ADVISER
INVESTMENTS

# Adviser Outlook

THIRD QUARTER 2019

**QUICK TAKES**

- ✔ U.S. stock markets climbed a wall of worries (U.S.-China trade, Iran, Brexit, Mueller report, recession fears) in Q2 to reach record highs in early July
- ✔ We are now in the longest U.S. economic expansion on record—signs point to continued slow growth, not recession
- ✔ Our focus remains on balancing near-term market risks with diversified investments and financial planning to meet our clients' long-term goals

With apologies to the unknown philosopher, "May we invest in interesting times." While the stock market is signaling continued bullishness about corporate earnings, the tale told by the bond market is the exact opposite—one of worry about economic prospects both here and abroad.

The current bull market is now one of the longest—though far from the strongest—in history. The U.S. economic expansion, which began in mid-2009, is now the longest on record, with few signs of an end in sight.

We believe the second half of this year will present a more challenging investment landscape than we've seen in the recent past, but also that there remain opportunities for gains both here and abroad.

The news over the past few months has besieged us with reasons to feel queasy about the prospects for our economy, the future for stocks, the state of global affairs and even the state of our country. The litany of concerns is lengthy and includes tariff actions and trade-war rhetoric, escalating tensions with Iran, Brexit uncertainties, continuing battles with President Trump's White House in the courts and the Congress, and the clamor raised by a 2020 presidential election cycle in full spin.

Granted, at the end of June, we got a bit of a reprieve from some of the headline stressors. On the trade and tariff front, the U.S. and China are negotiating again and won't impose new tariffs while doing so, levies on Mexican goods are on hold for now and the tariff standoff with Canada is at a standstill. All good, but we expect trade issues to be a live wire.

Flared tensions between the U.S. and Iran have settled into a war of words, but this is an impermanent state of affairs. The outcome of the British exit from the European Union, which faces a change in leadership due to Prime Minister Theresa May's resignation and a hard October 31 Brexit deadline, is in question.

For all the fearful headlines though, the fundamentals of earnings, interest rates and the health of the U.S. consumer tell us there is room for the economy to continue to run and space for investment gains.

Corporate earnings growth may slow or even contract from year-ago numbers (dubbed an "earnings recession"), which isn't a surprise now that the tailwinds from the 2017 tax cuts have subsided. Indications are that profits for S&P 500 companies

**QUARTER REVIEW**

- ✔ Stock markets around the world continued their advance during the quarter, though the pace of gains slowed from earlier in the year
- ✔ U.S. stocks outpaced foreign developed and emerging markets stocks
- ✔ All but one sector of the U.S. stock market earned a positive return in Q2: Energy stocks declined 4.0%; financials' 7.6% return made it the top performer
- ✔ The U.S. bond market added to its first-quarter gains and has now returned 6.1% year-to-date through June 30

will dip slightly in the coming quarters compared to 2018 numbers. That said, sales are expected to continue growing thanks to the U.S. consumer.

With the job market strong, consumers are not only well-employed, but also confident and benefiting from growing wages—albeit slowly growing wages. Household balance sheets are strong; the ratio of debt to income is near historical lows. This bodes well for moderately greater spending as we head into the back-to-school and then holiday shopping seasons.

As the year began, market-watchers expected the Federal Reserve to raise the benchmark fed funds rate at least twice in 2019. Yet in the face of slowing global growth and uncertainty about international trade (which has impacted business confidence and spending), the Fed—even in the wake of June's stronger-than-expected jobs report and other positive indicators—has left its rate-hiking ways and may trim the benchmark later this month.

Now that the scene is set, let's take a look at the quarter just passed.

## Second Quarter Review

The market's first quarter sprint tripped up in May, when the S&P 500 fell 6.4% before finding its feet again in June (it rebounded 7.0%) to finish the quarter with a 4.3% gain. The MSCI U.S. Broad Market index (which includes small- and mid-cap stocks) and the Dow Jones Industrial Average gained 4.0% and 3.2% in Q2, respectively. Year-to-date, the three indexes have returned between 15.4% (the Dow) and 18.7% (MSCI U.S. Broad Market). The S&P 500's 18.5% gain makes it the best first half of a year for that index since 1997.

For the year-to-date, every sector of the U.S. market has produced a positive return, ranging from health care's 9.8% gain (questions about further reform and drug pricing have given traders some pause) to the technology sector's 27.2% rise.

## FINANCIAL PLANNING FOCUS

### Building Your Budget

REACHING LONG-TERM FINANCIAL GOALS isn't only about investing; it requires saving too—and you can't do either without spending less than you bring home. A budget is simply a tool that helps you understand your spending while staying cash-flow positive.

**You may find a budget helpful if:**

- You often have less money in your accounts than anticipated
- You use credit cards or other forms of debt to finance expenses
- Your income and expenses vary greatly month to month
- You want to save for a big purchase

**A FEW STEPS CAN HELP ANYONE GET STARTED WITH BUDGETING:**

1. **PAY YOURSELF FIRST**—automatically send a portion of your paycheck to savings and investing accounts before it hits your checking or spending account.
2. **PAY OFF CREDIT CARDS** in full every month, and if you can't, prioritize paying off accounts with higher interest rates first.
3. **USE A PROGRAM** like Quicken or Mint to track your spending automatically.

Try tracking your spending over one or two months to get a good understanding of where your money is going. With that knowledge, it's easy to create a more complete financial plan. If you need help, our team can lend a hand. Just call us.

**OUR OUTLOOK**

- ✔ Consumer strength, low inflation and interest rates, and lower-but-still-positive corporate earnings create selective investment opportunities
- ✔ Uncertainties over trade policy, foreign relations and the administration's legal troubles could mean higher volatility in Q3
- ✔ The shape of the yield curve and the duration of the economic expansion are not strong recession indicators
- ✔ We continue to seek risk-aware means of diversifying and growing our clients' wealth and are attentive to the potential need for greater safeguards

Developed foreign markets nearly kept pace with their U.S. counterparts—the MSCI EAFE returned 3.7% over the three months through June and is up 14.0% through the first six months of 2019. Its 1.1% return over the last 12 months lags the S&P 500's 10.4% gain over the same period, however.

Emerging market stocks remain the laggards, with a meager 0.6% return in the second quarter and a respectable 10.6% return year-to-date. Slowing growth in China, concerns over its impact on other countries and worries over continuing tariff fights were a greater drag for the emerging markets in Q2 than for other markets.

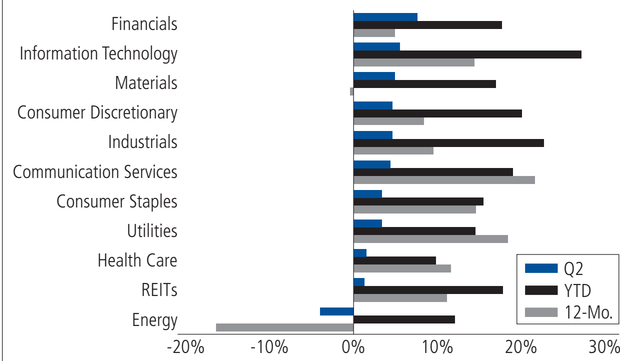
With yield-curve inversions and Fed policy often in the news, the broad U.S. bond market gained 3.1% in the second quarter. The U.S. bond market is up 6.1% this year and has nearly matched the returns of the stock market over the last 12 months with a 7.9% gain. Meanwhile, the 10-year U.S. Treasury's yield fell to 2.00% at the end of June, down from 2.41% at the end of Q1 and 2.69% at the end of 2018.

We view high-quality bonds as a valuable buffer to stock market risks as well as useful portfolio components for income-oriented investors. But at today's yields, bonds should not be viewed as wealth creators.

**Stocks & Bonds Climbed in Q2**

| | Q2 | YTD | 12-MO. |
|---|---|---|---|
| S&P 500 | 4.3% | 18.5% | 10.4% |
| MSCI U.S. Broad Market | 4.0% | 18.7% | 8.9% |
| MSCI EAFE | 3.7% | 14.0% | 1.1% |
| Dow Jones Industrial Average | 3.2% | 15.4% | 12.2% |
| Bloomberg Barclays U.S. Agg. Bond Idx. | 3.1% | 6.1% | 7.9% |
| MSCI Emerging Markets | 0.6% | 10.6% | 1.2% |

Note: Ranked by Q2 returns. Performance numbers are total returns, reflecting reinvested dividends through 6/30/19. Source: Morningstar.

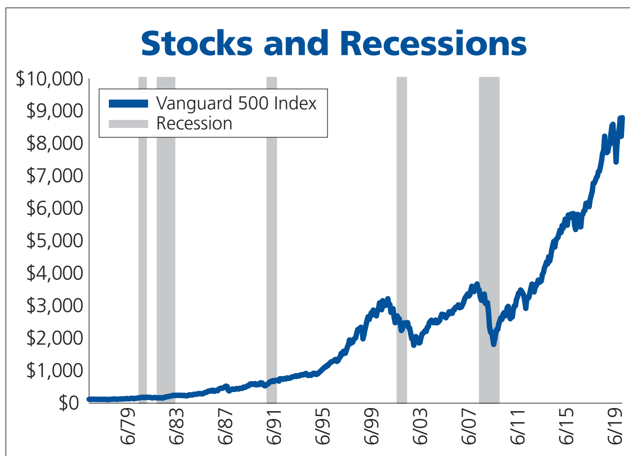



Source: Morningstar.

## Our Outlook

In the second half of the year, we would not be surprised to see the U.S. economy slow a bit from its current 3.1% pace and are expecting day-to-day market volatility to increase. Despite pundits' predictions for a recession here and now, we do not think that one is imminent. Why? Inflation has yet to heat up, the job market remains robust, interest rates are low and businesses are still generating profits.

To some, the yield-curve inversion indicates a coming recession, but we have our doubts when applying the theory to current events. First, the sample size upon which conclusions are being drawn is small. In addition, only part of the yield curve is kinked out of its ordinary shape (3-month Treasury bills yield more than 10-year Treasurys but 1- and 2-year bonds don't). The last five times a yield-curve inversion occurred, the lag between that move and the start of a recession averaged 13 months. To be convinced that the current bond market is predicting recession, we'd expect to see the 3-month and 2-year Treasury out-yielding the 10-year bond for an extended period of time, something that has yet to happen.




Note: Chart shows growth of $100 invested in Vanguard 500 Index at its 8/31/76 inception through 6/30/19 using total returns. Sources: Morningstar, National Bureau of Economic Research.

That said, the shape of the curve reflects a fundamental difference of opinion between bond and stock market investors. As mentioned above, the bond market is signaling caution. The stock market isn't buying it (or, you might say *is* buying it—stock prices continue to rise). Higher bond prices (and lower yields) at the longer end of the curve indicate that demand (particularly from overseas) has soared or that investors have lost some confidence in the economy, or both. Meanwhile, higher short-term yields show the Fed to be more optimistic, although that may be changing now that policymakers are mulling a cut.

We also don't lend much credence to the argument that the length of this expansion and bull market is a problem. Since the end of June 2009, the U.S. economy has grown about 25% (after inflation) from $15 trillion to $19 trillion in size. That translates into a 2.3% real growth rate—the slowest pace of the last 10 economic expansions. Recessions often begin as an overheating economy and inflation fears lead policymakers to lift interest rates to curb rapid growth. None of those conditions exist today.

When recessions have occurred, they've been a temporary setback for the stock market, as you can see in the chart to the left.

Looking ahead, all the known challenges to investor confidence that we opened this letter with are likely to linger. Sensational headlines are nothing new. But neither is our disciplined approach to managing uncertain times and volatile markets.

We can't predict the timing of the next recession or correction in stock prices. We can say with conviction that a recession and bear market are closer now than they were three months ago. But those who have sold on such concerns have already missed out on sizable gains and are likely to miss out on more long-term opportunities. As always, we are here to take your calls and answer your emails if you have any questions about our outlook or your portfolio.

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Listen to a replay of our *Third-Quarter Update: Tariffs, Trump and Trade* at AdviserInvestments.com/webinar

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