Investment Review and Outlook
June 30, 2019

"It's not whether you get knocked down; it's whether you get back up. That's how winning is done."
Vince Lombardi, NFL Football Coaching Legend (1913 – 1970).

Markets have been repeatedly knocked down over the past year due to economic, political, and global events that have shaken investor confidence. Since the beginning of 2018 the Russell 3000 Index of large, mid, and small cap U.S. stocks has experienced four pullbacks of greater than 10%. Despite these knock downs, markets have demonstrated incredible resilience as every sell-off has been met with a powerful resurgence.

Following a brutal fourth quarter collapse that saw most major indices touching bear market territory, stock prices surged through early spring. After four interest rate increases in 2018, Federal Reserve Chair Powell signaled the Fed would move to the sidelines until the economic fog cleared. Although welcomed by investors, this shift in policy raised concerns that the Fed was seeing signs of weakness that were not yet visible to investors.

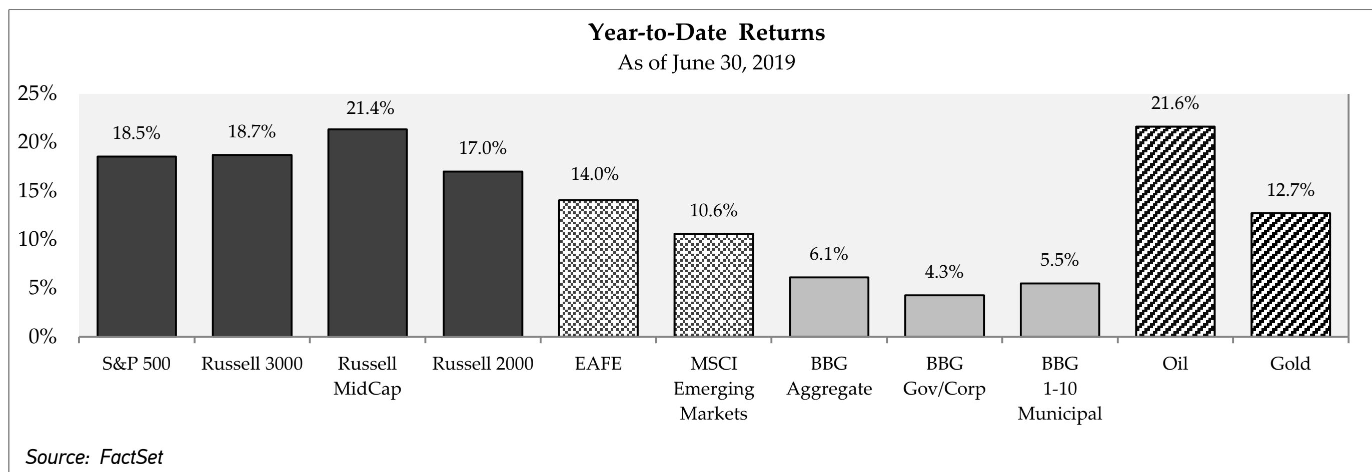
Economic uneasiness escalated in the second quarter over growing concerns that trade negotiations with China had stalled. Other geopolitical events including Iranian hostilities and Brexit uncertainty raised investor anxiety. After rallying through April, the weight of rising global discord caused equity markets to buckle in May, as the S&P 500 dropped 6.9% for the month. However, consistent with previous market knock downs stocks rallied back in June, surging over 7.0%.

Despite the volatility, markets ended the quarter solidly in positive territory. The Russell 3000 Index gained 4.11% and the S&P 500 jumped 4.32%. Mid caps joined large caps with a strong 4.13% rise; however, small caps posted a modest 2.12% gain. U.S. markets were pushed higher by strength in financials, technology, and consumer discretionary shares. The healthcare sector served as a drag on equity returns as it found itself in the political crosshairs of candidates jockeying for the Democratic nomination for president in 2020. In addition, the commodity and trade-oriented energy and industrial stocks also lagged the overall market.

International stocks continued to trail domestic equities in the second quarter. Short rallies in developed and emerging markets, driven by hopes of positive trade news, were repeatedly cut short when agreements failed to materialize. For the quarter the MSCI EAFE Index of developed markets posted a solid 3.68% gain; however, the MSCI Emerging Markets Index rose an anemic 0.61%. Although emerging markets such as India and Brazil posted modest gains, the China Shanghai Composite Index dropped 3.62% for the quarter.

While equity markets captured most of the financial headlines, fixed income markets delivered their own drama. Swirling concerns over the Fed's next move, declining global economic growth, and unrest abroad drove interest rate volatility to an extreme. The 10-year Treasury ended the first quarter yielding 2.39%, well below its early January level of 2.78%. As investors sorted through economic crosscurrents, yields jumped higher in April with the 10-year Treasury hitting 2.64% before plummeting to below 2.00% in late June. With sharp declines in interest rates, bond prices moved higher as the Bloomberg Barclays Government/Corporate Index gained 1.48%, and the 1-10 year Municipal Index rose by 1.64%.

Despite rising investor anxiety and historic volatility, markets delivered impressive results in the first half of 2019. The Russell 3000 posted an 18.71% gain through mid-year, representing the strongest first half start for stocks since 1995. Complementing the move in equities was an increase of over 4% for most major bond indices, and a jump in key commodity prices. In fact, this is the first year since the financial crisis that all major asset classes posted positive mid-years results. The chart below shows returns across the major markets.



Investors learned Coach Lombardi's lesson that winning is about getting up after you've been knocked down. Even after the harshest of declines, markets repeatedly bounced back to post solid gains at mid-year. Despite the market's resilience, the path forward remains uncertain.

Global Economies: The Slow Pace Ahead

"To climb steep hills requires a slow pace." **- Act One: The Life of King Henry VIII by William Shakespeare (1564 – 1616).**

U.S. economic growth is decelerating. After three consecutive quarters of better that expected GDP growth, all major segments of the economy are beginning to cool. First quarter GDP expanded by a surprising 3.1% - however, second quarter growth is expected to slow to below 2.0%. Consumer spending, which accounts for more than two-thirds of U.S. economic output, is slowing. The boom in business investment has given way to more cautious deployment of capital as the benefits of tax reform fade and the effects of the trade standoff kick in. Slowdown in regulatory reform and plateauing of business confidence is signaling a retrenchment in corporate spending plans.

However, there are some positive forces helping to offset these slowing economic trends. The economy is buoyed by continued tight employment markets, steady labor participation rates, low inflation, and increases in productivity. Rising confidence that the Fed's next policy move is to cut interest rates is also helping support economic optimism.

Like the U.S., other major global economies are experiencing similar slowing trends. The Eurozone, Japan, and other developed economies are seeing a slowdown in their manufacturing and service sectors. With trade as the central driver of emerging market growth, the current U.S.-China showdown has rippled through these vulnerable economies, causing growth expectations to decline.

Waning global growth is being combatted with major fiscal and monetary policies initiated by government policymakers and central banks. Germany, France, and Italy have announced plans for limited tax cuts and spending increases. The European Central Bank has announced it will provide financial institutions with low-cost credit starting in September. In addition, authorities in Australia, Brazil, Russia, and Japan have announced monetary initiatives to fuel additional global liquidity and avoid economic contraction.

Our view is that the global slowdown is underway and economic data will continue to reflect this declining trend over the balance of the year. Although we continue to see tight labor markets, productivity gains, and low inflation our expectations are that U.S. growth will moderate to 2.0%-2.5% in 2019, versus 3.0% in 2018. Our forecast for the global economy in 2020 is for a modest uptick as the current monetary and fiscal stimulus rolls through both developed and emerging markets. The pick-up in economic activity will depend on the successful resolution of outstanding trade issues which we believe will be settled before the U.S. election season heats up in early 2020.

Economic forecasting is notoriously unreliable. We believe the directional shift in growth expectations is more important than focusing on a precise estimate. Therefore, our investment strategy is built on the belief that global growth is slowing and that the U.S. economy will follow a similar path. This slow pace, without recession, should offer the opportunity for global economic growth to ultimately climb higher in 2020.

Investment Outlook and Strategy: Focus on What's Most Important

"Separating what's important from what's a waste of time is harder than ever. But once you do, life gets a lot easier." **Dara Khosrowshahi, CEO, Uber Technologies (1969 – Present).**

The investment environment over the past eighteen months has been treacherous. Since the historic tranquility of 2017, the financial markets have followed a violently volatile path, with wide price swings accompanied by unsettling geopolitical events. Although many investors have been thrown from the market roller coaster over the past year, our investment strategy has stayed steady. Our emphasis on diversification and focus on the long term has allowed us to remain rational in a market environment that often behaves irrationally.

As we prepare for the coming cyclone of escalating political rhetoric, rising global tensions, and reactive policy shifts, we intend to stay focused on what is most important to the markets. In our view there are two primary economic forces that will drive markets in the second half of the year. Although there will be a daily deluge of issues and concerns that will cause investor reaction, the drivers of markets for the balance of the year will be the timing and magnitude of the Fed's monetary policy, and resolution of the global trade war that has brewed since the Trump administration occupied the White House.

The Fed's next move is critical. After raising the fed funds rate four consecutive quarters in 2018 the Fed became concerned that economic growth had peaked, and was beginning to roll over. Since the beginning of the year Chairman Powell has repeatedly communicated that the Fed will "act as appropriate to sustain the economic expansion." Early in the year his statements signaled the Fed's intent to pause future rate hikes pending the direction of economic data. Our view is that the Fed has seen evidence of the slowdown and is now poised to initiate monetary easing through a series of interest rate cuts in the second half of the year.

Resolution of the trade standoff with China is crucial for the market's ability to move higher. Prolonged trade negotiations with China has raised dire warnings of rising consumer prices, breaches of national security, and escalating risks of economic contraction. The trade "piñata" has been pummeled by investors, politicians, and global leaders for the past two years with no clear resolution in sight. Although many pundits are calling for this economic standoff to continue, we believe increased clarity will surface prior to year end. We are well aware of the complexities and time commitments required to get a final agreement that is acceptable and enforceable by all sides. Full ratification and execution of a comprehensive trade agreement between the U.S. and China is too much to expect over the next two quarters. However, investors are looking for measurable progress that demonstrates there is strong intent to secure a mutually beneficial agreement. We believe that meaningful progress towards this goal will be achieved as China continues to feel the economic pinch of tariffs and the administration seeks to declare victory prior to the start of the election cycle.

During this time we intend to stay focused on these two key issues at the exclusion of all the noise and distraction we expect as we move through the second half of the year.

Investment Strategy

Mid-year is a good time to pause and assess investment strategy to insure that portfolio allocation is aligned with your investment outlook. We came into 2019 optimistic on the prospects for U.S. markets. So far this year, markets have exceeded our expectations with stocks delivering high-teens returns, accompanied by a meaningful drop in interest rates that has boosted the bond market. Our outlook for the second half is more cautious; with expectations for continued volatility and more muted return opportunities.

Our investment strategy has not materially changed since the beginning of the year; however, our view on international equity markets is becoming less optimistic. Over the past several years we have maintained an underweight position in international markets relative to its global market weighting. During this period U.S. stocks have outperformed international equities.

As global growth drifts lower and policymakers apply fiscal and monetary stimulus to avoid recession, we are most comfortable keeping our equity allocation focused on domestic opportunities versus international markets. We continue to believe international markets offer unique long-term growth opportunities, and provide much needed diversification during volatile markets. As a result, we intend to continue to maintain exposure to these important markets.

To capture return opportunities in these volatile times we continue to emphasize diversification across capitalization, investment style, and discipline – to include both active and passive strategies. This approach to equity investing allows volatility risk to be managed within the portfolio, and not through attempts to time market movements.

Interest rate volatility has increased considerably over the past several quarters. The yield curve remains historically flat, with bouts of inversion as intermediate and long term rates bounce to the low end of their recent range. This environment makes portfolio decisions regarding duration, credit selection, and yield curve positioning extremely important when managing bond portfolios.

Currently we favor corporate securities over Treasuries and agency bonds in taxable portfolios. Our view that a recession will be avoided makes corporate bonds more attractive than government debt securities. We have transitioned portfolios from short of their benchmark's duration towards neutral in order to better manage price risk and continue to allow for reinvestment when the opportunity arises.

While there is much uncertainty ahead, we are confident that maintaining discipline in our investment process and adhering to our investment philosophy will allow us to achieve your long-term investment objectives.

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