Second Quarter 2019
Market Review & Outlook

Feltz Wealthplan
A Registered Investment Advisor

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A REGISTERED INVESTMENT ADVISOR

Q2 2019 Highlights

- Economic Cycle Enters 11th Year
- Monetary Policy Shifts Back to Accommodation
- Equity Risk Premium Still Attractive

Category	Index	Q2 2019	1-Yr	3-YR
US Equity	**Russell 3000 Index**	**4.1%**	**9.0%**	**14.0%**
Large Cap	S&P 500 Index	4.3%	10.4%	14.2%
Mid Cap	S&P Midcap 400	3.0%	1.4%	10.9%
Small Cap	Russell 2000 Index	2.1%	-3.3%	12.3%
Growth	Russell 3000 Growth	4.5%	10.6%	17.8%
Value	Russell 3000 Value	3.7%	7.3%	10.2%
International Equity	**MSCI ACWI ex-U.S. Index**	**3.0%**	**1.3%**	**9.4%**
Developed	MSCI EAFE Index	3.7%	1.1%	9.1%
Emerging	MSCI Emerging Markets Index	0.6%	1.2%	10.7%
Fixed Income	**Bbrg Barclays Global Aggregate**	**3.3%**	**5.8%**	**1.6%**
U.S. Bonds	Bbrg Barclays US Aggregate	3.1%	7.9%	2.3%
U.S. High Yield	ICE BofAML US High Yield Master	2.6%	7.6%	7.5%
Cash	Bbrg Barclays 1-3 Month US Treasury Bill Index	0.6%	2.3%	1.4%
Alternatives	**Morningstar Diversified Alternatives Index**	**0.8%**	**1.0%**	**1.5%**
Commodities	Bloomberg Commodity Index	-1.2%	-6.8%	-2.2%
Real Estate	MSCI U.S. REIT Index	1.0%	9.7%	2.8%

Source: Morningstar

Stocks and bonds continued their rally in the second quarter, closing on a high note after a brief spell of volatility in May. Bad economic news is once again being welcomed by investors anxious for a reversal in Fed policy back towards accommodation. Even with an apparent moderation towards sub-trend growth, the U.S. continues to exhibit relative economic strength vs. global peers. U.S. stocks have, as a result, been the most rewarded with equity market returns.

As the U.S. stock market was hitting fresh all-time highs, bond investors were enjoying their own rally. Global central banks, including the Fed, have planted seeds for a shift back towards accommodation mode in the face of heightened economic uncertainty. As a result, yields have moved substantially lower and the U.S. treasury yield curve briefly morphed into an inverted shape. While this type of bond market activity often precedes an economic slowdown, mixed but still positive U.S. fundamental data and a supportive Fed are giving many investors optimism that the outcome could be transitory, not systemic in magnitude.

Last year equities had the support of a strong economy and corporate fundamentals, but equity valuations contracted by ~25% as sentiment soured in Q4. The combined result being ~5% loss for U.S. stocks. This year, corporate profits will be hard-pressed to post mid-single-digit growth, yet a reversal in valuations has led to the strongest first-half rally in the S&P 500 in over two decades. Such a momentous short-term impact from sentiment may seem out of whack, but it is not atypical given the backdrop of uncertainties such as global supply chain disruptions (tariffs) and an abrupt shift in Fed policy direction.

Now that we have at least a cease fire in tariffs and a Fed that is more concerned about extending the economic cycle than normalizing rates, the market has re-priced equities with the relevant premium to bonds.

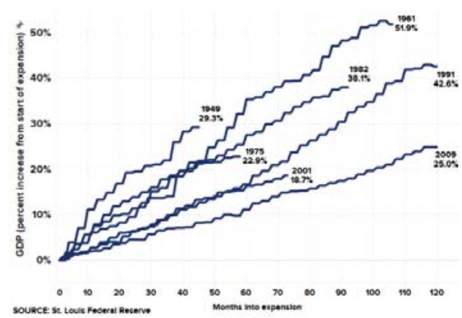
The strong rally in capital markets since late December does not mean there are not ever-present risks. Valuations are relatively attractive when compared to bonds, but on an absolute basis they have become somewhat extended, especially if you factor in potential risks to record-high profit margins. If the Fed does not live up to expectations on accommodation (the market is pricing in ~4 rate cuts over the next 12 months), or if the economy rolls over from escalating trade tensions or the multitude of other late cycle risks, the valuation premiums on stocks could just as easily reverse course once again.

We believe a shift towards quality, which includes a focus on high profitability, steady cash flows and healthy balance sheets, is now prudent for equity risk budgeting. Many companies have taken advantage of low rates to become highly indebted, and although some appear to be statistically “cheap” on multiples of operating income, they could be challenged in the event of an economic slowdown. As for fixed income, cautious duration positions may result in missed opportunities if longer-dated bonds rally further, but we think a flat yield curve and multi-year low interest rates make short-term maturities and selective credit exposure more attractive at this time.

As the last seven months have shown, becoming too cautious too quickly in the later phases of an economic cycle can result in severe opportunity costs for market participation. There is at least a possibility that this economic cycle, which is now the longest one on record entering its’ 11th year, could continue to trudge along for years to come. As a result, we think investors should remain steadfast in risk budgeting and avoid the temptations of overt cautiousness or, on the other end, chasing narrowing market leadership.

Economic Cycle Enters 11th Year

July marks the 121st month of this economic expansion, which makes it the longest run on record going back to 1854. Yet, if you look at the cumulative growth rate since July 2009, this expansion is on the lower end of economic cycles since World War II. Luckily, economic cycles don’t simply die of old age.



However, even if you have great medical assistance (e.g. a dovish Fed, historic tax cuts), you do become more susceptible to sickness as you age. We are monitoring for early symptoms such as a pickup in jobless claims or a breakdown of other leading indicators, but that has yet to manifest in a material way. In fact, the unemployment rate just hit a 50 year low in May. As it stands now, the economy is on pace to grow around 2% this year. That would be lower than the tax-infused growth of last year, but still close to the average of this current cycle.

Monetary Policy Shifts Back to Accommodation

At this point last year, the Fed "dot plot" of rate expectations implied ~3 rate hikes in 2019 with a target rate of 3-3.25% by year-end. Now it looks as if the next policy move following the December 2018 rate hike will be a 25bps rate cut in July, which the futures market is implying at nearly a 100% chance. Fed chair Jerome Powell all but confirmed this during congressional testimony last week. The futures market is also pricing in two more rate cuts by year end which would leave the target rate at 1.5-1.75%, assuming expectations play out accordingly. Even if they are slightly off, there is no doubt that the Fed has shifted their policy in light of recent market conditions.

It is not just the U.S. that has shifted gears in recent months, the European Central Bank (ECB) introduced new stimulative measures earlier this year, reversing course after having ended its bond-buying program last year. Japan has maintained its stimulative policy all along while the Bank of China recently implemented its own easing measures. Some central banks are trying to extend the economic cycle (U.S. and China), while others are just trying to fight off the constant threat of deflation (Europe and Japan), with no real success towards growth stimulus.

In any case, the result is a sharp trend lower in global bond yields. Nearly 50% of the developed global bond market trades at yields of less than 1% as of the end of June, including a record $13 trillion of debt that trades at ***negative*** yields[1]. All of that debt resides in Europe and Japan, but this speaks to the deflationary forces lurking in those economies and weighing on global growth. Even if the U.S. posts above-average growth, the companies exporting to those economies are not immune, and the rates fixed income investors are willing to pay in the U.S. are likewise affected.

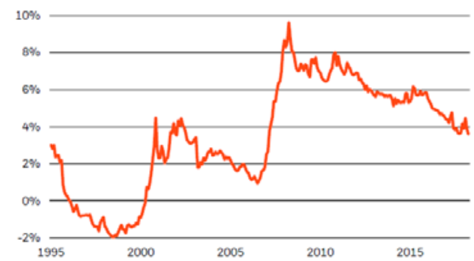
Equity Risk Premium Still Attractive

The equity risk premium is the earnings investors receive for owning stocks relative to nominal interest rates on bonds. And while earnings on bonds are fixed for the duration of the asset, equities at least have the opportunity to grow their earnings over time.

Although this equity risk premium is not what it was at the depths of the financial crisis, it is still above-average compared to historic economic cycles. So if you assume rates will remain lower for longer, it is at least possible that equities will remain relatively attractive vs. bonds in the years to come.

Despite asset flows favoring fixed income over the duration of this 10-year cycle, whether due to demographics or investor behavioral tendencies, we continue to be biased towards equities where we can in our portfolios. Investors still have the benefit of stimulative fiscal policy, now with an accommodative Fed and a healthy consumer devoid of cyclical excesses. If the economy remains at least stable, stocks should remain attractive relative to bonds.

Relative value
U.S. equity risk premium, 1995-2019



Past performance is not a reliable indicator of current or future results. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2019. Notes: We calculate the equity risk premium based on our expectations for nominal interest rates and the S&P 500 earnings yield. We use our expectations for interest rates so the estimate is not influenced by the term premium in long-term bond yields.

There is no secret sauce for predicting the twists and turns coming for markets over the next year, but we know that patience and a healthy bit of optimism has rewarded investors most during this long bull market. We don't expect that to change anytime soon, but we do think investors can benefit from becoming more selective within their equity allocations as the market potentially enters a late cycle phase.

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Sources:
1. *https://www.barrons.com/articles/100-year-bonds-51561744996*

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