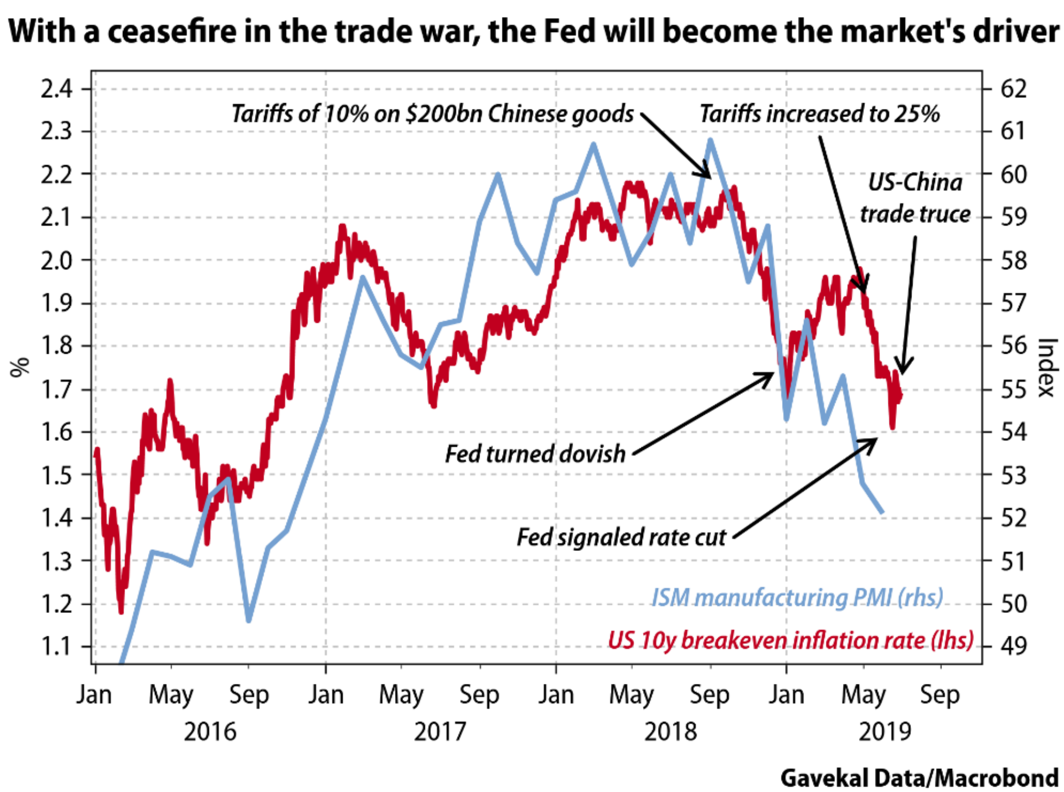
Q2 2019 MARKET COMMENTARY

The U.S. equity market proved its resiliency again in the second quarter of 2019. The S&P 500 should get a participation trophy for its best 1st half of the year since 1997, while the Dow Jones Industrial Average Index just enjoyed its best June since 1938 (yes 1938!)[1] The trade concerns of May quickly faded, and the market rallied as the Federal Reserve and the European Central Bank both indicated easier monetary policy may be upcoming. For the three-month period ending June 30th, the U.S. stock market rose over 4% and has now entirely recovered all of the fourth quarter 2018 drawdown.[1] The S&P 500 now sits near all-time highs (and as I write this has surpassed those all-time highs). And it wasn't just the stock market. U.S. bonds also posted extraordinary gains, confusing the interest rate normalization crowd (more to come on this). The U.S. 10-year note yields approximately 2% currently, down 0.50% in the last 6 months.[1] The total return of the Bloomberg Barclays Aggregate Bond Index exceeds a remarkable 6% for the year.[1] However, not all investors participated in this recent rally as virtually all other asset classes underperformed U.S. large cap stocks and U.S. fixed income. This recent rally has truly been highly focused between U.S. large cap stocks and fixed income. See below:

1 Year through June 26, 2019 *Source: Bloomberg*

Small caps and international stocks have meaningfully underperformed U.S. large caps over the past year. Small caps have been hurt by declining earnings expectations, and non-U.S. equity markets suffered from overall weakening economic growth and trade concerns. In these respective sectors, we maintain an active fund manager exposure, which has helped us outperform in these areas by a wide margin. Additionally, when one looks at sector performance, the picture is muddled further by conflicting data points: defensive sectors have led the market with utilities and real estate posting approximately 20% returns over the past twelve months which is well outside the median 10-year historical performance of both of those sectors.[1]

In the second quarter, the Federal Reserve, or "Fed", made it clear that it does not want to cut rates yet. This opinion clashes with President Trump, whose been pushing for the slashing of rates. Even though the Fed raised rates to a "2.25%-2.5% range" between 2015 and 2018, it's unlikely that the Fed will raise rates anytime soon under the current market conditions. The U.S. Federal Reserve's marked a dovish turn in response to diminished inflation expectations, has seen 10-year U.S. treasury yields fall back to 2%, and market expectations of a rate cut this month hit 100%.[1] The Fed has historically been and continues to be a driver of the current bull market, and the recent policy of cheaper rates and loans should aid banks and the overall market. The Fed will continue to keep an eye on inflation expectations, as they are falling short of their 2% target.



The rhetoric around the U.S.-China trade war has dominated the headlines for much of the last year. Throughout several merry-go-rounds of tariffs, and the scheduling, cancelling, and eventual rescheduling of negotiations, the United States and China have been in a staunch standoff for quite some time now. President Trump and President Xi officially met at the recent G20 Summit in Osaka, Japan, where a "truce" was agreed upon. There are four major elements to the truce: first, the U.S. delays tariffs on the $300 billion of goods, second, the U.S. allows some exports to Huawei, third, China agrees to buy some U.S. agricultural products, and fourth, there is no deadline linked to any of the first three items. It looks like there are limits on what can be sold to Huawei, but it is not clear what they are. We don't know how much U.S. agricultural products China will buy. With that said, even if there is a trade deal, do you think everything goes back to status quo? Do you think countries will base their strategies on the assumption that everything will be copacetic? Indeed, the events of the last several months have injected considerable uncertainty into how the world economy works, it's hard to imagine it going back to the old way. Consider Mexico, which agreed to Trump's NAFTA revamp, only to one day find itself threatened with fresh tariffs. The latter were never put in place, but the big picture is that trade agreements don't necessarily mean you are out of the woods just yet. While more tête-à-tête is possible, it is relieving to know that the two countries have resumed formal talks.

The U.S. bond market and interest rate sensitive investments have posted extremely strong returns over the past year, reflecting the low global rate environment, some weakening economic conditions and the likelihood of further monetary easing. In fact, the risk adjusted returns for fixed income have been exceptionally high relative to historical average returns.[1] A volatile second quarter also created record inflows for fixed income. With no U.S.-China deal, investors heightened their exposure to fixed income.[4] This caused a six-year high throughout May. The last time fixed income allocations were this high was in April 2013, at almost 20%.[4]

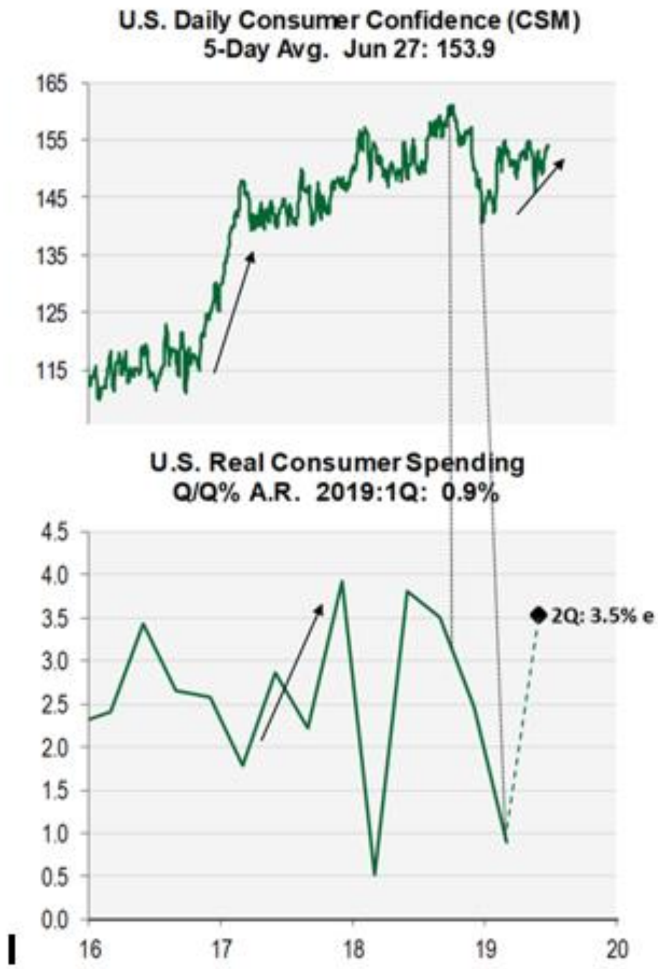
Secondly, bond market "signals," such as yield curve inversion, no longer convey the useful information about economic growth prospects as they used to. The bond market's signaling power has obviously been weakened since the global financial crisis by central bank intervention, but also by regulatory pressure on banks, pension funds, insurers and other liability-driven investors to hold bonds regardless of price or prudence. But a new important reason not to put too much emphasis on bond market signals has emerged since the Federal Reserve's dovish U-turn last December. Bond yields are now almost completely disconnected from economic prospects, because the Fed has decided that the linkages between inflation, unemployment and economic growth that used to be the main guides to monetary policy are no longer valid.

The Fed may or may not be right in believing that the links between inflation and output have broken down. All that matters for many bond investors is the near-certainty that the Fed will keep policy rates at extremely low levels between now and likely the end of 2020, and perhaps for much longer, regardless of how strongly the economy grows or how far unemployment declines. With bond market investment decisions almost completely determined by central bank behavior, which in turn is disconnected from economic growth prospects, it follows logically that bond yields no longer convey much useful information about economic growth.

On the flipside, you see many extremes in other parts of the global bond market. Today it is estimated that $13 trillion of developed market government bonds are currently at negative nominal yields, more than double from just six months ago.[1]

Municipal bonds have been on the rise recently. Municipal market performance has proven to be increasingly strong, as our current macroeconomic environment has aided these bonds. While geopolitical trade concerns have slowed the global growth of municipal bonds, their demand has reached an almost record-breaking high.[1]

As you can imagine, today's consumer plays an active role in today's market and economy. Following a harsh decline in the first quarter, consumer spending rallied in the second quarter.[5] While the pickup is not strong enough to be considered a trend, it has had positive effects, such as alleviating the headwinds of the tightening of consumer lending standards.[5] We're also currently giving the average consumer a clean bill of financial health: low interest payments, low debt, and a high savings rate.



"A Volatile but Healthy Consumer", Cornerstone Macro 7/1/19[5]

While the U.S. dollar exhibited strong growth in 2018, its growth in 2019 has been tumultuous at best. However, the second quarter has shown that the dollar is relatively on the up again, with a positive trend. The dollar hit a high on June 21st, during the public's expectation of a U.S.-China trade deal, demonstrating the country's reflective trust.[1] The U.S. dollar's strength over the last year or so has been largely attributed to expectations that the U.S. administration would impose additional tariffs on imports from China. With those expectations on hold following last week's agreement between Donald Trump and Xi Jinping to resume trade negotiations, and with several other forces weighing on the richly-valued U.S. currency, you might think the U.S. dollar should be falling.

So what direction should we expect the dollar to take over the rest of 2019? In the near term, investors should be wary of betting on U.S. dollar depreciation in anticipation of a new Fed rate cut cycle. While the Fed is likely to cut at the end of this month, U.S. growth is still healthy, and despite weak inflation expectations, U.S. inflation risk remains to the upside. As a result, a cut this month is likely to be "one and done," rather than the start of a whole new cycle. With no persistent narrowing of interest rate differentials on the cards, the U.S. dollar is therefore likely to track sideways within its current range until growth rates in the rest of the world begin to show a clear improvement relative to U.S. growth. That is unlikely to happen this year.

The summer sun signals the arrival of the second quarter earnings season. Out of the hundred plus companies that have issued their earnings so far, "77%...are showing negative earnings per share guidance."[6] In addition, more bearish economists predict that "the total earnings for the S&P 500 index will decline -2.9% from [Q2 2018]".[7] While these numbers may signal gloom and doom, we should remember the positive effect that the tax reform had on earnings last year. Expectations should be somewhat muted when comparing this year to last.

Following the continuation of U.S.-China trade negotiations, European shares came close to a 2-month high. With global confidence somewhat restored, European markets have shifted focus to another political rat race, the European Central Bank or "ECB" presidential election. With outgoing President Mario Draghi stepping down in October, the ECB will have a new captain at its helm- who could alter the course of the European markets. As I write this piece, there is word that Christine Lagarde, the current head of the International Monetary Fund, has been chosen to succeed Draghi.

The United Kingdom has also had a wild ride in the press recently. With Brexit and the lost momentum because of the current global slowdown, U.K. manufacturers claim to have had their "worst month in over six years", while consumer borrowing has increased at the "slowest pace since 2014".[8] London's housing market even took a hit, with prices dropping 1.2% year-on-year this past April.[9] Some economists attribute this to the ripple effect of the U.S-China trade war, especially considering there's been no deal on the table. With the current U.S.-China truce, the U.K. should benefit in the short-term, but future Brexit discussions will inevitably cause market turbulence.

As hopes grew through June for some form of trade détente between the U.S. and China, emerging market assets staged a broad rally. Between late May and the start of July, the MSCI Emerging Markets index rose 8%, propelled by portfolio inflows at a five-month high of US$40bn.[1] Similarly, emerging market currencies pushed broadly higher, on the back of a wider U.S. dollar softness. Yet, over the last week, since Donald Trump and Xi Jinping agreed to resume trade talks, emerging market equities and currencies have pulled back. Is this just a pause for breath, and can we reasonably expect the emerging market rally to continue on stronger hopes for a peace deal in the trade war? Or are there other forces at work that will weigh against the broad emerging market complex over the coming months? For emerging market assets, it is doubtful that two out of three key favorable conditions, a soft oil price and soft U.S. interest rates, will be enough to offset the resilience of the U.S. dollar. As a result, sustained or meaningful emerging market outperformance looks less likely through the second half of 2019.

Protests continue in Hong Kong, where demonstrators seeking the scalp of unpopular chief executive Carrie Lam invaded the legislature. Lam may go, many of the protesters may face long jail terms, and for the moment Hong Kong will carry on. The simmering conflict over Hong Kong's ability to retain judicial independence from the mainland will remain a long-run risk.

Commodities were a mixed bag this quarter. The energy sector suffered an overall loss, while oil rose to a high of "$66.60 per barrel" just to take a dive to "$50.60", and then recover just in time for the quarter end.[10] In the precious metals division, gold prices have continually increased, and although off its highs, gold saw its best month in three years in June.

All in all, there is no evidence in economic data or market behavior that a U.S. recession or serious weakening of the U.S. economy is in the cards this year. There is no reason to expect any such event in 2020, barring some huge exogenous shock such as a European political crisis or an oil price spike triggered by war in the Middle East. In other words, a black swan event. Sudden surprises in individual U.S. economic reports, such as the apparent slump in payrolls from 263,000 in April to just 75,000 in May (subsequently revised to 216,000 and 72,000, respectively) are nothing out of the ordinary, and should not cause much concern unless they are supported by substantial amounts of other data.[1]

Over the past two quarters, volatility and uncertainty have led many to fear for the market, specifically to fear its nuclear threat: the R word. Recession is a genuine concern, but there's no need to sound the alarm right now. The chances of a recession this year are highly unlikely, but it is possible the market could experience a correction. A correction is generally defined as a market decline that is more than 10%. Unbeknownst to most, the average intra-year decline over the last 39 years is 13.9%, with annual returns positive in 29 of 39 years.[1] To prepare for a market correction, it's a good idea to check that your portfolio can sustain a corrective environment, while being able to withstand price volatility and fulfill your goals over time. This is something we here at HighTower keep in mind as we invest client portfolios for the long-term.

As you know, we constantly preach portfolio diversification, because what worked today might not work tomorrow and vice a verse. Below you will see that no singular asset class offers the best return each year and it is hard not to notice that U.S. large cap equities and U.S. bonds are near the top rung of the ladder in almost every year out of the past ten.

Source: Capital Group

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The recent moderation in U.S. and Global growth appears to be the pause that refreshes. Lower interest rates (including corporate bond yields), more dovish Global central banks, the hook down in corporate bond spreads, the steady/slightly weaker dollar (all set against the backdrop of a relatively healthy U.S. economy), will likely help boost U.S. and Global growth expectations. The health of the U.S. economy is most clearly seen in the rebound of jobs, and the breadth of job growth. Yes, we know there's plenty of weak data, but as we outlined previously, we believe those data points are now old news. Then there's China, the debate continues on its growth trajectory, but Beijing policy has eased aggressively and they've clearly signaled there's more stimulus in the pipeline.

I read recently that people make a common error of overestimating the frequency of "inflection points" in whatever they're studying or predicting. For example, geopolitical forecasters are likely to overstate the odds of an imminent regime change or coup in any given country, despite those events being extremely rare. Part of the problem is that simply saying "the status quo will probably persist for the time being" comes off as boring and doesn't win you any headlines in the media. Anyway, I was thinking about this with respect to the market and the economy right now. The post-crisis era has been characterized by an exceptionally long, stable period of moderate growth and cool inflation. It's a cliché, but it's basically been a "goldilocks" environment for investors. Right now, we're in a period where people are starting to wonder if this is coming to an end. The fact that the Fed might ease policy is one reason they're anxious. The surge in negative-yielding sovereign debt is another. The trade war is also a huge wild card. And yet on the flipside, if you look at Friday's jobs report, with 224,000 jobs created and wage growth failing to accelerate, it certainly looks like the stable and cool economy remains. While there are all kinds of crosswinds and headline risk at the moment, people should be open to the idea that not much has changed from what we've seen virtually non-stop since 2009.

To discuss this commentary further, please contact us at 914-825-8630. Hightowerwestchester.com

1 *FactSet financial data and analytics. www.factset.com*

2 *Bloomberg*

3 *"The Focus Turns to the Fed" by Tan Kai Xian, Gavekal Research 7/1/19*

4 *https://www.etftrends.com/fixed-income-channel/3-top-performing-fixed-income-etps-in-the-second-quarter/*

5 *Lazar, Nancy. "A Volatile but Healthy Consumer." Cornerstone Macro, 1 Jul. 2019, https://research.cornerstonemacro.com/ResearchPortal/LatestResearch#. Accessed 1 Jul 2019.*

6 *https://seekingalpha.com/article/4273126-q2-earnings-season-kabuki-dance-rife-downward-guidance-bad-good-buy*

7 *https://finance.yahoo.com/news/handicapping-q2-2019-earnings-season-210209982.html*

8 *https://finance.yahoo.com/news/1-uk-economy-feels-strain-124103876.html*

9 *https://www.theguardian.com/business/live/2019/jun/19/uk-inflation-report-sterling-house-prices-markets-rate-cuts-business-live?page=with:block-5d09f5ff8f08532f138d47f3#block-5d09f5ff8f08532f138d47f3*

10 *https://seekingalpha.com/article/4272926-energy-q2-review-2019-outlook-q3-2019*