed rate cuts through the end of the year it will be interesting to see if the Fed acts accordingly. The market needs a catalyst to grind higher other than the actions of the Fed and equity valuations are already high. Also, the bond market is signaling a slowdown as rates are lowered. Similar to the Fed, we are data dependent to determine where the markets go from here and take a wait and see approach as we maintain a neutral stance in our portfolios.

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