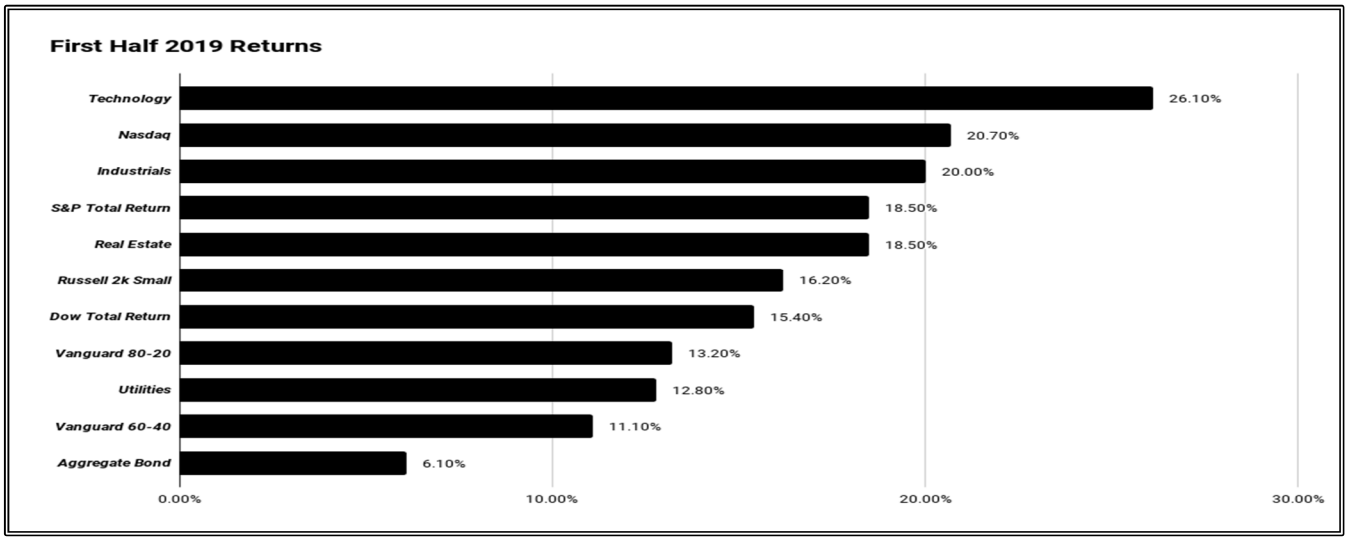
J | M
BROWN
FINANCIAL PARTNERS

7060 South Yale | Suite 701
Tulsa, Oklahoma 74136-5740
T 918.496.5460
F 918.496.5160

Second Quarter 2019 Market Commentary

Market Performance and Analysis

This year's sentiment-driven markets saw further gains in the second quarter but not without significant volatility. Stocks set numerous records and the S&P 500 posted its best first half since 1997 and reached three new all-time highs.



Source: Yahoo! Finance (rounded)

As you can see the peculiar phenomenon of risk-on and risk-off assets appreciating in tandem continued in the second quarter. This year's rally in response to December's brief bear market has been vigorous but always guarded. Investors piled into all manner of stocks including those that perform best when the economy is in growth-mode (e.g., technology and industrials stocks) and defensive stocks meant to limit losses in case of a pullback (e.g., utilities and real estate stocks). At the same time investors are buying up bonds with equal amounts of confidence.

Given the gravity of the uncertainties still facing markets—trade war, Federal Reserve—an abundance of caution makes sense, though insecure investing leads to volatile markets. Hence the whiplash of the 6% loss in May followed immediately by the 7% gain in June. Filtering out the noise our outlook is positive for the next half of 2019 and we are prepared for the inevitable arrival of more volatility.

The Fed

There are two primary movers of the markets this year: the Federal Reserve and the ongoing trade war. As the economy grew following President Donald Trump's election, the Federal Reserve hiked their benchmark federal funds interest rate to keep a lid on inflation and to restore its monetary ammunition in case of recession. Their thinking is that, in case of emergency, higher rates can be dropped to create easier money which can be loaned to struggling businesses and consumers. The Fed final rate increase was in December in the face of a slowing global economy and accumulating

evidence that the domestic economy was also slowing. The market threw a tantrum at this Fed obliviousness which led to almost 20% drawdown during the 4th quarter of 2018. This market shock forced Chairman Jerome Powell and company to reverse course and begin thinking about cutting rates this year.

The market loves easy money, so investors have taken to parsing every word that comes out of the Fed for any indication of a rate hold or cut. If the Fed hints at any degree of confidence in the strength of the economy the likelihood of a cut goes down and with it goes the stock market (remember, the market loves easy money). Conversely, if there is some bad economic data and the Fed acknowledges the weakness a rate cut becomes more likely and the market rejoices. Thus, for sentiment-driven investors bad economic news is good news for markets. Such cognitive dissonance is unsustainable in the long run and shows the perils of emotional investing detached from fundamentals. A growing economy benefits all participants regardless of the nominal fed funds rate. That being said, any Fed action or inaction has the potential to cause significant market movement the rest of the year. Options traders are betting a 100% certainty of a rate cut at the end of July.

July Rate Cut Odds 100%

Trade War

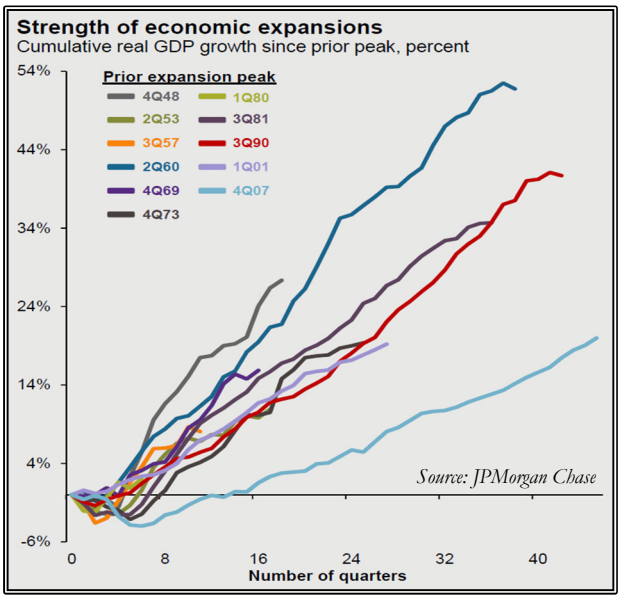
At 9:00am on May 5, President Trump tweeted in frustration about the breakdown of trade negotiations with China and announced new tariffs of 25% on a total of $250 billion of Chinese imports. These two tweets set the pessimistic tone for the month as investors readjusted their expectations for a quicker resolution to the U.S.-China trade spat. The implications of a prolonged, hard fought trade war weighed heavily in investors' minds throughout May leading to a peak-to-trough drop of -7% for the S&P.

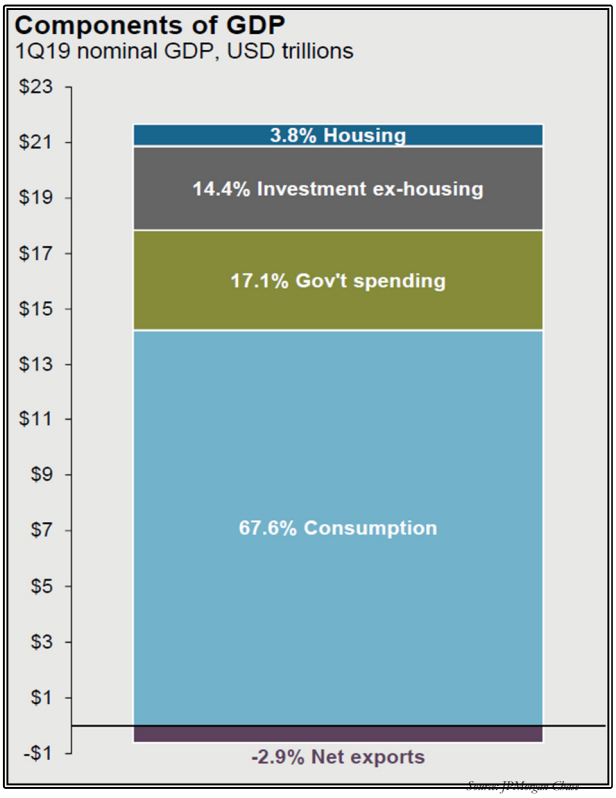
Current China Tariffs 25% on $200bn

In early June President Trump again spooked markets with a tweet. This time he threatened up to 25% tariffs on Mexican imports. These tariffs weren't meant to cure a trade imbalance or protest unfair trade practices but were threatened in order to motivate the Mexican government to enact tougher immigration policies on their southern border. Thankfully an agreement was hashed out very soon after the threat and before this potentially disastrous (Mexico is our biggest trading partner) policy could further damage markets. Expectations of Fed easing and further discussions between trade representatives fueled June's healthy stock rebound. President Trump met with President Xi Jingping at the G-20 Summit at the end of June and restarted the interrupted trade deal negotiations. These tariff developments proved to investors that there is some bite to Trump's bark, that through powers ceded by Congress to the president the president has the awesome power to pursue his policy goals, however damaging to the economy, via unilateral tariff actions. Thus, we see some justification for this year's cautious investors buying up both risk assets *and* safe haven assets.

Slower Growth with Signs of Strength

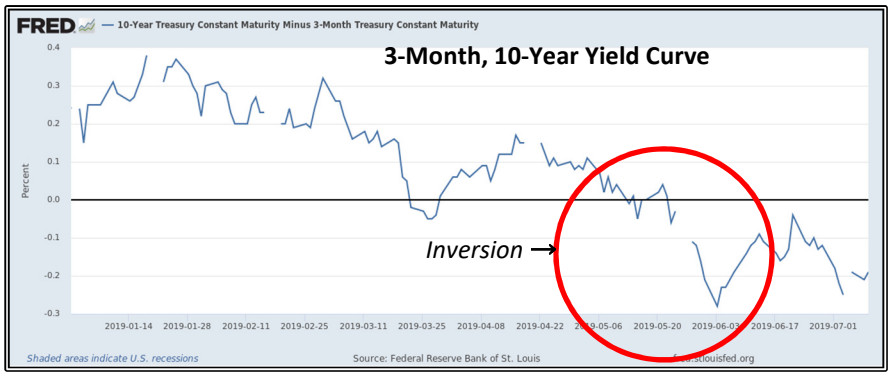
By the time that you read this the American economy will be in its 121st month of expansion. This is the longest period of growth in our nation's history. The impressive length of this expansion is tempered by its modest growth rate, as you can see on the chart nearby. The pale blue line at the bottom is the current growth streak. Low and slow has been this economy's mantra. Nevertheless, we saw 3% annual growth last year for the first time since 2005 as President Trump's administration made business-friendly policy a top priority. Growth persisted in the first quarter clocking in at 3.1%. We expect a mild slowdown in the second quarter—between 1 and 2% growth—which could pick up in the second half with trade war conclusions and confident consumers.





Speaking of the American consumer, whose consumption accounts for over 2/3 of GDP, recent surveys document their resilient optimism. Confidence and sentiment, two separate surveys, fell slightly in June but remain elevated. Bloomberg's survey of consumer comfort rose to its highest level in 18 years last month as personal finances improved thanks to our outstanding labor market. The unemployment rate sits at 3.7% and wage growth has been rising at about a 3% rate since the fourth quarter. The combination of optimism and wage gains should help to bolster growth in this next half of the year. The most recent data on consumer spending beat expectations of a decline to advance in May.

Our Investment Strategy Going Forward



We maintain a positive outlook on the next half of 2019. Equity returns may not be as robust as the blockbuster performance of the first half of the year, but fundamentals remain positive and macro events (the trade deal, rate cuts) could come to resolutions favorable to the stock market. There are unmistakable signs of a slowdown: manufacturing is nearing contraction levels, business capital expenditures are down, and the 3-month, 10-year treasury bond yield curve has been inverted for over a month (see graph). Recall that such inversions always precede recessions. Yet, at the same time, the benchmark 2-year, 10-year treasury yield curve is still positive, GDP growth has yet to contract, employment and wage growth are sturdy, inflation is tame, and consumers are content but not exuberant. Although we may be late in this economic cycle, expansions don't die of old age.

As we saw in the disparate returns these past six months, 2019's markets are volatile and easily swayed by headlines. The headline uncertainties linger on so this bipolar volatility will continue through the rest of the year. Recent research has shown that the extreme ends of volatility have become more extreme so that periods of calm are very calm (think 2017) while periods of volatility are more violent (think December and May). Our quantitative investment software strategy has us prepared for these extremes. The portfolio

management software we use focuses only on asset price movement so that allocation decisions are made based not on subjective, emotional reactions but on identified, quantifiable price trends. Along with your diversified risk-appropriate portfolio these tactical and strategic allocation decisions provide the opportunity to avoid deep drawdowns but still participate in growth.

Sources:

- https://www.bea.gov (GDP data)
- https://www.bls.gov (employment data)
- https://www.conference-board.org (consumer confidence)
- https://www.finance.yahoo.com (index returns)
- https://fred.stlouisfed.org (GDP, employment, yield data)
- http://www.sca.isr.umich.edu (consumer sentiment)
- *The Fed Apologizes*, WALL ST. J., Jan. 31, 2019, at A18.
- David Andolfatto and Andrew Spewak, *Does the Yield Curve Really Forecast Recession?*, ECONOMIC SYNOPSES, Nov. 30, 2018, https://doi.org/10.20955/es.2018.30.
- Sarah Chaney, *Hiring Lull Taps Brakes on Growth*, WALL. ST. J., March 9-10, 2019, at A1.
- Ira Iosaebashvili and Saumya Vaishampayan, *China Concerns Loom Over U.S. Stocks*, WALL ST. J., Feb. 5, 2019, at B12.
- Greg Ip, *Fed's 'Normal' Is Anything But, And That Is Cause for Worry*, WALL ST. J., March 21, 2019, at A6.
- Greg Ip, *Global Boom Might Be Over Already*, WALL ST. J., Jan. 24, 2019, at A2.
- Paul Kiernan, *U.S. Data Spur Rate-Cut Expectations*, WALL ST. J., March 23-24, 2019, at A5.
- Yoko Kubota and Lingling Wei, *Beijing Beefs Up Its Offer in Trade Talks*, WALL ST. J., April 12, 2019, at A7.
- Eric Morath and Sarah Chaney, *Jobs Rebound Eases Fears*, WALL ST. J., April 6-7, 2019, at A1.
- Eric Morath and Lauren Weber, *3,045 Days of Job Growth*, WALL ST. J., March 2-3, 2019, at B4.
- Howard Silverblatt, *Market Attributes: U.S. Equities March*, S&P DOW JONES INDICES, April 2, 2019 (on file with author).
- Alexandra Stevenson, *Beijing Opened the Money Spigot Full Blast. And It Worked, For Now…*, NY TIMES, April 17, 2019, at B8.
- Nick Timiraos, *Fed Signals Hold on Rate Increases*, WALL ST. J., Jan. 31, 2019, at A1.
- Nick Timiraos, *Growth Fears to Keep Fed on Hold*, WALL ST. J., March 21, 2019, at A1.
- Harriet Torry, *Economic Vigor Seen in New Data*, WALL ST. J., April 18, 2019, at A2.
- Chuin-Wei Yap and William Boston, *China's Slowdown Hits Growth Globally*, WALL ST. J., Feb. 1, 2019, at A6.
- Josh Zumbrun, *IMF Cut Its Forecast for GDP Growth*, WALL ST. J., April 10, 2019, at A9.
- Howard Silverblatt, *Market Attributes: U.S. Equities March*, S&P DOW JONES INDICES, April 2, 2019 (on file with author).