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Longest Bull Market Grinds Higher Despite Concerns

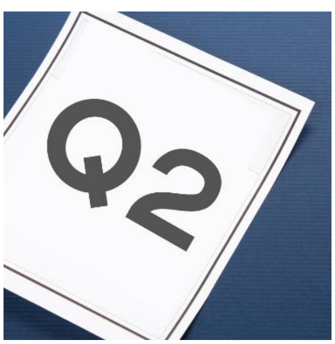
July 2019

My Dear Client:

There is an adage that the market climbs a wall of worry. That is the description for a market continuing to rise when there is significant uncertainty about its sustainability due to factors like the ones we are currently seeing in trade (China), fiscal policy (deficits), monetary policy (the Fed), geopolitics (Iran, Brexit/EU) and conflicting economic data.

These rising tensions through the end of Q2 created the backdrop for fresh all-time highs, with the S&P 500, Dow, and Nasdaq reaching previously uncharted territory multiple times. Another spurt could come at on any given day, yet the mood among investors appears decidedly more suspect than it has been at nearly anytime over the course of this ten-year bull market.

Second Quarter Review



Equity markets were broadly higher last quarter despite the ongoing trade tensions and disappointing economic data. The S&P500 returned 4.3% during the quarter and 18.5%for the year. The market rally was driven mostly by the prospect of a July Fed rate cut. While equity markets celebrated the chance of easing monetary policy, the bond market languished amid pessimistic sentiment. The 3-month Treasury bill rate has been higher than that of the 10-year Treasury since March. This inverted yield curve indicates a higher probability of recession.

Economic data this quarter was mixed. To the positive, Q2 GDP grew at a solid rate of 2.1%, according to the early numbers; unemployment remains at a historic low of 3.6%; and core inflation is right on target. Yet other areas of the economy are pointing to a slowdown. Monthly job gains have slowed to a 164k pace this year, compared to 233k per month in 2018. More concerning, the May manufacturing PMI data hit its lowest level since 2009, and consumer confidence also declined to a two-year low. The uncertainty surrounding the U.S. and China trade talks likely contributed to the weaker data. Fed Speak: The U.S. Federal Reserve held rates steady in June at a target range of 2.25-2.50%. Fed Chair Jerome Powell indicated that the case for accommodative policy has increased as the global economy slowed. Traders are pricing in a100% chance of at least a 25-basis point (bps) cut in July, with a 36% chance of a 50-bps cut. Powell also emphasized the Fed's independence, even as the President reportedly considered demoting the Chair for the Fed's inaction earlier this year. Speaking before the House of Representatives, Mr. Powell was emphatic that he intended to complete his four-year term as Chair and that he could not be removed lawfully. A few months ago, investors, pundits, politicians and other fiscal policy experts were seriously concerned about U.S. growth going negative for the first quarter and beyond. Now that the Fed has changed its tune, however, the Stock Market is ready to hum along.

U.S. Equity Market

In the second quarter, the broad U.S. equity market (as measured by the MSCI USA IMI Index) moved up 4%. U.S. large cap stocks (as measured by S&P 500® Index) posted a similar gain of 4.3%. U.S. small caps paused from the torrent pace that began the year and were up an additional 2.0% for this quarter. Growth equities across all market capitalization sizes continued their dominance over value stocks. In the second quarter, growth equities added to their lead over value stocks by nearly 1% on the quarter and 5% for the year. Mid-Cap Growth was the best performing style, up 5% QTD and 26% Y TD.

Surprisingly, despite the decline in yields and a dovish Fed, Financial stocks performed the best of the 11 S&P500 economic sectors, with a rally of 8%. Typically, banks' strongest period of outperformance is in a rising interest rate environment. Materials and Information Technology were the next best performing sectors, each climbing 6%, with Consumer Discretionary following at 5.3%. Consumer Services, Consumer Staples, Industrials, and Utilities were all closely bunched in the 3.5% to 4.5% range. Health Care was positive by 1.4%. Energy was the only sector that posted negative returns this quarter, as it fell 2.8%, in lock step with WTI Crude Oil prices. The growing chatter about and actions with and around Iran provide an interesting example of how investors' attentions are leaning. A series of events, including tough rhetoric out of Washington, the ascendance of Mr. Bolton as National Security advisor, the cancellation of the six-Nation Nuclear agreement, the expansion of sanctions, the increased U.S. Naval presence, the shooting down of drone planes, and the capturing of oil tankers logically, moved the price of oil downward. *But none of this has not had a real dampening effect on the overall markets or economies!*

Emerging Markets

Despite the seemingly cataclysmic resignation – after ouster (by fellow Tory party members!) – of British Prime Minster Theresa May, the International equity markets were positive in second quarter of 2019. International developed markets, as measured by the MSCI EAFE Index (net of taxes), were up 3.4 % for the quarter. This gain, like that in the U.S., was likely bolstered by the European Central Bank's accommodative monetary position, even as Mr. Draghi leaves and Christine Lagarde, former French Finance Minister and current head of the International Monetary Fund, prepares to replace him. Emerging markets (as measured by the MSCI Emerging Markets Index) were barely positive, up only 0.61% for the quarter. The impact of a strong dollar, declining oil prices, and other commodities coupled with China's slowing growth and tariff issues made for a tough environment for markets in general. However, some countries, like Brazil (nearly 20% YTD) and Russia (up 17% this quarter and 31% YTD) continue to experience rising market returns. I note the Brazilians and Russians because they exemplify that, regardless of the broader index, there can always be economic sectors and portions of the global economy that outperform. The outperformance of these countries' markets further demonstrate that the tariffs and related trade policy are having a concentrated effect on Global trade and supply chains broadly in emerging market economies.

Bonds

The broad U.S. bond market, as measured by the Bloomberg Barclays US Agg. Index rallied 3.1% in Q2 19. Like equities, fixed income prices rose as the Fed indicated a greater likelihood for a rate cut this year. In response to the cautious. tone, investors demanded longer-maturity bonds: the Bloomberg/Barclays US Agg. 10+Year was the best performing bond index with nearly a 7.0% return this quarter. Cash and short-term muni's lagged, rising less than 1% this quarter. The U.S. 10-Year Treasury yield fell from 2.41% in Q1 to 2% at the end of Q2 19. The yield curve has been inverted now for more than a quarter with the 3-month Treasury yielding 12bps higher than the 10-Year yield. Investors and policy makers are monitoring the inversion, which often precedes a recession.

On the horizon, I remain vigilant in monitoring the leveraged loan market for increased default activity, and I am worried about the concomitant pressure this would have on the market for collateralized loan obligations (CLO). When the cycle turns, the fall-out will not be pretty. The application of broadly accommodative monetary policies globally has pushed institutional investors (pension fund, mutual fund, hedge fund, and private equity managers) into highly leveraged and highly illiquid instruments. As Don Rissmiller, Chief Economist at Strategas Research Partners, LLC, noted in the wake of one such default last week, "negative rates don't make sense." Thus, given the loan ownership of such instruments by the investment banks that underwrite them (estimated to be roughly 5% of issuance), when the music stops, it is the pensioners, mutual fund shareholders, and hedge fund and private equity fund LPs that will be left 'holding the bag.' Stay tuned and know what you own!

Global growth is slowing; inflation is too low; and the policy answers are less clear. The Fed has signaled its intent to lower interest rates, and the other global central banks are in hot pursuit to match. As equities push higher and doubts continue to mount with respect to the fundamental health of the economy, I conclude that some investors see the Fed's rate cuts as likely to have a less-than-desired impact on Chair Powell's wish to "prolong the expansion."

However, just as the market climbs a wall of worry, so too is there typically a great story for the multi-year rise in stocks. Today, we now lack a good story to support market optimism. The opportunity set seems just as nebulous as the uncertainties. A China deal will spur capital spending. A steeper yield curve will bolster the consumer. Some investors see this is part of the problem, while many cheering Bulls do not. These bulls ignore the cues - government and corporate debt at record heights; slowing car sales & manufacturing at home and abroad, rising U.S. auto loan delinquencies; student loan debt at $1.5 Trillion and; the doubling of U.S. farmers' bankruptcies in Wisconsin, Minnesota, North Dakota, South Dakota, and Montana in 2018. Furthermore, farmers are auctioning away farm equipment and leasing their farmland (since land values have declined at least 25%). *So, tensions keep rising, waiting either for the market to implode or for everything to continue going right.*

This is now the longest Bull Market in history – March 9, 2009 through today with a total rise of 344% by the S&P. While its length alone is a natural reason to show concern, we are seeing other indicators pointing toward caution. I offer a reminder… last winter's sell-off (seems like a long time ago, even though it's only been a few months). The market struggled with the likely damage posed by two potential policy errors (trade and monetary) and an impending standoff between the Administration and Congressional Democrats (which ultimately would result in the longest government shutdown in history). These worries were man-made disasters, and each was quickly neutralized as: 1) the White Hoe stated that a China trade deal was 80-90% complete and 2) the Fed made its 0.25% December interest rate hike and then went into campaign mode to mitigate market panic. In the near term, these moves can continue to churn out frothy returns. But, be forewarned…the grinding usually comes to an abrupt halt.

A Look Ahead

I remain increasingly cautious about the 1-to-2-year outlook. While Equities continue to roll on, this is no longer the time to maintain extremely high (above target) allocations within your equity holdings. *Rebalancing is never easy or comfortable, yet its long-term benefits are well-documented, and the second half of 2019 into Q1 2020 is the time to begin.* As Barron Rothschild is famously quoted to have said, "I made my fortune by selling early."

Maintain a focus on a risk-balanced, multi-asset class approach and to evaluate opportunities should larger short-term dislocations occur. My portfolio considerations are consistent with the recommendations I have made over the past few quarters, as the periods of high multi-year gains are very likely behind us. I would suggest consideration of the following portfolio actions:

1) keep U.S. equity allocation within target ranges;
2) continue to use gains in U.S. equities for liquidity needs;
3) rebalance portfolios toward the following: bond allocation targets, hold cash from gains, and increase the margin of safety;
4) maintain the allocation tilt towards emerging market and international equities and away from U.S. equities;
5) favor small caps over large caps, be they domestic or abroad;
6) seek out selected niche and special illiquid private investments;
7) consider giving preference to U.S. value stocks versus U.S. growth stocks.

We will remain watchful over your asset allocation plan and the targets, along with rebalancing thoughtfully to continue achieving your financial objectives and goals. We should discuss whether any changes are needed or if the plan in place remains suitable. As always, it is a pleasure to serve you, and I look forward to continuing to work with you toward achieving your investment goals.

Appreciatively,

Walid L Petiri

Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, Strategas Insight