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Quarterly Update & Economic Commentary—June 30, 2019

Quarter in Review

The strong returns during June helped the markets have a positive quarter and locked in an exceptional close to the first half of the year. The S&P 500 TR recorded a positive 7.05% in June, 4.30% in the second quarter and is now positive by 18.54% year-to-date. The top performing S&P 500 sectors for the quarter were Financials (8%), Materials (6.31%) and Technology (6.06%) – Technology is also the top performing sector year-to-date, positive by 27.13%. The worst performing S&P 500 sector was Energy, down 2.83%; it was the only negative sector for the quarter. The S&P SmallCap 600, outperformed the S&P 500 during the month of June, returning 7.45%. The small cap index was positive by 1.87% during the quarter and is now positive year-to-date by 13.69%.

International equities also had a strong quarter but, underperformed U.S. stocks. The MSCI EAFE NR, returned 5.93% for the month of June, 3.68% for the second quarter and is positive by 14.03% year-to-date. Emerging markets had a good month, positive by 6.24%, but barely finished positive for the quarter, 0.61%, and the index is positive by 10.58% year-to-date. A weakening U.S. dollar drove international stock returns.

In addition to the strong equity returns, fixed income returns are also having a superb year. Falling interest rates have driven fixed income prices higher. The yield on the 10-year treasury fell about 41 basis points, closing the quarter at a yield of around 2%. The Barclays US Aggregate Bond Index returned 1.26% for the month of June, 3.08% for the quarter and the index is positive by 6.11% year-to-date. The growing appetite for risk during June and the previously mentioned falling rates helped high yield bonds. The Barclays US Corporate High Yield Index increased 2.28% for June, 2.50% for the quarter and 9.94% year-to-date.

The commodity markets saw some relatively big moves. Gold had a strong June, returning 7.83% for the month and 8.87% for the quarter. Silver and platinum were other precious metals that performed well late in the quarter. Silver was up 5.31% and platinum was positive by 5.91% in June. The oil markets were volatile, rising in June but falling for the quarter. Brent crude rose 4.44% in June, lost 4.20% during the second quarter but is positive by 20.33% year-to-date. Other notable commodity spot returns for the quarter were corn, 19.14%, wheat, 15.18% and natural gas, -13.30%.

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The second quarter was full of action, from relatively big moves in the equity markets, a spike and then plummet in longer-term interest rates, a mix of good and bad economic news, a trade war that escalated, only to simmer down by quarter-end, the Fed's change in tune on interest rate policy and rising geopolitical tensions with Iran.

The Fed and the U.S.-China trade war were the two dominating headlines during the quarter. The Fed, which raised interest rates four times in 2018 and did so as late as last December, has changed course and set the stage for multiple rate cuts later this year. With the economy continuing to grow and unemployment near multi-decade lows, it is not clear-cut whether the Fed should cut rates or stay patient and keep the status quo. The Fed can use the argument that inflation has been moving down and away from the 2% target and that some economic indicators have looked a little sluggish. The Fed's interest rate policy for 2019 began the year with a two rate hike forecast, then the Fed changed the language to being "patient" with any additional hikes, and finally during the June meeting they dropped the word "patient" and said they would take measures to sustain the current economic expansion. Following the June meeting and the change in language, the market now expects the Fed to cut rates at least twice in the second half of the year.

Related to the Fed has been the trajectory of the yield curve. The yield curve of a healthy economy is typically an upward sloping yield curve, with shorter-term interest rates lower then longer-term interest rates. The Fed Fund's Rate (on the short end of the curve) is targeted between 2.25% and 2.50%, and when the longer-dated 10-year Treasury moved lower to around 2% the yield curve inverted. An inverted yield curve generally means something is wrong with the economy and historically has signaled an upcoming recession. Historically, the yield curve has inverted when shorter rates move higher than longer rates, typically from the Fed raising rates too fast, but this time longer-term rates dropped below shorter-term rates. Market bulls are looking for all kinds of reason why this time it is different. Only time will tell if a recession is imminent but it is a notable occurrence to watch.

The trade war escalated during May and markets reacted negatively. The S&P 500 lost over 6% and small-cap stocks lost more than that. The trade discussions abruptly broke-off and President Trump increased tariffs from 10% to 25% on $200 billion of Chinese goods. The President also threatened to put tariffs on almost all other Chinese goods that were not yet subject to tariffs. The Chinese reacted by increasing tariffs on $60 billion of U.S. goods. Being that the U.S. imports significantly more goods from China than China does from the U.S., the U.S. has the advantage on the tariff weapon.

In addition to the tariffs, President Trump banned Huawei, a major China technology company, from doing business in the U.S. and influenced many other nations from doing business with the company. The President called the company a national security risk, which might have some truth to it, but it's generally believed that the ban was more influenced by the trade war. China's response has been to apply pressure in other ways. China has been selling U.S. Treasury securities that it owns, but they can only take this so far since they would also be devaluing a portion of their holdings. There were rumors that the Chinese were considering restricting the sale of rare earth metals to U.S. technology companies. This act would cause significant damage to many U.S. companies. The U.S. also has the rare earth materials but decided a long time ago to not process the metals here because of the messiness, danger and pollution associated with the process. There is currently one company, located in Texas that will be able to process rare earth metals in small batches in the future. The U.S. government is looking into the business of rare earth metals as it realizes the problems with China's control of the rare earth supply.

The announcement that President Trump and Chinese President Xi would meet at the G-20 in late June calmed the markets. Following the meeting, the two sides agreed to a tariff truce and were to begin re-negotiating a deal. Part of the deal was to allow certain U.S. companies to sell general products to Huawei. This part of the agreement pulled into question the credibility of the national security reasoning previously provided for the Huawei ban – apparently it is only a security threat if China will not agree to a trade deal.

The U.S. economy grew at 3.2%, year-over-year, for the first quarter, well above analyst expectations. The unemployment rate for May remains at multi-decade lows, 3.6%. Wage growth showed an increase of 3.4%, which is low for historical standards but is near a 10-year high. An economic indicator that is causing some concern is inflation data. Core CPI was 2% for the month of May but Core PCE came in a little light at 1.6%. The Fed targets 2% inflation growth and prefers the PCE calculation.

Global economic growth, as measured by GDP, showed a 3% growth rate for the first quarter. The performance of the global manufacturing sector continued to weaken during the second quarter. The reading of 49.4 is the lowest reading in over six years and posted back-to-back sub-50.0 readings for the first time since 2012. A reading below 50 indicates a contraction, while a reading above 50 signals an expansion.

In other international news during the quarter, the United Kingdom's Prime Minster Theresa May announced she would step down effective June 7. She had been Prime Minster for almost three years but it was becoming clear that she was not going to be able to deliver a plan for the U.K.'s departure from the European Union. While the country holds elections and picks their new leader, Theresa May has agreed to continue to serve.

A Look at the Numbers

Name	Second Quarter	Year-to-Date
DJ Industrial Average TR USD	3.21	15.40
S&P 500 TR USD	4.30	18.54
S&P MidCap 400 TR	3.05	17.97
S&P SmallCap 600 TR USD	1.87	13.69
NASDAQ Composite TR USD	3.87	21.33
MSCI EAFE NR USD	3.68	14.03
BBgBarc US Agg Bond TR USD	3.08	6.11
Wilshire US REIT TR USD	1.63	17.92
IA SBBI US 30 Day TBill TR USD	0.60	1.18
Source: Morningstar Direct		

Forecast In Brief

The Fed meeting at the end of July will be closely watch and will have market implications. As the expectations for a July rate cut increased during the month of June, the markets rallied. Despite the market beginning to price in a rate cut, it is not a done deal that the Fed will cut rates. The U.S. economy is still growing, unemployment rate is low and interest rates have fallen, making it cheaper for businesses and consumers to borrow money to make large purchases. While some of these headline numbers look positive, the economy is beginning to slow. Knowing that it takes time for monetary stimulus, like rate cuts, to make its way into the economy, the Fed may feel compelled to cut rates as insurance to protect against a recession in the quarters ahead. The Fed is also seeing their preferred inflation gauge—the Personal Consumption Expenditure Price Index—decelerate in recent months. The Fed has a dual-mandate to "promote effectively the goals of maximum employment, stable prices and moderate long term interest rates." With prices falling, the Fed could point to the stable prices component of their mandate to justify a rate cut despite the strong labor market. Although the trade war rhetoric has calmed, the uncertainty of the timing or substance of any deal remains. This lack of clarity could lead to businesses slowing down purchases until more confidence is established.

The Fed will continue to watch data up until their meeting but the trap is already set. The market now expects a rate cut. If economic data improves, the probability of a rate cut will fall and so will the market. If the market falls leading into the Fed meeting, the Fed may feel they have no choice but to provide an insurance cut to protect the wealth effect of consumers.

As of the end of June, more companies had issued negative earnings guidance for a quarter than any time since 2006. Companies in the Technology, Health Care and Consumer Discretionary sectors have led the negative guidance. Earnings growth is expected to be negative and if this pans out it would mark the second consecutive quarter of year-over-year declines, the first such occurrence since 2016. As it currently stands, analysts are also expecting to see earnings decline for the third quarter as well. This should not come as a surprise and it is not as bad as it looks. Last year earnings were "artificially" higher because of the lowered corporate tax rate; now companies have a more difficult year-over-year comparison. Earning growth rates will be something to watch but corporate conference calls will be more important to see how companies feel about the current environment and whether they are willing to continue to spend money during this time of uncertainty.

The U.S. and China trade wars have negatively affected the Eurozone, Japan, Korea and Taiwan. The Chinese economy has slowed, causing a ripple effect that hurts both developed and emerging market economies. There has been a decline in global trade and, as seen in the PMI readings, a drop in global manufacturing. Europe continues to putter along; there has been manufacturing weakness in Germany and the continued uncertainty from the U.K. exit from the Eurozone.

The ECB looked to end its monetary easing at the end of 2018, but with the risk of recession increasing the ECB may initiate additional stimulus as early as the third quarter 2019. As the market looks for additional stimulus from the ECB, the ECB will also be working on transitioning their leadership. Mario Draghi, who has been leading the ECB for the past 8 years, and has arguably saved the Eurozone with his decisive and non-traditional monetary policy, will end his reign in October. Christine Lagarde, the current IMF President, is expected to be the next ECB President. There is some concern over her transition but this is less because of her ability than it is about the removal of such an influential and successful figure at an increasingly difficult time.

With the Fed ready to cut rates and the trade tensions mitigated, it will be interesting to see in the coming weeks what narratives take hold in the market. The first half of 2019 produced a booming rally that was partly a rebound from a rocky fourth quarter and partly on the hopes of a newly accommodative Fed. In most circumstances an 18.5% return in the first half to the year would cause investors pessimism about prospects for the next six months. While there are a number of things that could send stocks falling in the months ahead, it's not difficult to envision a continued rally, particularly with the support of the Fed.

If anything has changed with your financial picture that may affect your investment strategy, please let us know so we can make any necessary changes.

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