HIGHTOWER

RDM FINANCIAL GROUP

RDM Market Update

July 11, 2019

Key Takeaways

- Equity and fixed income markets are off to a solid start in 2019.
- The U.S consumer appears to be on solid footing, but we are seeing some weakness in manufacturing, trade and corporate profits.
- The Federal Reserve Bank has changed course and now appears likely to reduce rates somewhat as soon as the July, 2019 Fed meeting.
- We continue to believe the odds of recession remain a low probability over the next few quarters.
- We would not be surprised to see somewhat higher volatility during the second half of 2019 until we have greater clarity on issues like trade, the global economy, Fed policy and corporate profit growth.

INTRODUCTION

In the equity markets, the first half of this year has largely been defined by three trends. From the end of last year through the end of April, equity markets rallied and made up ground that was lost during the fourth quarter sell-off last year. In May, equity markets took a step back following President Trump's tweet that he might raise tariff rates on Chinese imports. Then following more dovish talk by the Federal Reserve Bank, equity markets advanced once again during the month of June. The current expansion just entered its 121st month, making it the longest expansion in modern American history. Looking ahead, (according to the data source Factset), U.S. GDP is currently forecast to increase 2.5% this year and 1.9% in 2020 (compared with growth of 2.9% in 2018).

Based on return data from S&P, the S&P Composite 1500 Index (which consists of the S&P 500, the S&P Mid Cap 400 and the Small Cap 600 indices) gained 17.2% during the first half of 2019. What's more, all 11 sectors of the market registered increases. This year's impressive first half rise in the S&P 500 ranked in the top 10 (#8) of all first half gains since 1950. Overseas, equity markets also advanced this year but failed to keep pace with returns in the U.S. Compared with the United States, the MSCI All Country World Index ex. USA which includes both developed and emerging markets outside the U.S. has advanced 14.0% year-to-date (still a respectable performance). So far this year large capitalization stocks have outperformed small capitalization stocks and growth stocks have once again outperformed value stocks.

For much of the current bull market (dating back to March, 2009), a majority of equity market gains have been driven by business fundamentals i.e. an increase in corporate profits. However, during the first half of 2019, rising valuation levels (as opposed to an increase in corporate profits) has been responsible for 92% of the advance in stock prices (source: Goldman Sachs – US Macroscope, July 1, 2019). With the forward P/E (price to earnings ratio) for the S&P 500 currently at close to 17x, we will need to see a pickup in earnings to help generate additional gains in stock prices over the next few quarters.

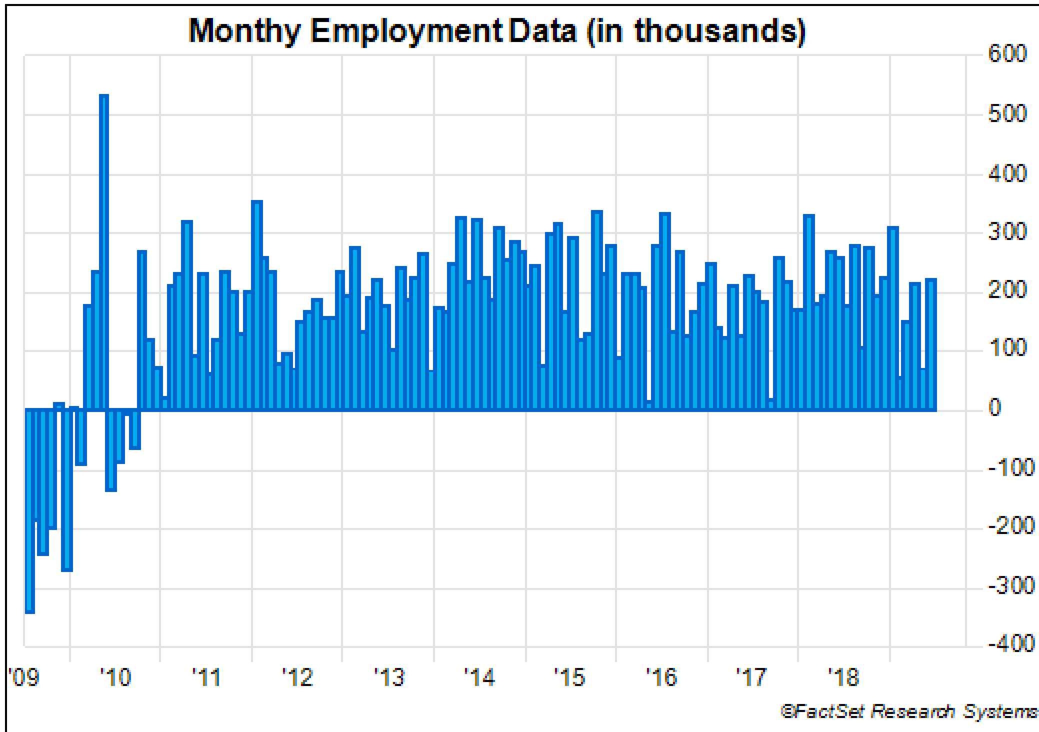
In the first quarter of this year, GDP grew by 2.9%. Due to a boost from inventories and exports (ahead of a possible further rise in tariffs), we believe 2.9% growth may represent the high-water mark for the year. Weakness in the economy that we have

started to see has been linked to three factors: trade, housing and manufacturing. A downturn in economic growth overseas has also played a role. The bright spot in the U.S. remains on the services side of the economy. Last month, employment rebounded and posted a solid increase following weakness in May, the unemployment rate currently stands at 50-year lows and wages continue to grow at a moderate rate. Despite some pockets of weakness, the U.S. economy still appears to be on relatively solid footing (although we acknowledge that the situation may change the longer trade talks with China remain unresolved).

Following an escalation in trade talks between the U.S. and China this past May, equity markets pulled back somewhat as investors started to price in a more worrisome market outlook. Fast forward just a few weeks and the S&P 500 (along with other major indices) climbed back and established new all- time highs this past week. Lower interest rates, expectations of rate cuts by the Federal Reserve Bank and a temporary truce between the United States and China all helped propel equities higher in recent weeks. We still believe that the risk of recession remains a low probability event in 2019. However, due to continued uncertainty on a number of fronts (i.e. weakness in manufacturing, trade concerns, a slowdown in corporate profits and weak growth overseas) it would not be surprising to see some additional market volatility during the second half of this year as investors contemplate the outlook for the economy and financial markets over the next few quarters.

The U.S. Consumer

Throughout the now 10-year old economic expansion, the U.S. consumer has continued to provide a solid backdrop for economic growth (see chart below – source: FactSet). The latest jobs report was better than expected and showed an increase of 224,000 new jobs versus estimates of an increase of 160,000. Job growth in June rebounded after just 75,000 jobs were created the prior month. The three-month average of job growth currently stands at 171,000 which is a healthy number but does represent a modest slowdown from average monthly job growth of 223,000 per month in 2018. As the economic expansion continues and gets more mature, it’s reasonable to expect that the rate of job growth will likely slow over time.



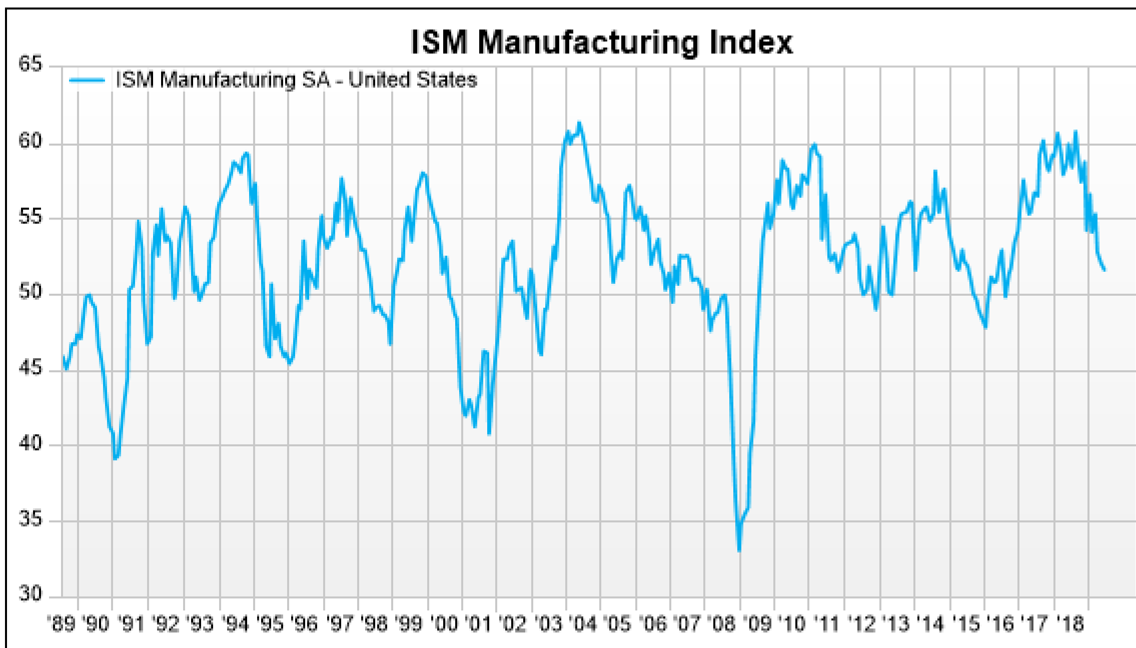
Within last month's employment report, job gains were widespread with increases in business services, manufacturing and healthcare. Overall 60.7% of all companies added jobs last month which is a healthy reading. Looking at other parts of the report, wages increased 3.1% on a year over year basis, the average work week remained unchanged at 34.4 hours and the unemployment rate rose slightly from 3.6% to 3.7% (due to the fact additional workers entered the workforce last month). One negative is that the retail sector lost jobs for the 5th consecutive month (down 15,000 last month).

Another statistic we like to look at is the JOLTS report (i.e. Job Openings and Labor Turnover - source: BLS) which comes out every month. This provided a somewhat different way of looking at the labor markets compared with the employment data cited above. The latest data was released last week and indicates that there have been 18 straight months during which the nation has had more job openings than unemployed persons. According to the latest report, there are 7.3 million job openings in the country with just under 6 million unemployed persons. This could be the result of a number of different factors, for example a mismatch between employee skills and

employer needs. However, the data points to the fact that labor markets continue to remain healthy for now.

MANUFACTURING ACTIVITY

One area where we have started to see a slowdown in recent months is on the manufacturing side of the economy. Weakness overseas combined with signs that corporate CEO's and CFO's may be starting to pull back somewhat on business spending is starting to show up in economic data. For example, in the chart of the ISM Manufacturing Index below (source: FactSet), you can see that the index has recently pulled back from a high of around 60 last year to a recent low of just over 50. As a reminder, a reaching above 50 indicates expansion while a reading below 50 signals contraction.



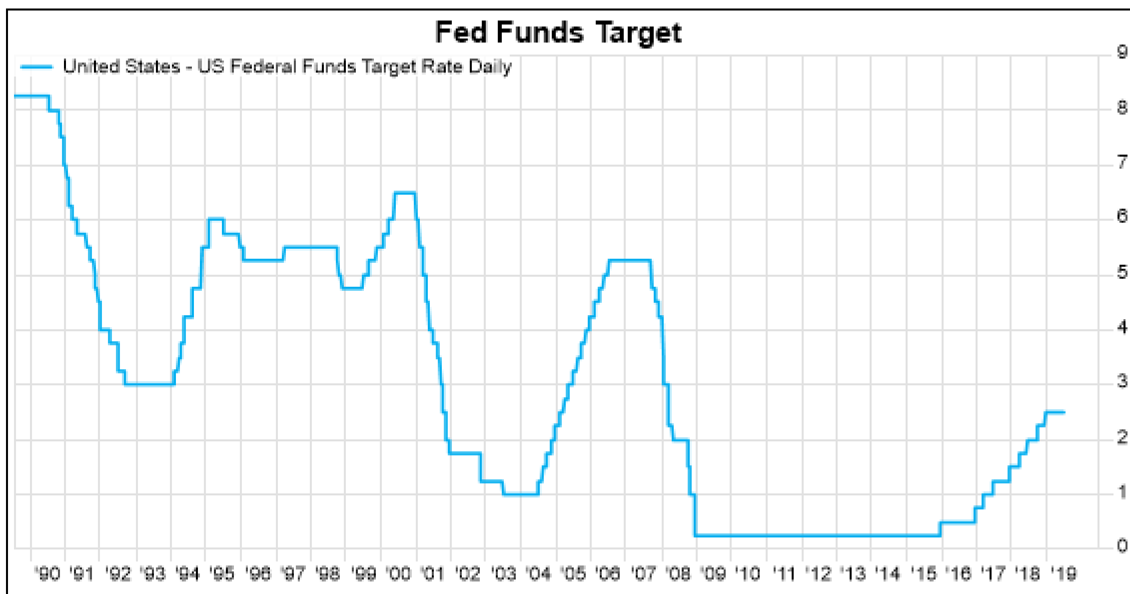
Within the most recent quarterly GDP report, non-residential fixed investment rose at a rate of 3.0%. This is similar to the level of 3.1% in the prior quarter but less than half the growth rate of 7.1% that the economy averaged during the first half of 2018.

President Trump's 2017 tax cuts were meant to simulate business spending and boost productivity in the economy. At least so far, the jury is still out on this.

FED POLICY

One of the big stories in financial markets this year has been the change in policy from the central bank this year. Last December the Federal Reserve Bank raised short-term rates by a quarter point to a range of 2.25% - 2.50% (where rates stand today). Historically the central bank has what is called a dual mandate. Its goal is to create full employment while maintaining stable inflation. Recently, inflation data has largely missed the Fed's 2% target, manufacturing data has started to weaken, growth overseas remains below trend and trade issues between the U.S. and China remain unresolved. Thus, the central bank has now signaled that it stands ready to cut rates in order to maintain the current economic expansion.

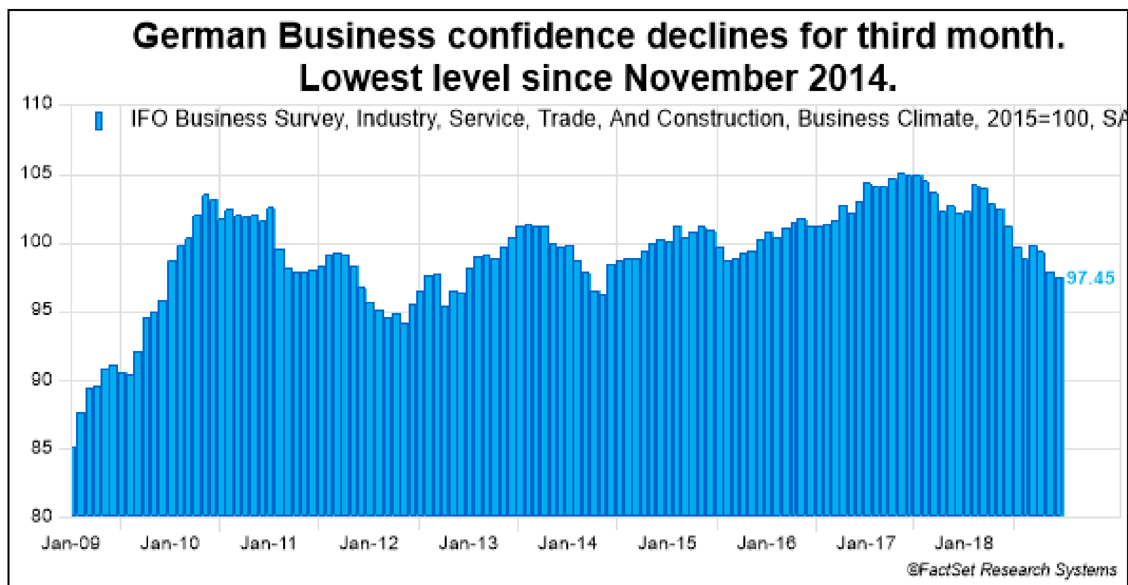
In the chart below (source: FactSet), you can see the level of short-term rates set by the Federal Reserve Bank dating back to 1990. Optimists hope that the period ahead will resemble that of the mid 1990's, when the Fed cut rates a few times, the economy picked up momentum again and equity markets moved higher.



The next meeting of the Federal Reserve Bank takes place at the end of July followed by three additional meetings throughout the rest of 2019. President Trump has publicly stated (on multiple occasions) that the central bank should reduce rates to help spur the economy. The central bank is supposed to be immune to political pressure but appears increasingly likely to cut rates somewhat over the next 2-4 meetings in order to do its part to keep the economic expansion on track.

OVERSEAS

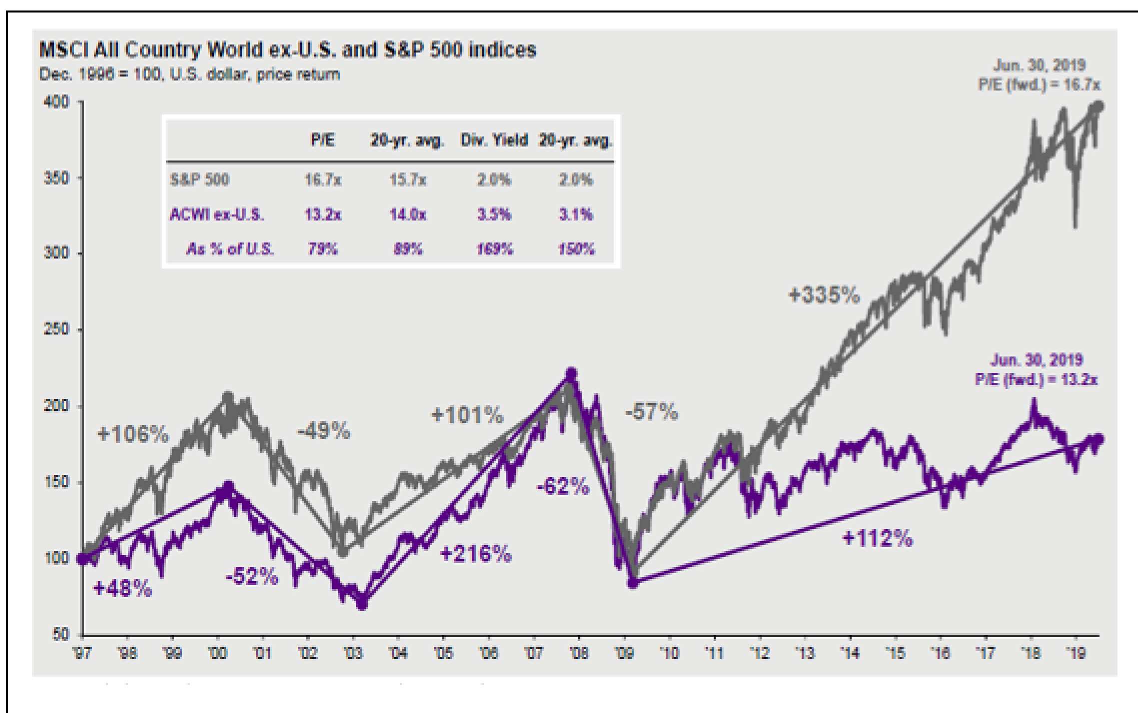
While the U.S. economy continues to grow at a moderate rate, growth in many parts of the world remains fairly weak. The current level of the Markit Manufacturing Index (equivalent to the ISM Manufacturing Index in the U.S.) is currently below 50 in China, Japan and Europe (source: FactSet). In South Korea, for example, which is a country with an export-oriented economy, exports have fallen at year over year rates of minus 13.5%, minus 9.5% and minus 2.1% in each of the past three months. In Germany, which is the largest economy in Europe, economic data has also been quite weak in recent months. This can be seen in the chart below (source: FactSet) which tracks the level of business confidence over time.



The biggest concern for the global economy remains ending the ongoing trade dispute between the United States and China. If the two sides can somehow resolve their differences (which we believe is the most likely outcome over time), this should provide a boost for consumer and business confidence as well as the global economy. Until then, there is probably only so much that central banks overseas can really do to help generate additional growth. Instead, more of the stimulus will likely have to come from fiscal (i.e. government) policy measures.

U.S. versus Overseas Positioning

For much of the past several years, we have had either minimal or modest exposure to overseas markets in our investment portfolios. During this time, U.S. markets have significantly outperformed overseas. You can see this in the chart below (source: JP Morgan Asset Management). For reference the gray line is the S&P 500 (U.S. markets) while the purple line is the MSCI ACWI ex. USA (global markets excluding the U.S.).



	P/E	20-yr. avg.	Div. Yield	20-yr. avg.
S&P 500	16.7x	15.7x	2.0%	2.0%
ACWI ex-U.S.	13.2x	14.0x	3.5%	3.1%
As % of U.S.	*79%*	*89%*	*169%*	*150%*

We recognize that these trends change over time. That's the nature of investing. Foreign markets currently have lower valuation levels and more attractive dividend yields. In addition, central banks overseas are providing more accommodative monetary policy. However, due to the fact the U.S. continues to generate more attractive (and consistent) growth, we remain overweight the U.S. in our investment portfolios for now but also have a small amount of foreign exposure to remain diversified.

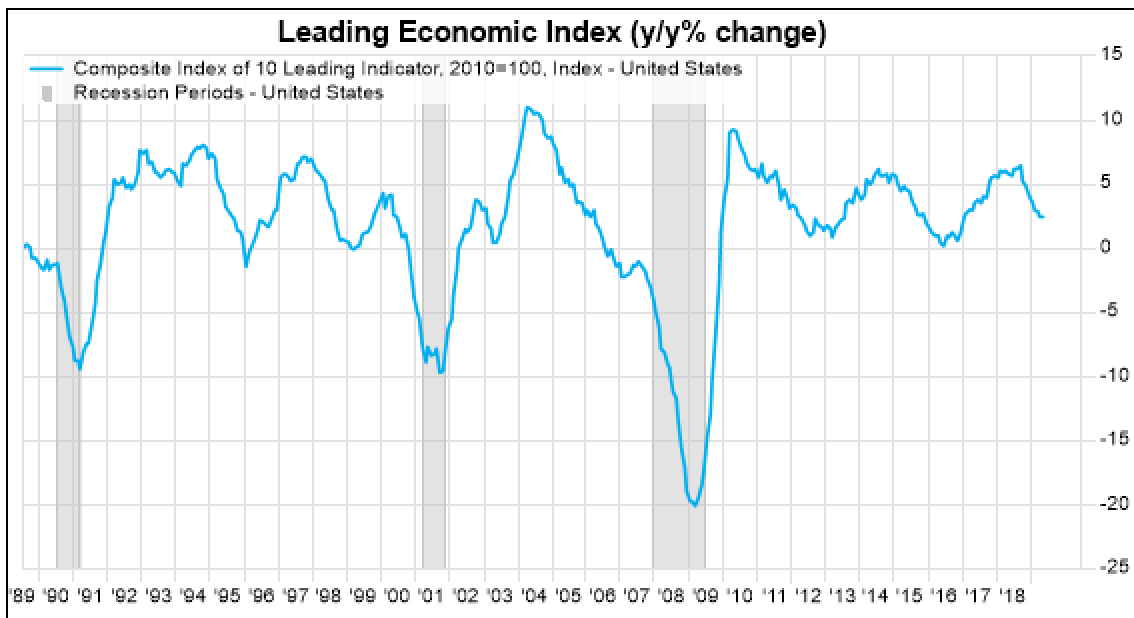
LEADING INDICATORS

Every quarter we keep an eye on a number of economic indicators to help forecast the direction of the economy over the next few quarters. For reference, some of these indicators include:

- Weekly jobless claims (to measure the health of the job market)
- Corporate bond spreads (to help gauge financial market conditions)
- Consumer Confidence (to provide a reading on the state of the U.S. consumer)
- The Federal Reserve Bank's Quarterly Loan Survey (to help measure bank lending conditions)
- Manufacturing New Orders (to provide insight into the outlook for the manufacturing sector)
- Housing Starts (which have historically helped forecast changes in the overall economy)
- The yield curve (another signal that helps forecast the outlook for the economy)

While these indicators are currently not booming, the majority continue to point to a period of moderate growth in the period ahead. The one exception is the yield curve. While the yield difference between 2-year U.S. Treasury notes and 10-year U.S. Treasury Bonds remains positive (i.e. above 0%), the yield difference between shorter maturity 3-month U.S. Treasury Bills and 10-year U.S. Treasury Notes is currently negative (i.e. below 0%). This is a concern, but we also have to keep an eye on other indicators as well.

Lastly, we also monitor the Monthly Leading Economic Index or LEI (see chart below – source: FactSet). This index tends to forecast the direction of the economy looking ahead over the next 2-4 quarters. When the economy is performing well, the LEI is generally rising and above 0%. When there is a downturn in the economy, the index has fallen below (although we have to keep in mind there have been a few false signals along the way). In recent months the growth rate of the LEI has slowed but for now it remains in positive territory signally slow to moderate growth ahead.



THE OUTLOOK FOR EARNINGS

In coming days, second quarter earnings will start to be released and we will get a better picture of what the outlook for corporate earnings looks like (as well as what to expect during the second half of the year). As of the latest week, the forecast was for second quarter earnings to decline 2.6% versus an estimated increase of 0.5% as of 12/31/18 (source: FactSet). For the remaining two quarters of this year, corporate profits are currently forecast to decline 0.5% in Q3, 2019 followed by an increase of

6.3% in Q4, 2019. Looking ahead, investors will soon start to focus their attention on the outlook for 2020 earnings.

According to the data provider FactSet, corporate profits are currently forecast to rise 10.9% in 2020 (versus estimates of an increase of 15% as of 12/31/18). For next year all 11 sectors of the S&P 500 are currently forecast to generate positive EPS growth with six sectors forecast to generate double digit growth). The three strongest sectors next year are projected to be energy, industrials and technology (cyclical sectors) while the three weakest sectors are forecast to be utilities, real estate and consumer staples (defensive sectors). Given recent trends in the economy, and the uncertain outlook on trade with China, we believe that the outlook for corporate profits in 2020 is probably too high. However, much can change between now and the end of this year.

Market Internals

Market internals are a mixed picture right now. On the positive side, the Dow Jones Industrial Average, Nasdaq and S&P 500 all recently hit new all-time highs. Looking under the hood, the cumulative advance decline line for the S&P 500 (which keeps a running tally that tracks the level of advancing versus declining stocks over time) continues to hit all-time highs. This is a positive sign because at least historically, the market's advance / decline line has peaked and started to weaken before the stock market turns lower. Looking at major indices, the S&P 500, Nasdaq Composite, Dow Jones Industrial Averages, Russell 2000 Small Cap as well as the Dow Jones Transportation Index are currently all above both their 50 and 200 day moving averages. Even the MSCI EAFE Index and the MSCI Emerging Markets Indices are also currently above both their 50 and 200 day moving averages.

On the other hand, we have noticed a few recent negative divergences in the market. While the Russell 2000 small cap index and the Dow Jones Transportation indices are both participating in the market's advance, these two widely watched parts of the market have at least so far failed to reach all-time highs in recent months. For reference, the Russell 2000 Small Cap Index and the Dow Jones Transportation Index

are currently 10.3% and 10.2% off their 52-week highs. These trends can always change, but the longer they persist, the more concern they are likely to cause.

FIXED INCOME MARKETS

Since peaking at around 3.25% earlier this year, the yield on the U.S. 10 Year Treasury Bond recently fell below 2.0% (Note: it currently stands at 2.06%). The main reasons for the decline in yields include falling inflation data, an inversion of the yield curve (between 3-month treasury bills and 10 year notes), weak economic data overseas and indications that the U.S. central bank may reduce short term rates as soon as the next Fed meeting at the end of July.

One thing that sets this period apart from prior economic cycles is that around the world, we now have approximately $13 trillion in government securities with negative interest rates - see chart below (source: Strategas Research). Intuitively, this is something that is hard to understand. In Austria, the government just issued 100-year bonds at just 1.2%!

With the interest rate on German 10-year Bonds at minus 0.34% and Japanese 10-year bonds at minus .15%, the yield on U.S. 10-year Treasury Bonds at around 2.0% looks pretty attractive on a relative basis. Since global financial markets are interconnected, low rates on overseas fixed income investments have helped drag down yields on U.S. fixed income securities. As long as the amount of overseas fixed income securities with negative yields continues to grow, that will likely continue to put downward pressure on U.S. rates as well.

As we have highlighted previously, with a majority of your fixed income assets (in larger portfolios), we have been laddering corporate bond portfolios from approximately 3 – 8 years. This takes the guess work out of trying to accurately forecast and time what happens to fixed income yields over time (something very few investors can do on a consistent basis). The current lower interest rate environment does present challenges for new money that needs to be invested. We don't intend to change our long-term fixed income investment strategy. However, we may make some small changes around the edges of your fixed income portfolio in the days ahead.

SUMMARY

At 121 months and counting, the U.S. expansion is now the longest in the post WWII period. Global equity and fixed income markets are off to a solid start so far in 2019. This comes after a market decline during the fourth quarter of last year. The U.S. is outperforming most overseas markets so far in 2019 which is a trend that has been in place for much of the past several years. Equity markets have improved this year despite global trade concerns between the U.S. and China, weak growth across a number of countries overseas and a slowdown in corporate profits. Despite these headwinds, which have contributed to somewhat uneven global growth, the world economy continues to grow.

At this point, it is unclear whether the current period is 1) a replay (or at least a version) of the mid 1990's when growth slowed temporarily before picking up again or 2) the start of a more pronounced economic downturn. There have been a number of headwinds and speed bumps throughout the now 10-year old economic

expansion. Each time we experienced one of these speed bumps, investors questioned if the end of the economic cycle was just around the corner. Growth has been below trend throughout most of the current expansion. As a result, the U.S. economy has not built up the kind of excesses that have marked prior market peaks. Our base case for now is that we are working our way through yet another temporary growth slowdown.

If the U.S. and China can settle their differences before too long (we recognize that the jury is still out on this topic), this should provide a boost for consumer and business confidence and ultimately set the stage for a pickup in global growth. Looking ahead towards the second half of the year, until there is greater clarity on trade, Fed policy, earnings and overseas economic growth, financial markets may experience some additional volatility. For investors, having the appropriate asset allocation helps ride out the inevitable ups and downs that come with investing and helps keep you on course towards achieving your long-term investment goals.

As always, we welcome any comments you may have.

Respectfully,

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Managing Director & Partner

Data Source: FactSet

Disclaimer:

S&P 500 Index: A popular benchmark for US large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.
MSCI Emerging Market Index: The MSCI Emerging Markets Index captures large and mid-cap representation across 23 emerging markets countries. With 834 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

RDM Financial Group

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