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Q3 2019 Newsletter | Jeff Griggs, CFA

Due to the wide range of risk tolerances of our clients, some topics or asset classes may have more, less, or no importance to your portfolio. For a detailed analysis, give us a call, or request a detailed performance review.

Big Picture

Trade concerns took over in May and led to a -6.8% drop in the S&P 500, but the fear subsided by June as the Fed adopted a far more accommodative stance than the market had anticipated at the beginning of the year. The Fed about-face led to a 7.6% rally in the S&P 500. We came into the year expecting as many as 3 rate hikes throughout the year, now at the end of June the market is pricing in a 0% probability that the Fed holds rates steady in their July 31 meeting. In fact, the market is pricing in a 34% chance that the Fed cuts rates by more than 25bps. With a 100% probability of an easing in July, I'm inclined to expect a rate cut to happen; however, this situation sets the market up to be sorely disappointed if the Fed decides to stand pat.

The disregard the market has shown for potential disruptions is actually quite worrisome at this point. While trade tensions seem to have simmered a bit, no resolution has been reached and contention can rear its head at any point. The market is expecting up to three rate cuts through the second half of the year, and this possibility seems to be priced in as a certainty. According to FactSet, S&P 500 earnings fell -0.23% in the first quarter and are expected to fall -2.45% in the second quarter. To be fair, those numbers are compared to results that were pumped up by tax cuts last year, but still the market continues to make new highs in the face of drastically reduced earnings expectations. Altogether, it seems clear the US is firmly in a late-cycle expansion, while near-term recession risks remain low. Nevertheless, the risks on the horizon provide a wide dispersion of possible outcomes and uncertainty remains significant.

The market may be pricing in up to three rate cuts this year, but two seems a reasonable estimate. With that in mind the currently inverted yield curve may not be as dire a signal as it has been in the past. The market is already pricing in rate cuts on the short end and central bank purchases across the globe have placed unusual pressure on mid and long-term US Rates.

Looking Ahead

It is hard to argue we are in anything but the late stages of a record economic expansion. With a historically long bull market, an inverted yield curve, slowing global growth, and the threat of an expanding trade war, it's easy to make a case for increased recession risk. However, I just don't see it on the immediate horizon. Market sentiment can shift rapidly, as we saw in the fourth quarter of 2018, and to a lesser extent in May of this year. Moreover, trade tensions and other fears are sure to boil over and cause market contractions from time to time, but longer-term these disruptions should even out. I believe the risk of real fundamental disruptions to continued economic growth remain moderate. Notably, the cyclical sectors of the economy (autos, housing, business investment spending, and inventories) show no sign of overheating. Consumer and business debt levels remain healthy, and inflation remains surprisingly subdued.

US real GDP growth is expected to clock in at 2.5% in 2019 and 1.8% in 2020, a below average 2% growth rate seems like a reasonable expectation barring any significant disruption. While 2% puts us just below the expansion average of 2.3%, and below the long-term average of 2.7%, it continues the slow and steady nature of the ongoing expansion and provides some assurance that it can continue. As JP Morgan Chief Global Strategist, Dr. David Kelly puts it, "without a boom, it's hard to generate a bust."

On the Fridge

Corporate Bonds

Corporate bonds continued their strong year rising +4.5% in the second quarter and beating all other asset classes. That brings their year-to-date gains to 9.9% as interest rates have fallen dramatically.

Financials

The Financial sector rose 8% in the second, nearly two percent more than the next best sector. The sector was buoyed by strong balance sheets and strong interest income.

In the Dog House

Floating Rate Bonds

Floating rate bonds, as measured by the Bloomberg Barclays US Treasury Floating Rate Index, were the worst of the asset classes we track in the first quarter, rising 0.6% and just matching the return on cash (as measured by the Bloomberg Barclays US Treasury Bill 1-3mon Index).

Emerging Markets

Emerging markets rose just 0.7% in the second quarter, far less than US Equities (+4.3%) and Developed markets (+4.1%). That brings year-to-date gains to 10.8% a full 8% less than US equities.

Links and Articles

- **Trade, Fed, and Productivity**
  Capital Economics shares their view on what will effect GDP going forward.
- **Global Recession Risks Are Up**
  The New York Times argues recession risks are up and central banks aren't ready.
- **Trump's Trade War**
  The Atlantic illustrates the effects the trade war is already having on business.
- **The Case for Regulating Big Tech**
  The New Yorker outlines the growing case for regulating the biggest tech companies.

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Performance

Global equities returned 3.8% in the second quarter while bonds returned 3.3%. Corporate bonds actually outperformed US Equities in the quarter, rising 4.5% vs. 4.3% from US stocks. Year-to-date (YTD) through two quarters US stocks remain the top performers up 18.8%, with developed markets taking second place at 15.1%. Notably, emerging markets have underperformed rising only 0.7% in the quarter, and 10.8% YTD. Interestingly, Chinese stocks despite falling -5.5% in the second quarter, have outperformed the broader emerging markets index on the year.

	Benchmark Index	Q2 2019	YTD	LTM	3yr	5yr	10yr
Cash	**BBgBarc US Treasury Bill 1-3 Mon TR USD**	0.6%	1.2%	2.3%	1.2%	0.8%	0.5%
Fixed Income	**BBgBarc Global Aggregate TR USD**	3.3%	5.6%	5.9%	1.6%	1.2%	2.9%
Fixed Income Blend	BBgBarc Global Aggregate TR USD	3.3%	5.6%	5.9%	1.6%	1.2%	2.9%
Government	BBgBarc US Government TR USD	3.0%	5.2%	7.2%	1.4%	2.5%	3.0%
Inflation Protected	BBgBarc US Treasury US TIPS TR USD	2.9%	6.2%	4.8%	2.1%	1.8%	3.6%
Municipal	BBgBarc Municipal TR USD	2.1%	5.1%	6.7%	2.6%	3.6%	4.7%
Floating Rate	BBgBarc US Trsy Floating Rate TR USD	0.6%	1.2%	2.3%	1.5%	1.0%	0.0%
Corporate	BBgBarc US Corp Bond TR USD	4.5%	9.9%	10.7%	3.9%	4.1%	6.1%
High Yield	BBgBarc US Corporate High Yield TR USD	2.5%	9.9%	7.5%	7.5%	4.7%	9.2%
International Bond	BBgBarc Gbl Agg Ex USD TR USD	3.4%	5.0%	4.1%	1.0%	-0.1%	2.1%
Equity	**MSCI ACWI GR USD**	3.8%	16.6%	6.3%	12.2%	6.7%	10.7%
Equity Blend	MSCI ACWI GR USD	3.8%	16.6%	6.3%	12.2%	6.7%	10.7%
US Equity	MSCI USA GR USD	4.3%	18.8%	10.3%	14.2%	10.6%	14.7%
Developed Markets	MSCI World ex USA GR USD	4.1%	15.1%	1.8%	9.6%	2.6%	7.3%
Emerging/Frontier	MSCI EM GR USD	0.7%	10.8%	1.6%	11.1%	2.9%	6.2%
Alternatives	**Wilshire Liquid Alternative TR USD**	1.3%	4.6%	1.7%	2.2%	0.7%	2.3%
Alternatives Blend	Wilshire Liquid Alternative TR USD	1.3%	4.6%	1.7%	2.2%	0.7%	2.3%

	Q2 2019	6mo	1yr	3yr	5yr	10yr
Information Technology	6.1%	27.1%	14.3%	26.2%	18.5%	18.6%
Financials	8.0%	17.2%	6.3%	16.4%	10.6%	13.1%
Health Care	1.4%	8.1%	13.0%	10.8%	10.6%	15.5%
Consumer Discretionary	5.3%	21.8%	10.2%	16.8%	14.0%	19.7%
Consumer Staples	3.7%	16.2%	16.4%	4.8%	8.4%	12.8%
Industrials	3.6%	21.4%	10.4%	12.5%	9.3%	15.6%
Energy	-2.8%	13.1%	-13.3%	0.2%	-5.5%	5.0%
Utilities	3.5%	14.7%	19.0%	8.1%	10.0%	12.2%
Materials	6.3%	17.3%	3.2%	10.4%	5.4%	11.4%
Communication Services	4.5%	19.1%	13.7%	0.6%	5.3%	9.8%
Real Estate	2.5%	20.4%	16.8%	6.9%	9.7%	17.2%

Source: Morningstar; The 1,3,5, and 10 year performance is annualized.

Bonds performed well in the second quarter as rates fell dramatically throughout the quarter. The 10yr treasury yield fell 50bps throughout the quarter from 2.5% to 2%. The iShares iBoxx $ Investment Grade Corporate Bond ETF (LQD) rose 5.8% in the second quarter bringing its YTD gains to 11.92%. With a yield of just 3.28%, the majority of the return comes from falling rates as the ETF maintains an effective duration of 8.78yrs.

Financials were the top performing sector in the second quarter on the back of strong balance sheets and higher interest income. Energy was the worst performer and the only sector to finish in the red as it fell -2.8%. Oil prices sustained a -21% peak-to-trough drop during the quarter but ended down just -3.6%. Materials and tech took second and third place rising 6.3% and 6.1%, respectively. The Health Care sector continued it's disappointing 2019, rising just 1.4% for a year-to-date gain of just 8.1%, a full 5% less than the next best sector, Energy.

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Asset Class	Benchmark	Description
Cash	BBgBarc US Treasury Bill 1-3 Mon TR USD	Measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.
Fixed Income	BBgBarc Global Aggregate TR Hdg USD	The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers.
Government Bonds	BBgBarc US Government TR USD	The Bloomberg Barclays US Government Bond Index comprises the US Treasury and US Agency indices. The index includes US Dollar-denominated, fixed-rate, nominal US Treasuries and US agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).
Inflation Protected	BBgBarc US Treasury US TIPS TR USD	The Bloomberg Barclays US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.
Municipal	BBgBarc Municipal TR USD	The Bloomberg Barclays U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.
Floating Rate	BBgBarc US Trsy Floating Rate TR USD	The Bloomberg Barclays US Treasury Floating Rate Index measures the performance of floating rate bonds issued by the US Treasury.
Corporate Bonds	BBgBarc US Corp IG TR USD	The Bloomberg Barclays US Corporate Bond index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
High Yield Bonds	BBgBarc US Corporate High Yield TR USD	The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.
International Bonds	BBgBarc Gbl Agg Ex USD TR Hdg USD	The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers. This version excludes USD-denominated debt.
Equity	MSCI ACWI GR USD	The MSCI ACWI captures large and mid cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,477 constituents, the index covers approximately 85% of the global investable equity opportunity set.
US Equity	MSCI USA GR USD	Captures broad US equity coverage. The index includes 3,108 constituents across large, mid, small, and micro capitalizations, representing about 99% of the US equity universe.
Developed Market Equity	MSCI World ex USA GR USD	Captures large and mid cap representation across 22 of 23 Developed Market countries, excluding the United States. With 1,023 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Emerging Market Equity	MSCI EM GR USD	The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 829 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Alternatives	Wilshire Liquid Alternatives TR USD	Measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe, including the Wilshire Liquid Alternative Equity Hedge, Global Macro, Relative Value, Multi-Strategy, and Event Driven indices. This index is meant to provide a representative baseline for how the liquid alternative investment category performed as a whole. Constituents comprised of '40 Act mutual funds.
US Large Cap Equity	S&P 500	Widely regarded as the best gauge of large-cap US Equities. The S&P 500 is a market-weighted index that includes 500 leading companies and captures approximately 80% coverage of available market capitalization.