PRIVATE WEALTH MANAGEMENT

FINANCIAL MARKETS

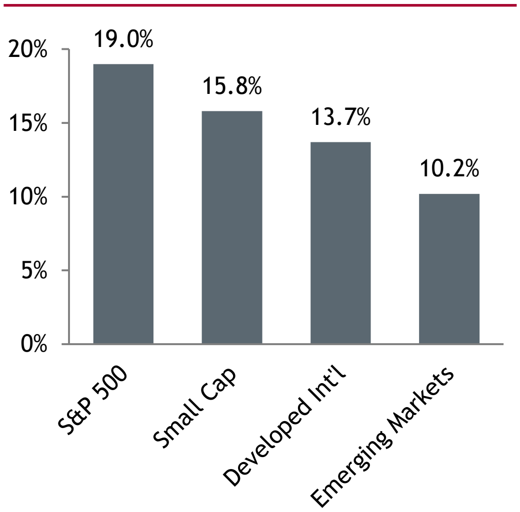
A View at Midyear

Midyear is a natural time to review financial market activity and to consider what may occur in the remainder of 2019.

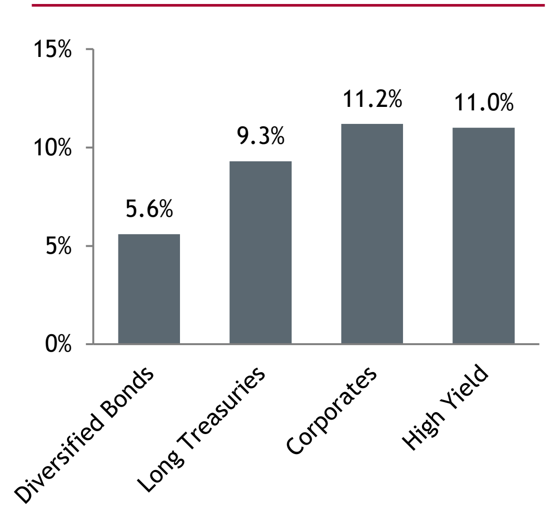
A LOOK BACK

Returns for the year-to-date suggest that stock markets, and more risky parts of the bond market, are soaring. References to a "market melt up" or even a "bubble" are prevalent.

Year-to-Date Equity Returns

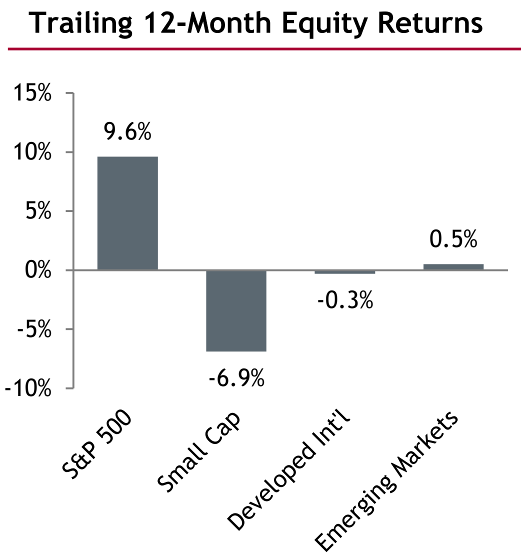


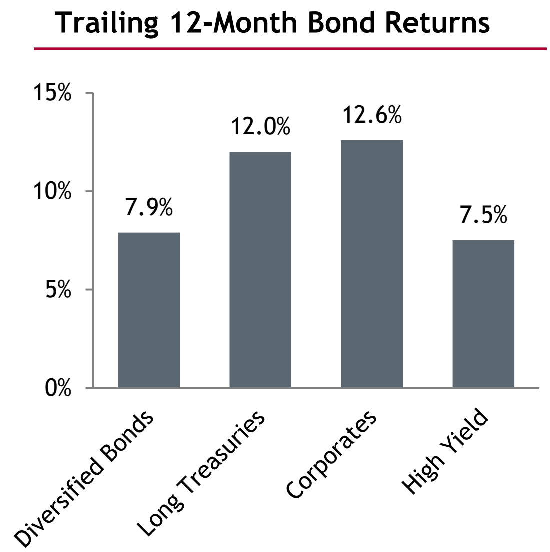
Year-to-Date Bond Returns



However, it's important to extend the analysis a bit. On the next page are returns for the same market benchmarks over the past 12 months. As you can see, this data sends a very different message:

- A roughly average return for the S&P 500
- Negative results for small cap and international equities
- Strong results from safe-haven fixed income investments, in many cases outperforming stocks





Source: Bloomberg. Returns are total returns through 06.21.2019. Benchmarks or funds used are S&P 500, Russell 2000, MSCI EAFE, MSCI Emerging Market, iShares Core U.S. Bond Aggregate ETF, iShares 20+ Year Treasury Bond ETF, iShares IBOXX Investment Grade Corporate Bond ETF, SPDR Bloomberg Barclays High Yield Bond ETF.

Clearly, a big part of the stock market surge in 2019 represents a relief rally after the near-bear market experience of the last quarter of 2018. The upswing in sentiment was propelled by first quarter earnings clearing the bar of low expectations; perceived momentum on a U.S.-China trade deal early in the year; and, in June, monetary policy comfort from the Federal Reserve after trade negotiations went sideways, inflation numbers weakened and the yield curve inverted.

The Federal Reserve's June 19 Federal Open Market Committee (FOMC) meeting represented a shift in tone and expectations, and was warmly received by financial markets. Chairman Powell stated that while the economy was performing reasonably well, uncertainties related to trade and weak overseas growth had risen. He also acknowledged that inflation was well below their target. While taking no action, the FOMC laid the groundwork for at least one interest rate cut in the second half of the year, and probably more. The day after the FOMC meeting, the S&P 500 rose to an all-time high.

A LOOK AHEAD

After an eventful—and profitable—first half of the year, we believe the following issues will be critical to the outlook for the economy and markets in the second half.

Geopolitics

For investors trained in fundamental analysis, it is uncomfortable when markets are highly sensitive to largely unforecastable geopolitical events. This is one of those times.

For more than a year, the U.S.-China trade dispute has been overshadowing the market, with analysts parsing every tweet, rumor or theory to determine if or when an agreement might be reached. These efforts have been largely unsuccessful.

Our view is that there will *ultimately* be an agreement—or at least a de-escalation process—between the two countries. That is because there are increasing signs that the trade battle and tariffs already imposed are beginning to take a toll on both the Chinese and U.S. economies. President Trump needs a strong economy headed into next year's election and President Xi needs the same in order to continue with promised reforms, and to retain his perceived invincibility as China's leader for life.

While we're confident in that eventual outcome, it is difficult to predict the timing. In fact, the trade dispute could get worse before it gets better. President Trump is a risk taker, and he may perceive that the economy is doing well enough to withstand continued trade tensions for a while, and that there are political benefits to a "tough on China" stance. President Xi has more policy tools at his disposal to prop-up China's economy in the short term, and of course, is not facing re-election.

We are writing just before the two leaders meet in Japan, but believe that whatever comes out of that discussion will not be the definitive last word on the subject. The imposition of tariffs on all Chinese imports—the next punitive step laid out by the U.S. administration—would likely have a significant negative impact on the global economy and risk assets.

The dramatic deterioration in relations between the U.S. and Iran is another unpredictable variable with potentially dramatic consequences. While the U.S.-China dispute has occurred under the veil of diplomacy, the conflict with Iran has already involved several acts of physical aggression.

The immediate financial trigger for rising tensions in the Middle East is the price and supply of oil, about 20% of which travels through the Strait of Hormuz.[1] It is important to note, though, that the balance of power in the oil markets has shifted dramatically in the U.S.'s favor. Domestic oil production has more than doubled in the last seven years,[2] and the U.S. is on the verge of becoming a net exporter. While the U.S. economy is less subject to being held over a barrel by Organization of the Petroleum Exporting Countries (OPEC) in general—or Iran in particular—a military confrontation with Iran would likely be a catalyst for significant volatility in equity markets.

Monetary Policy

Monetary policy at home and abroad has gotten more supportive of financial markets this year. Twenty-five central banks around the world have cut interest rates.[3] The Federal Reserve, European Central Bank and People's Bank of China are likely to do the same in the second half of the year. Futures markets have priced-in virtual certainty of a cut in the Fed Funds rate at the FOMC's July 31 meeting.

This all feels a bit like “back to the future.” Most of this decade-long bull market was propelled by a combination of slow global growth, low inflation, easy monetary policy and low bond yields. Looking at the remainder of the year, our view remains that the bull market will continue, and that stocks will outperform bonds.

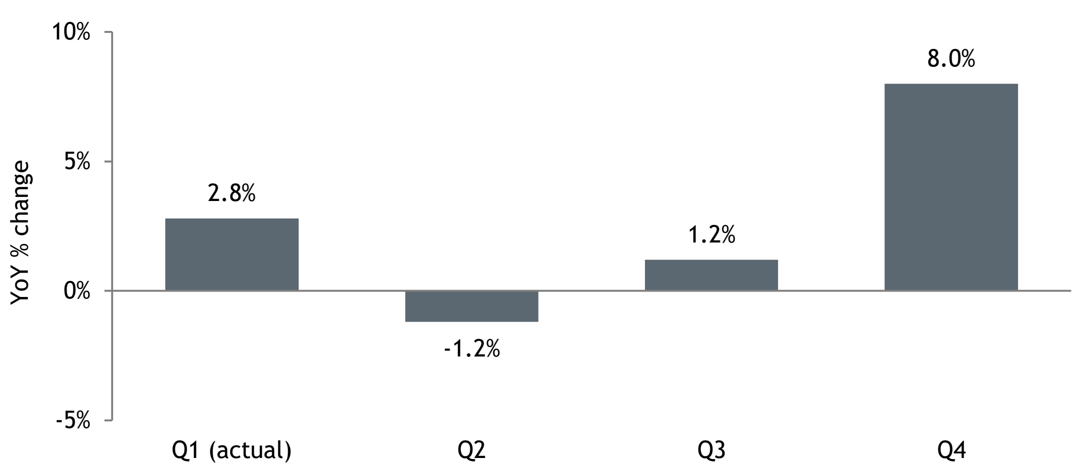
Extending the outlook, investors should be mindful of the fact that implementing easy money policies late in the economic and financial-market cycle can run more risks compared to accommodative policy employed early in the cycle. We are 10 years into this economic recovery and bull market. Equity valuations are higher, earnings growth potential is lower, and it is a more risky time to be reaching for yield in the darker corners of the credit markets.

In this environment, we are focused on both the bullishness implicit in the old adage “don’t fight the Fed,” and on the potential for cycle-ending excesses or imbalances that may be encouraged by the charity of central banks.

Corporate Profits

As described above, macro issues have dominated investor attention in recent months. However, beginning in early July, second quarter corporate earnings releases will be important for setting the tone for the last half of the year. Much like the first quarter, forecasts are low for both second- and third-quarter operating earnings, before an expected acceleration in the fourth quarter.

2019 Quarterly Earnings Growth Consensus Estimate

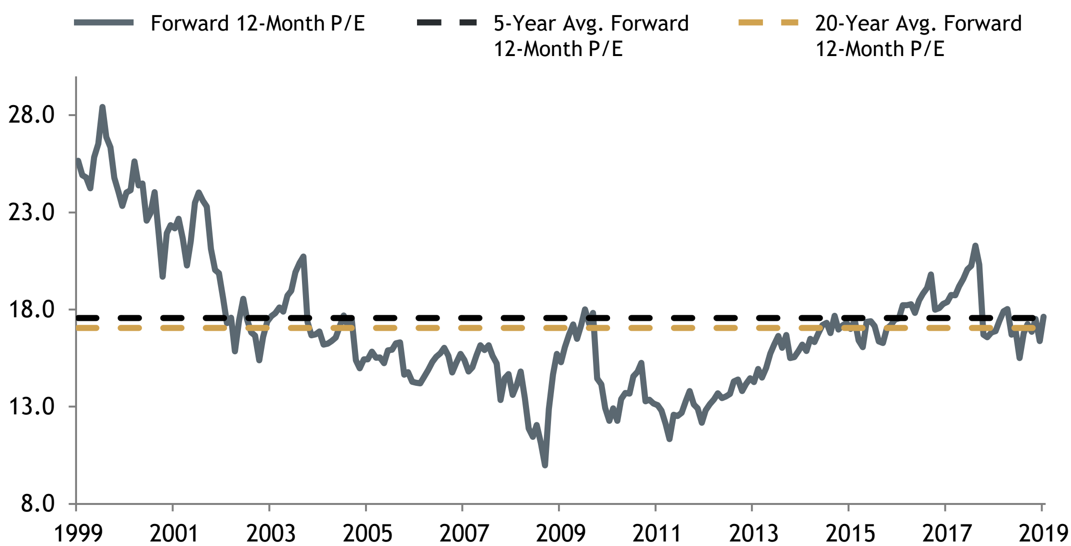


Source: I/B/E/S, Yardeni Research as of 06.13.2019.

It may well be that these low expectations will be exceeded. But we will be more interested in commentary and forward guidance from company CEOs on whether they are facing substantial headwinds on global demand or tariff related issues that would cast a pall over the outlook for the rest of the year.

The good news is that profits don't need to be great to support current market valuations. The exhibit below suggests that valuations are neither rich nor cheap. There is room for equities to move higher on better-than-expected profits. Similarly, if earnings disappoint already low expectations, there is little buffer to prevent a downward rerating.

S&P 500 Forward 12-Month P/E Ratio: 20 Years



Source: FactSet, S&P 500, data as of 05.31.2019.

Our analysis leads us to expect the continuation of the bull market into 2020, but with the acknowledgement that we've already come a long way, and that a number of unquantifiable geopolitical issues remain unresolved. ■

1 U.S. EIA, 06.20.2019.
2 Yardeni Research, 06.20.2019.
3 Strategas, 06.20.2019.