Insights: July 2019

Market Overview and Performance

As we enter the traditionally quieter months of summer, we are faced with some truly uncertain times. In general, uncertainty is a constant and necessary component of market dynamics. One party believes that the value of an asset will go down while the counterparty conversely believes that the value will increase, yet neither side is ever certain. However, sometimes increased uncertainty can become paralyzing. As the St Louis Federal Reserve stated in early July, "A rise in uncertainty is widely believed to have detrimental effects on macroeconomic, microeconomic, and financial market outcomes affecting economic activity and decision making. In particular, firms may delay investment and hiring, households may reduce spending and increase savings, and financing costs may rise as risk premiums increase." The root of the current angst is two-fold: on the one hand, we are seeing signs of a slowdown in global growth, however on the other, assets almost across the board continue to elevate higher and now sit at new all-time high levels. If things were so bad, wouldn't investors be selling risk assets and not increasingly buying them? If things aren't as economically dire as portrayed, then why is the market 100 percent convinced that the Federal Reserve will be reducing interest rates fairly aggressively over the next six months in an effort to spur growth? Both conditions simply cannot exist at the same time. In the past, a concerned investor would assume a defensive posture in their portfolio, but if one had done that at the end of 2018, they would have missed out on substantial gains. Conversely, those who ignore the current recessionary and declining global growth warning signals may be taking unnecessary risk. In our view, it is unlikely that this uncertainty resolves soon. As always, thank you for reading our latest Insights.

	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	**7.05**	**18.54**
Russell 2000 Index	7.07	16.98
MSCI EAFE Index	5.93	14.03
MSCI Emerging Markets Index	6.24	10.58
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**1.26**	**6.11**
Barclay's U.S. Aggregate Credit Index	**3.90**	**15.44**
Barclay's U.S. Aggregate Corporate High Yield Index	2.28	**9.94**
Barclay's Municipal Bond Index	0.37	**5.09**
Macro Measures		
Gold	**7.83**	10.33
Crude Oil	**9.29**	**28.76**
CBOE Volatility Index	**-19.40**	**-40.68**
USD Dollar Index	-1.54	-0.06

Current Theme – Conflicting Narratives Foster Uncertainty, Yet Many Asset Classes Continue to Rise and are Now Near All-Time Highs

Illogically, Investors are Forced to Believe that the Global Economy is Good Enough to Justify New Market Highs, While at the Same time, Weak Enough to Merit Rate Cuts

As we described in our opening, despite a prevailing environment of uncertainty, the S&P 500 rose a dramatic +7 percent in June, propelling the index to new all time high levels. Importantly, this represents a breakout from the previous three attempts to rise above the prior peak level of around 2940. This is generally regarded as a bullish scenario for stocks.

S&P 500 Has Broken Out to New All-Time High Level

Source: Bespoke Investment Group

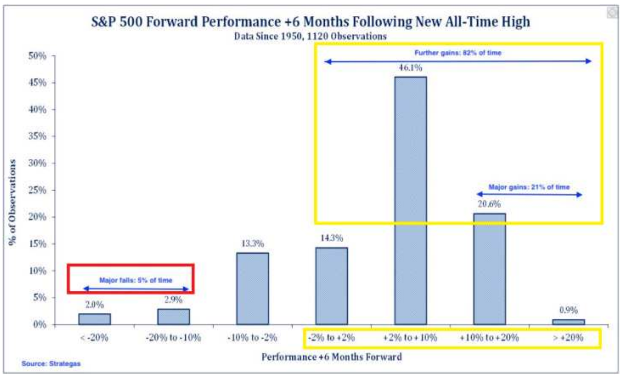
But it wasn't just the S&P - both the Dow Jones and NASADQ indexes also notched new highs. More notably, long bonds delivered strong returns as well resulting in the best combined first half performance since 1995. Even Gold was up over 10 percent.

2019 Best First Half for Both Stocks and Bonds Since 1995

Source: Financial Times; Refinitiv

In spite of these results, much skepticism remains in the marketplace. While it's certainly true that we have witnessed a tremendous 25 percent recovery off of the December 2018 lows, the S&P 500 has actually not made much progress over the past 12 months. In fact, on June 30, 2018, the Index stood at 2714. On June 3 of 2019, the Index price was 2744, less than 1 percent higher. On a June 2018 to June 2019 basis, the S&P 500 was up about 8 percent, which is precisely in line with long term annual return averages. This is hardly a runaway market that has "gone too far too fast".

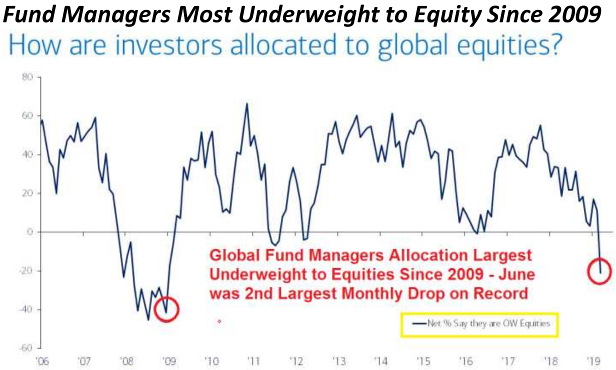
+6 Months Following New All-High Positive 82% of Time



Source: Strategas Research Partners

And contrary to what many believe, the market hitting new all-time highs historically marks a prelude to further gains rather than a time to "lighten up" on equities. As the chart above from Strategas highlights, since 1950, in the 6 months following a new high for the S&P, the index has seen further gains 82 percent of the time, with major gains (10-20%) occurring 21 percent of the time. Conversely, major declines of greater than -10 percent were seen only 5 percent of the time. In fact, declines of any kind transpired during only 18 percent of the following six month windows.

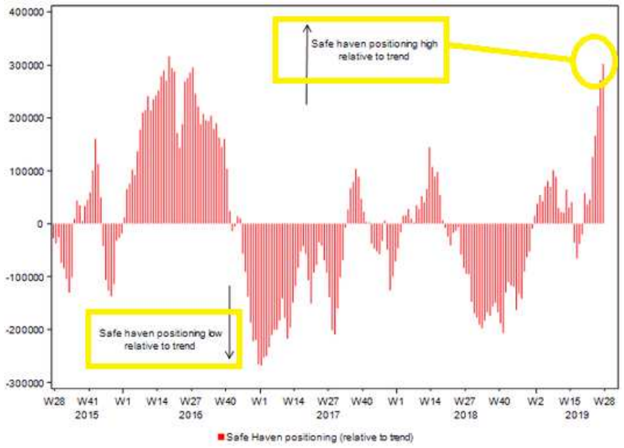
Fund Managers Most Underweight to Equity Since 2009



Source: BofA Merrill Lynch Research

Despite this historical precedent, investors remain highly skeptical. Consider the previous chart from BofA Merrill Lynch's monthly Global Fund Manager survey. Their June data suggests that fund managers are now the most underweight to equities since 2009 and June saw the second largest monthly drop in the survey's history.

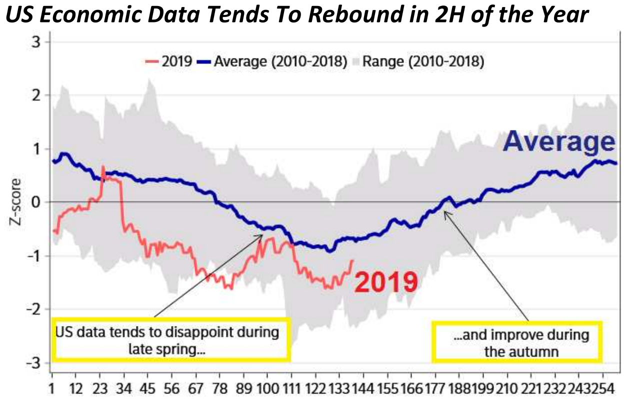
Safe Haven Positioning Largest Allocation Since 2016



Source: Longview Economics; MacroBond

Similarly, the chart above from Longview Economics illustrates their research findings which point out that investors are now as defensively positioned in safe haven assets as they were in 2016 preceding the uncertain US presidential election.

US Economic Data Tends To Rebound in 2H of the Year



Source: MacroBond; Nordea

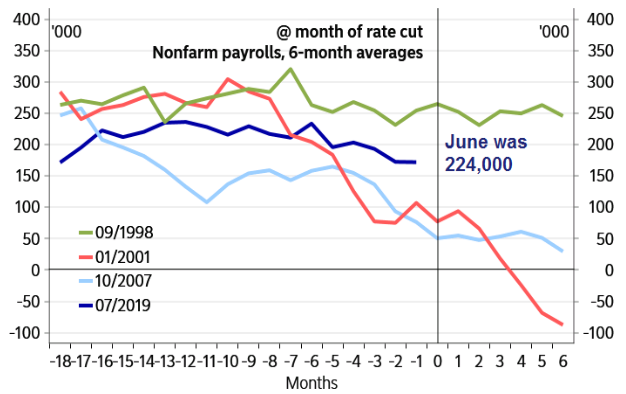
Again, this is somewhat at odds with what the overall data would suggest. As Nordea highlights in the chart above, although US economic data has been somewhat soft thus far in 2019, the pattern of the previous 9 years is for fundamentals to improve during the second half of the year. Yet we are not seeing investors positioned for this improvement despite the fact the recent data has provided evidence of a generally solid environment. For example, June retail sales readings showed year over year growth of +4.6 percent, close to the fastest rate of sales growth seen over the past ten years.

+4.6% Yearly Retail Sales Growth Close to 10 Year Highs

Source: Zero Hedge

As a reminder, American consumers drive roughly 70 percent of US GDP, and this data helps solidify the notion that consumers are feeling good about their current situation. This likely has a lot to do with the fact that the employment situation in the US remains robust with the June payroll data coming in at 224,000 and the 6 month average hovering around 200,000.

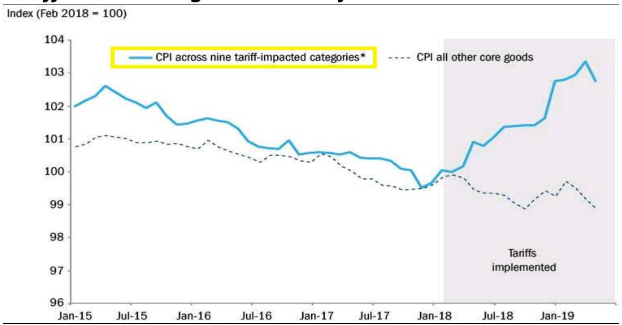
Strong Labor Data Does Not Suggest Rate Cuts Needed



Source: Nordea; MacroBond

Apparently however, this is not good enough in the eyes of market participants as an interest rate cut at the end of July is now 100 percent priced in according to the futures market. As the chart above shows, the Fed initiated a round of rate cuts after the labor market had already slowed in 2001 and 2007, but cuts have at times been implemented during years with strong employment numbers like 1998. The argument for a reduction in interest rates is even harder to justify when one looks at the second part of the Fed's dual mandate, inflation levels. While Core CPI has been an uninspiring two percent or so for quite some time, the initiation of trade wars and the subsequent tariffs has pushed inflation on some goods to rise by almost 4 percent as the chart below from Goldman Sachs illustrates. This would suggest that Fed should be thinking about rate *increases*, not rate cuts.

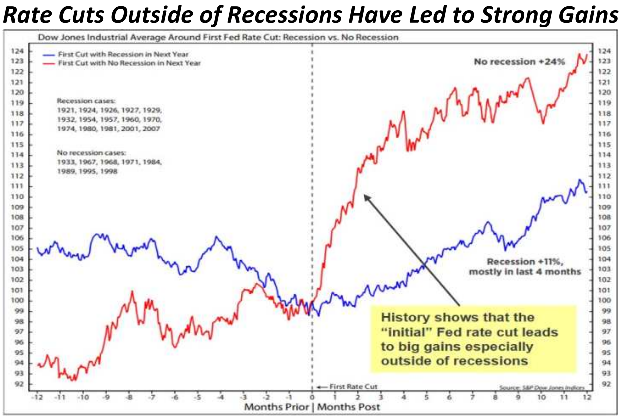
Tariffs are Causing Increased Inflation in Certain Goods



Source: Goldman Sachs Investment Research

However, as the saying goes, you have to invest the market you are given, not the one you want. So if the Fed cuts rates at the end of July as anticipated, what can we expect from stock prices in reaction? Ned Davis Research went back and tracked the one year forward return of the Dow Jones Industrial Average in years when rate cuts occurred both inside and outside of a recession. In the 8 years when the Fed cut rates in a non-recessionary period (which we would argue we are in now), the subsequent one year return was +24 percent. Further, even within recession years the forward return was over +10 percent for stocks.

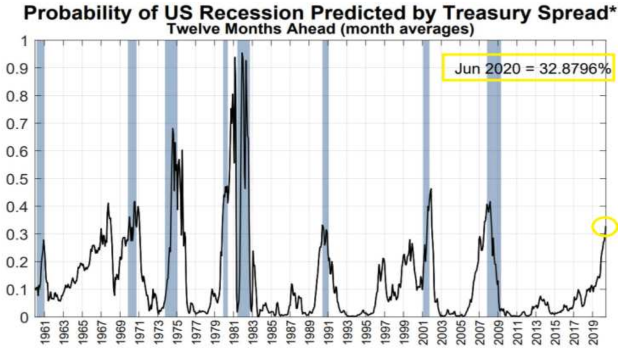
Rate Cuts Outside of Recessions Have Led to Strong Gains



Source: Ned Davis Research

The Market is clearly aware of this historical precedent, so dovish comments from various Fed officials have been welcomed with open arms. Yet, as we have pointed out, investors remain surprisingly defensively positioned.

New York Fed Model Shows 32% Chance of Recession



Source: DataTrek research; New York Federal Reserve

It is likely tied to the fact that investors are leery about the hazards of ignoring charts like the one above. Within the graph, we see that the last three times the Federal Reserve of New York's recession model showed higher than a 30 percent probability of hitting a recession, we in fact, saw one. The probability right now stands at 32.8 percent, however there are some caveats to consider here. First, during the last three recessions, the price of oil had doubled – today, oil has actually fallen from $75 to $55. Second, the Fed actually controls the model above since it is based off the spread between the 3 Month and 10 Year Treasury rate. By lowering the short term rate as anticipated, the yield curve will revert back toward normalizing. And in fact, even before the actual action, we are seeing the impact as the curve inversion is dissipating as seen below.

Fed's Preferred Yield Curve Measure is Normalizing

Source: Bloomberg; Bianco Research

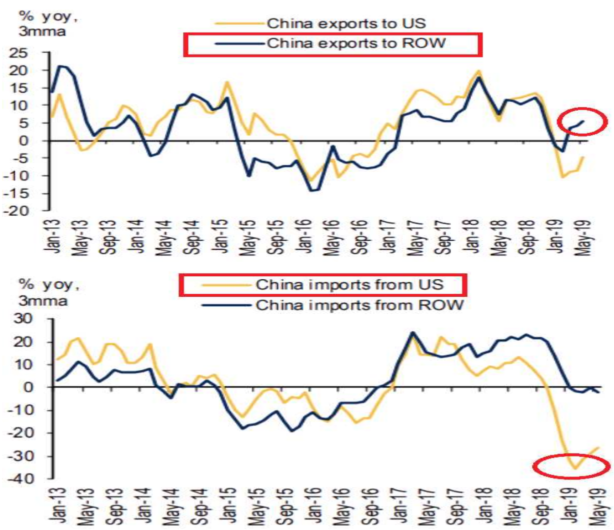
While we would suggest that the outlook for the US looks constructive at this point, we do remain concerned that the trade war issues could be the one factor that actually causes potential lasting damage. As one can see in the chart below, after almost a two year period of increasing growth, global trade is now in contraction.

World Trade in Contraction After Recent Growth Period

Source: Oxford Economics

China is obviously the biggest influence here since it sits in the middle of a multitude of global supply chains. And contrary to what some may think, China has many tools available to counter a slowdown in its own economic growth caused by the dispute with the US. In short, they are turning to the rest of the world as a counter balance. As the charts below highlight, China's exports to other nations are on the rise while imports from the US are down sharply.

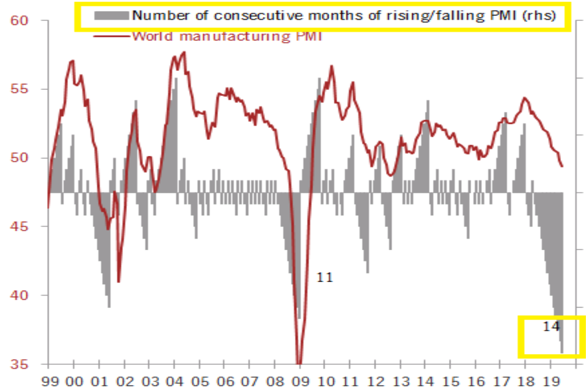
China Managing Trade War by Turning to Rest of World



Source: BofA Merrill Lynch

Importantly, while China has increased tariffs on American goods in retaliation to measures taken by the US, it is *lowering* tariffs on goods imported from the rest of the world. In fact, according to *The Atlantic*, it is on average now 14 percent cheaper in China to buy something from Canada, Japan, Brazil or Europe, than it is to buy something from the US.

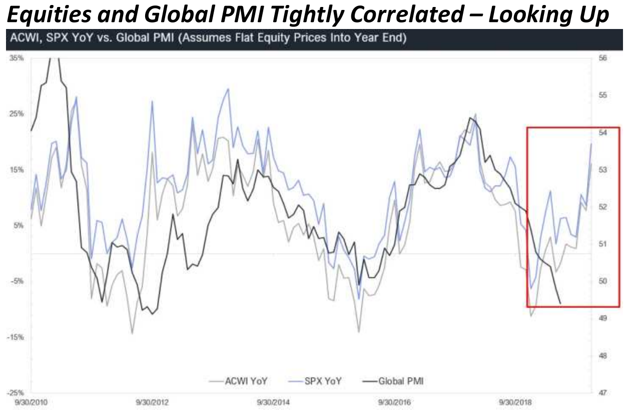
World Manufacturing Down Record 14 Straight Months



Source: Frederik Ducrozet

Hopefully, these kind of policies will help mitigate the effects of the trade slowdown seen in the chart above. For 14 straight months, global manufacturing activity (PMI) has been in decline, the worst period seen in the last 20 years. As we have written about in the past, our base case view is that a trade resolution will come to fruition in the coming months as all parties have a vested interest in the global economy moving back into expansion mode. And with equity markets at all-time highs, there is reason to believe that investors have come to the same conclusion since equity prices and Global PMI have been tightly correlated for the past 10 years.

Equities and Global PMI Tightly Correlated – Looking Up



Source: Pervalle Global; Bloomberg

Going Forward

As we have discussed, the current environment is marked by inconsistent narratives. While the yield curve and various economic data in the US suggest that a slowdown or even recession is likely over the next 12 months, we also see evidence to the contrary. Similarly, while global economic activity has clearly slowed as a result of the friction implemented via tariffs, a resolution of the trade dispute between the US and China appears to be fully anticipated by market participants particularly in light of the US election coming in 2020. This would clearly be a positive shift in dynamics. As such, we are constructive on the near-term outlook for risk assets, but would anticipate some largely sideways price movement over the summer months as negotiations evolve. In our view, a resolution of trade disputes combined with a reduction in interest rates has the potential to fuel meaningful gains in equities into year end and 2020, despite the fact that many indices currently sit at all-time highs.

With that outlook in mind, we would emphasize the technology, financial and industrials sectors as we look toward the second half of the year. Technology, although viewed as vulnerable to trade interruptions, continues to lead the market this year, up over +30 percent. Financial names, up +19 percent year to date as group, still display attractive valuations relative to the S&P 500 Index. We feel that this discount is unwarranted and see several opportunities in very well run, highly profitable companies priced at multi-year lows. The industrial sector stands to benefit from a likely positive outcome to the trade disputes which have handicapped global growth. In fact, despite the threat of disruption to the global supply chain, the sector is still up over 21 percent year to date.

After sharp declines at the end of last year, small and mid-cap stocks remain attractive in our view despite outperforming their large cap counterparts since the decline in late 2018 through the end of May. Since that time, large cap stocks have made up some relative ground, and all three market segments now display returns in the high teens for 2019. These companies are generally less impacted by trade tariffs, making them a good counterbalance to companies exposed to the global supply chain. Additionally, despite the fact that they are experiencing higher growth rates, both small and mid cap stocks trade at a discount to the S&P 500.

With the recent volatility in US markets related to trade, equity markets outside of the US are even more compelling in our view. Non-US markets remain much more accommodative in their monetary policy endeavors. Importantly, valuations are substantially lower than the US – at multi-decade lows in some cases. This, combined with improving economic activity trends in markets like Europe and Japan make non-US markets attractive. We have favored emerging markets equites for quite some time. The asset class has been hindered by both a strong US dollar and trade tensions. However, their valuation and growth levels are compelling, and PMIs (a reflection of economic health) across emerging markets as a group are now expected to exceed developed markets for the first time in many years.

The flattening yield curve is far and away the largest source of unease for many fixed income investors. With a re-visiting of a yield curve inversion in early May, concerns over a dramatic slowdown in growth and even a recession sometime in the near future are still top of mind for many. However, a meaningful shift occurred this month when the Chairman of the Federal Reserve virtually assured market that interest rate will be declining, which would alter the shape of the curve, returning it back to a more normal distribution. For our fixed income exposure, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value.

Our measured allocations to gold and non-precious metal commodities have continued to serve us well as a diversifier in portfolios thus far in 2019.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.