Investment Update
Second Quarter 2019

By the end of June, the S&P 500 had a respectable return for the quarter and was up over 18% for 2019. That is the best start to a year since 1997, which sounds great, but should be considered in the context of the similarly sized selloff last year that ended on Christmas Eve. The second quarter was not particularly volatile as measured by the number of days with price moves greater than 1%, a metric we cite from time to time. However, there were distinct moves up or down by 5% or more that roughly corresponded with each of the three months.

Equity Markets (Total Return)	2Q19	1-Year
Dow Jones Industrials	3.2%	12.2%
S&P 500	4.3%	10.4%
S&P Mid-Cap	3.0%	1.4%
S&P Small-Cap	1.9%	-4.9%
MSCI All-Country World	3.8%	6.3%
MSCI Foreign Developed Markets	3.7%	1.1%
MSCI Foreign Emerging Markets	0.7%	1.6%
US Bond Markets	**2Q19**	**1-Year**
Barclays US Govt/Credit Intermediate	2.6%	6.9%
Barclays US Govt/Credit Long	6.6%	13.8%
BAML Municipal Intermediate	1.7%	5.6%

In April, the S&P 500 built upon its strong first quarter with another 5% increase in price, leaving the large cap index already up over 18% for the year. There was a continued sense that political expediency would bring the trade conflict with China to resolution in a timely fashion even if the news flow was often to the contrary, and investors were optimistic after seeing better than expected first quarter earnings growth (albeit basically flat year-over-year).

A complete reversal of the prior month's gains for stock prices followed in May, with the S&P 500 dropping more than 6%. Early in the month it became clear that trade negotiations had stalled and the US was heading towards instituting the next round of tariffs on China. On top of this there were more signs of slowing economic growth overseas and a few US economic indicators showed signs of peaking. The yield for the 10-year Treasury echoed stock's growth concerns, falling throughout the month roughly from 2.5% to 2.2%, while shorter-term Treasuries continued to yield around 2.5%.

June saw yet another about face in the stock market, with the S&P 500 running up 7%, again more than making up for the previous month's move in the opposite direction. Fed Chair Powell seemed to indicate that he and his colleagues were mindful of the mounting growth concerns and prepared to reduce rates. Fed Funds futures markets started to price in a high likelihood of a 50bp cut in July and the possibility of several more later in the year. While the stock market was embracing a positive spin on what otherwise would be unfavorable economic news, the 10-year yield dropped all the way to under 2%, and shorter-term yields finally followed lower in anticipation of rate cuts.

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With near all-time low bond yields in the US now forecasting a low growth, low inflation outlook for the next ten years, what should we make of the seemingly conflicting signal being sent by stocks being back at all-time highs above those reached late last summer when the 10-year yielded about 3.25%? Is one market right and the other wrong? Can they both be right, or at least is it possible one is not spectacularly wrong?

There certainly are enough reasons to be concerned about future growth for bond yields to be lower than they were a year ago, but they are also being pulled further down by falling yields around the globe where an astonishing $13 trillion of bonds trade with a negative yield. If lending money to Germany involves paying them for the privilege, it does make lending to the United States, even at only 2%, an attractive relative value to a global investor.

In short, this incremental demand likely results in an overstatement of bond investors' collective negativity about future growth. Looking at stocks, there are also some nuances that would suggest the fact that the S&P 500 is at all-time highs also overstates stock investors' collective positivity. All things being equal, lower bond yields should push up stock valuations, as they increase the present value of companies' future cash flows, yet stocks are actually cheaper than or in-line with the valuation levels for most of the last five years, suggesting that there is not necessarily any newfound exuberance driving prices up. Many defensive stocks are performing well alongside growth stocks, also belying a cautious stance on the part of investors, and small company stocks, which are more sensitive to the domestic economy, are still more than 10% off their all-time highs. Finally, US stocks are generally benefiting from the fact that there now are few other asset classes or regions where investors can hope to achieve any sort of elevated long-term return targets.

Valuation levels aside, stock prices have been underpinned by earnings that have slowed in 2019 but still have not contracted. We remain mindful of the fact that several economic indicators related to employment, manufacturing, and the all-important consumer sector have recently showed signs of topping off, reflecting an economy that appears to have at least lost much of its forward momentum. All the trade uncertainty could cause a sudden retrenchment in corporate hiring and investment plans and although it was only briefly on the table, the President's threat to place tariffs on Mexican goods in June was nerve-jarring and concerning in the sense that tariffs are increasingly being weaponized to achieve non-economic ends. The Fed is cognizant of the risks posed by potential trade wars, but it will be hard for them (and us) to weigh this variable, given that it could rather quickly reverse itself. Markets have cheered the Fed's willingness to act, but it is unclear if the increases in rates they have implemented in recent years are even the primary culprit in the first place for any weakness the U.S. economy is experiencing. Thus reducing them, the primary tool it has to stimulate the economy right now, may not help.

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