1919 INVESTMENT COUNSEL
Complexity to Clarity
100 YEARS

Investment Review & Outlook

Second Quarter 2019

July 15, 2019 | 5 minute read

Trade Tensions May Threaten the Longest US Expansion in History

The US economy marked 121 months of consecutive growth at the end of June, officially surpassing the 1991-2001 cycle to become the longest expansion on record. The Fed's pause in raising interest rates boosted the markets, but trade tensions and weaker global growth heighten the risk of future policy mistakes by central banks. Interest rates are low around the world, and the US economy has been resilient beyond expectations, but we are in the late stages of the economic cycle and global uncertainties may produce a cooling effect later in the year.

Highlights

- The S&P reached an all-time high of 2965 in late June and was up almost 4% in the quarter, after a volatile May when trade wars resurfaced.
- Prior to the G-20 meeting, the US froze $300 billion in new tariffs on China, yet anticipated Chinese demands may keep markets off balance until a trade deal is finalized.
- Markets are pricing in between one and three cuts in the Fed policy rate from the current 2.5% by the end of the year.
- Further quantitative easing is expected by central banks in the EU and Japan as Brexit is deferred and growth in major economies is slowing.
- Annualized US GDP growth is now forecast at 2.1% in 2019, and the 10-year expansion likely is in its late stages, given rising wages, a tight labor market and high corporate debt loads.
- Global growth appears to have stalled, with the IMF predicting 3.2% annualized GDP growth worldwide and weak 1.2% growth for the Eurozone.

Investment Implications

- Significant geopolitical disputes, including US trade negotiations with China and Mexico and political tensions in the Middle East, are likely to persist, increasing the risk of policy mistakes by central banks.
- Friction between the Fed and the administration over insulation from political pressures adds another layer of risk.
- Even with buoyant US equity markets, corporate earnings growth is slowing; current Q2 guidance suggests the possibility of two consecutive quarters of earnings decline for the first time since 2016.
- Bonds have outperformed stocks in the US, EU and Japan over the past 12 months, as investors favored safe haven vs. risk assets.
- Technology and Health Care stocks are at some risk, subject to ongoing policy debates connected to the election cycle.
- The yield curve has continued its inversion, with the 3-month Treasury bill paying a higher rate than the 10-year note; when an inversion persists, historically this has indicated that a recession is probable within 9 to 18 months.

Key Takeaways

- While the stock market is still strong, we will continue to monitor signs of slowing growth and geopolitical risks closely to assess their potential impact.
- As always, we emphasize investment management for the long term, guided by defined goals and investment policy, as we purposefully seek positive and sustainable outcomes for our clients.

Economic and Market Drivers

Tailwinds	Headwinds
Low but Positive Inflation Expectations	Trade Conflict Escalation & Expansion
Lower Interest Rates	Scarce Global Pricing Power
Improving US Consumer Confidence & Incomes	Slowing Profit Growth, Reliance on Buybacks
Low Expectations, Lack of Investor Euphoria	US Election Rhetoric & Uncertainty
Slower but Positive Revenue & Income Growth	US Business Optimism Waning
Fed Adopts Dovish Bias	Exogenous Shock Risk Higher

Economy

The US surpassed its longest expansion since World War II, a remarkable 121 consecutive months of growth. The Fed is insulating itself from political interference, while believing that the risk of inflation is minimal and that an openness to cut interest rates would help to sustain the expansion. Despite strong equity markets, mixed signals are present: corporate earnings growth is slowing, business sentiment is cautious and trade tensions are on the rise, so we expect the 10-year expansion to moderate later in the year.

The 10-Year US Expansion Is In the Late Stages: Corporate earnings growth is slowing, business sentiment is waning and the unmistakable impact of sustained trade uncertainty on asset prices indicate that the 10-year US expansion may cool down in the second half of the year. Annualized US GDP growth of 2.1% is a percentage point lower than last quarter's consensus. The Leading Economic Index was flat month-over-month in April and May, following three successive increases, pointing to a wait-and-see attitude for both businesses and consumers.

Source: St. Louis Federal Reserve Economic Data (FRED)

The Fed Maintains Its Independence: Fed Chair Jerome Powell affirmed in a June 25th speech that "The Fed is insulated from short-term political pressures," despite periodic messaging from the administration. The Fed is undergoing a broad public review of its policymaking strategies and tools, in an effort to consolidate its dual mandate—maximum employment and price stability—and to maintain its independence. The Fed's recent signaling of a willingness to cut rates was welcomed by the equity markets. Powell has noted that inflation is expected to return to "our symmetric 2 percent target," but more slowly than anticipated.

Growth Is Slowing Around the World: In April, the IMF lowered its annual forecast for global GDP from 3.5% to 3.2%, the third reduction in the past six months, predicting that 2019 would represent the weakest global growth since the 2009 contraction. Annualized GDP for China remains at 6.4%, though trade conflicts clearly may have an effect on the actual number, given a swing factor of up to $500 billion in trade at risk of higher US tariffs. A McKinsey & Co. survey of global executives reported the lowest level of confidence in global growth in 8 years, with a majority of leaders expecting economic conditions to worsen in their own country and globally by the end of the year.

Currency Risk Is High: The trade dispute between the US and China may affect equity markets, but there are also real risks for the currency markets. Based on past actions, China might devalue the yuan in response to increased US tariffs, which could have a ripple effect on other emerging market economies. Unusual pressure on the US dollar appeared in late June, when the President indicated several times that he would like a weaker dollar to help US exports, even asking the Fed "to make it happen." A strong dollar has been a linchpin of US economic and foreign policy for decades, but with the stakes so high on a US-China trade deal, the risk of Chinese currency manipulation is running higher than usual, which would complicate the ability to reach a deal.

Global Supply Chains Are Reacting to Trade Uncertainty: Trade is moving away from multilateral agreements and towards bilateral, or country-to-country, deals. The effects of this change are still to be proven, but early evidence suggests that companies have to plan for potential disruption in their supply chains and are likely to reduce production and inventories to manage pricing and market access risks. The Purchasing Managers Index (PMI), a leading indicator of business activity, dropped from 52.6 in April to 50.1 in June, reaching its lowest level since mid-2016. The PMI for Services reached a 3-month high in May, indicating that the US secular trend towards a service-based economy is a key driver of both market value and employment.

M&A Activity Is Strong: The first half of 2019 was the third strongest on record for corporate takeovers, at $1.1 trillion. Private equity firms have approximately $2.5 trillion in unspent cash, and with institutional investors such as pension and sovereign wealth funds behind them, PE represented 13% of all global acquisitions, the highest level since 2013. Most takeover activity is centered in the US, given the buoyant markets and low borrowing costs, and first half deals, which included acquisitions by AbbVie, Occidental Petroleum and United Technologies, are likely to continue throughout the year in anticipation of a more volatile 2020.

Consumer Indicators Are Mostly Positive: Consumer sentiment reached a 15-year high in May and held near that level throughout June, indicating both optimism about the future and a willingness to buy goods and services. Likewise, personal income advanced in April and May, providing additional support to the consumer. Despite the positive signs, retail sales were down 1.3% from March to May, so there are mixed signals on the horizon. Data suggest that higher-income households, with assets invested in the markets, are more aware of the potential economic slowdown and have curtailed some spending, while middle- and lower-income households remain active.

Housing Market Is Trending Positively: With mortgage rates at a two-year low, new home sales rose 1.1% in May. This is welcome news for a market that had slowed down in 2018, as interest rates climbed, but is now springing back to life under the umbrella of a pause by the Fed. The combination of low rates, slower growth in real estate prices and higher wages provides favorable conditions for continued growth in housing, especially if the Fed makes any rate cuts this year. Housing starts were up slightly in May and preliminary June data show continued positive momentum. A mitigating factor for housing is the US Home Affordability Report, which indicates that a home purchase is too expensive for average wage earners in over 75% of US real estate markets.

What We're Thinking

- Economies and markets are complex systems and movements can be gradual or sudden, defying the ability of experts to predict. The US political climate is unusually volatile today, and the effects of any US actions on an interdependent global ecosystem of trade are likely to be significant. In an election season, we should expect increased rhetoric and headline risk.
- Investor and consumer sentiment have been buoyed by the 10-year expansion, but signs of weaker growth ahead should not be ignored.

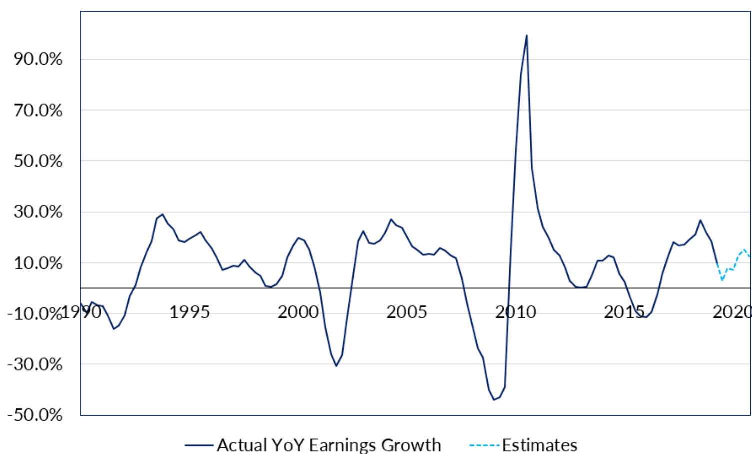
Equities

The US equity markets have been remarkable this year, with major growth spurts and only minor pauses. As the markets may cool later in the year, income becomes more valuable as we enter a period of high-stakes geopolitical events. We expect the equity markets to tilt towards all-weather stocks such as Utilities and Consumer Staples that provide reliable performance across economic climates and that pay dividends. Sectors with strong growth profiles, including Technology and Health Care, are subject to political pressures that might compromise their short-term performance.

Earnings Slowdown On the Horizon: Earnings in Q1 2019 were solid but lower than Q1 2018, when the tax cut provided a one-time boost to corporate performance. Estimated earnings for Q2 2019 will not be available until the end of July, but FactSet, a major financial data service, is projecting a 2.6% decline for the

quarter, based on 87 companies providing negative preannouncement guidance by the end of June, the highest level since 2006. Seven of 11 sectors have more negative EPS guidance than their five-year averages. The slowdown in earnings is the result of many factors, but high on the list would be reduced levels of reinvestment, a tightening in factory orders and rising labor costs. Share buybacks over the past five years have created the largest inflows into equities, and any slowdown would be a negative indicator.

Year over Year Operating Earnings Growth for S&P 500



Source: S&P Dow Jones Indices

Corporate Debt Remains a Latent Risk: Last quarter we identified the risks of bloated corporate balance sheets, with over $1 trillion in leveraged loans and a deregulated environment providing few guardrails. The risks of large-scale debt obligations in a late cycle expansion are more pronounced, as lenders and borrowers may actually increase their activity levels while underwriting policies are still lax. Much of the debt was put to use in share buybacks and dividends, in excess of free cash flow. With easy access to loans, companies that did not have strong balance sheets overindulged in taking on debt, and despite a positive impact on earnings and share prices, this trend has started to turn downwards. The risks of a day of reckoning are probably rising and serve to underscore the value of owning quality stocks and avoiding highly-leveraged, riskier assets.

A Pending Shift to Safe Haven Stocks Is Likely: All 11 stock sectors rose in the first half of 2019, led by Technology, Consumer Discretionary and Industrials. In the event of an economic slowdown, however, stock sectors including Energy, Utilities and Consumer Staples are historically likely to perform better, given their evergreen characteristics. Companies that are less dependent on global supply chains have an obvious advantage in a time of trade disputes, but some corporations with strong risk management capability can shift sourcing of raw materials and manufacturing to other markets. For companies tied to household spending, sales of technology and entertainment products and services may continue at reasonable levels in a slowdown, but travel, dining out, automobile or appliance purchases are likely to suffer.

Technology and Health Care Sectors Face Political Risks: Technology has done well until recently, but the assault on the FAANG (Facebook, Amazon, Apple, Netflix, Google) companies may put these strong performing stocks at some risk. Calls to break up some of the FAANGs have received support from both political parties, reflecting an ongoing public policy shift in the definition of a monopoly and the applicability of traditional antitrust tests. Policymakers are now looking at whether or not the raw concentration of economic power among the FAANGs inhibits competition, dampens innovation, compromises consumer privacy and even creates behavioral addictions to technology. In the Health Care sector, the election issue of private vs. public health insurance is unlikely to be settled until well beyond November 2020, so at a time when innovation in medical devices, diagnostics, informatics and genomics is pushing the boundaries of health care in exciting new ways, the lack of clarity over our national health insurance may compromise the ability of the sector to capture its true value.

The Rise of the Non-IPO: IPOs posted a strong Q2, raising $25 billion across 62 issues, including Uber, Pinterest, Zoom and Beyond Meat. Continued growth in IPOs is expected through the end of 2019, but an interesting new phenomenon is worth noting: the direct listing. In a direct listing, early private investors, including venture capital firms and institutions, can sell their shares immediately after the listing to any investor, bypassing the limited-access IPO process. The net effect of the direct listing is to push many more institutional investors into early-stage financing where company valuations are more speculative, but the ability to access early stage opportunities is greater. We will keep evaluating the direct listings market for the potential impact on financial services companies.

What We're Thinking

- The stock market reached the midpoint of 2019 with a remarkable show of strength, but corporate earnings growth is slowing and ongoing uncertainty about trade suggests that stocks could face headwinds in the second half of the year.
- We invest in businesses, not stocks. High quality companies that demonstrate sustained revenue, cash flow and EPS growth, as well as pay dividends, continue to be important components of a long-term strategy.

Fixed Income

Long-term rates are dropping as trade fears grow. The yield curve started to invert last December and may indicate a recession later in 2020, based on its 50-year record of predicting the magnitude and timing of economic downturns.

The Inverted Yield Curve: The "yield curve" indicates the difference between short- and long-term yields and represents a consensus on a more optimistic or pessimistic view of macro conditions. The yield curve has inverted several times recently, beginning in late 2018, but June saw a steady inversion, with the 3-month bill paying a higher rate than a 10-year note.

Every recession in the past 50 years has been foreshadowed by an inverted yield curve, indicating that the downturn (two consecutive quarters of declining GDP) is between 9 and 18 months away, but not all inversions have been followed by a recession. While many economists believe that the current inverted yield curve is a harbinger of recession in 2020, as it has been in the past, others are discounting the risk due to a more dovish Fed.

Treasuries Are a Proxy For Investor Sentiment: US Treasury securities are widely held by global investors and sovereign wealth funds, so their yields represent a large-scale proxy for investor sentiment. The yield on the 10-year note was 3.2% in November 2018 and has continued to decline since then, hovering around 2.0% in late June. The term premium, a measure of how much investors require to hold long-term bonds, is near record lows, reflecting the sentiment that low rates and low inflation are durable. Meanwhile, a decade after the financial crisis, the Fed is in the midst of a balance sheet normalization process, reducing the amount of Treasury and mortgage-backed securities it holds by $50 billion a month. The target for reducing the balance sheet was lowered in Q2 and the Fed stated that it is prepared to reinvest principal payments, and even reverse course and increase its holdings, if conditions warrant.

Investment-Grade Inflows Were Significant: Reflecting a large-scale rotation from stocks to bonds, investment grade corporate bonds have captured inflows of $45 billion since January. Returns on investment grade bonds were positive in the quarter. With issuance forecast to be lower for the balance of the year, and with continued demand for additional yield, the risk to investment grade bonds should remain relatively contained compared to other asset classes.

Municipal Bonds Continue their Strong Performance: Municipal bonds surged 5.1% in the first half of the year, as measured by the Bloomberg Barclays Municipal Bond Index. While the sharp drop in Treasury yields set the path for all fixed income, tax-free bonds benefitted from high demand, particularly within states most impacted by the tax reform act. Mutual funds that focus on municipal debt saw inflows for 25 straight weeks through the last week of June. While issuance picked up late in the quarter, there remains a shortfall of bonds to meet new demand, as well as for the reinvestment of maturity and call proceeds. We are concerned about the expensive nature of the municipal market, which is priced to perfection, since wages are rising despite the recent slowdown and the unemployment rate is near a 50-year low, although any rise in rates will likely be modest.

What We're Thinking

- Given the importance of income in a slowing economy, bonds can play an important role in portfolios and offer downside protection as well.
- Adding longer duration bonds can offer further protection if the economy slows more than expected.

Conclusions

- The US economy has proven resilient and the late cycle slowdown is likely to be gradual, absent any major geopolitical events.
- The Fed acknowledged "how important it is to sustain this expansion," while being "mindful of ongoing crosscurrents."
- Historically in an election season, the incumbent administration ultimately has acted to promote market stability and economic confidence.

Many investors get distracted by, and overreact to, headlines and short-term market moves. Our portfolio managers believe a continued commitment to goals-based planning and long-term objectives is the best way to navigate through uncertain markets.

As always, our focus is on protecting and growing your wealth, regardless of economic conditions or the business cycle. Each individual, family and institution has unique needs, aspirations and values, and our commitment is to create tailored investment solutions that will help you to realize all of your financial goals.

The views expressed are subject to change. Any data cited have been obtained from sources believed to be reliable. The accuracy and completeness of data cannot be guaranteed. Past performance is no guarantee of future results.