HIGHTOWER
RDM FINANCIAL GROUP

MARKET UPDATE
AUGUST 9, 2019

KEY TAKEAWAYS

- President Trump initiates new tariffs on China.
- The U.S. Central Bank does its part and cuts rates.
- The U.S. consumer remains on track. Business spending…not as strong.
- Corporate profits have slowed but a rebound is forecast next year.
- Growth concerns have impacted U.S. interest rates.

Following a positive July, global equity markets have turned lower in early August. We wanted to take this opportunity to share our thoughts on a few of the issues currently affecting global financial markets. Last week, the Fed cut rates by 25 basis points (one quarter percent) and announced that they made a "mid cycle adjustment." Following the Fed's rate cut, the President raised tariffs by 10% on an additional $300 billion in goods. President Trump's actions caught the market by surprise and raised the stakes in an ongoing tariff fight with China. Ultimately, we believe that China and the United States will come to an agreement because it is in the best interest of both parties. However, at least for now, the two sides appear to be moving further apart.

Heading into August, the S&P 500 had just established a new all-time high (on July 26, 2019) and investor sentiment based on the equity put/call ratio was somewhat extended. Keep in mind that even after the market's recent 6.3% pullback off its all-time high of 3,025, most U.S.

indices have still posted double-digit gains for the year. Two exceptions are the Russell 2000 Small Capitalization and Dow Jones Transportation Indices which are both positive on a year-to-date basis but not up as much as the large cap S&P 500 Index. Foreign markets, where we remain underweight, are up a more modest amount year-to-date as of this writing.

Stock volatility has been relatively subdued so far this year. Looking back since 1990, the S&P 500 has declined an average 14% from peak to trough in an average year (source: Bloomberg). Even in years when equity market returns were positive, the S&P 500 still declined an average of 11% intra-year. Thus, it's common for markets to experience some volatility each year. That's the nature of equity market investing. Due to increased trade friction with China, weak economic growth overseas and now the potential for currency trade wars, we would not be surprised to see some additional market volatility during the second half of the year.

One interesting development is that due to the recent decline in interest rates, the yield on the S&P 500 (2.1%) is now higher than the yield on U.S. 10-Year Treasury Yields (1.75%). According to research from SunTrust Bank, more than 50% of stocks in the S&P 500 now have dividend yields greater than the yields on the S&P 500 versus an average of 17% dating back to 1990. The yield on the S&P 500 has been above the yield on U.S. 10-year Treasury Bonds four times over the past decade and six months later, the S&P 500 was higher each time by an average of 12.15% (note: positive returns ranged from +2.66% to +25.88% - source: Wells Fargo Research). A lower interest rate environment, like the current one, may provide a tailwind for dividend-oriented stocks in the market as investors continue to search for income. Ultimately, business fundamentals like sales, corporate profits and inflation will help determine the direction of stock prices down the road.

Yes, we have some concerns. Global growth continues to slow, the ISM Manufacturing and ISM Services indices here at home are currently at multi-year lows (although both are still above the 50-level, indicating growth), business spending has softened, the yield spread between 10 year U.S. Treasury Notes and 3-month U.S. Treasury bills has turned negative, and outside the U.S. there is approximately $14 trillion in mostly government securities that currently have negative yields. When the next downturn comes, we are concerned that global central banks may not have enough ammunition needed to help boost global economic growth.

While business activity has slowed somewhat in recent months, the U.S. consumer remains in a healthy position which should continue to help support moderate economic growth in the quarters ahead. Looking at corporate profits, EPS for the S&P 500 has slowed significantly this year compared with 2018 but is currently forecast to rise 4.5% in the fourth quarter of this year and increase by double digits in 2020 (note: we would not be surprised to see profit estimates revised lower as we get closer to next year). Weekly jobless claims this week came in at 209,000 representing the 7th lowest reading since 1970. In addition, Fed policy has changed direction. We came into 2019 expecting multiple rate increases by the central bank and we are now likely to have multiple rate cuts.

In our opinion, equity markets are likely to continue climbing a wall of worry which is something they have done throughout the now record 10-year plus economic expansion. At present, we believe that the odds of a U.S. recession in 2019 remain a low probability. Until trade issues are resolved, we expected market volatility may remain somewhat elevated. Having the appropriate asset allocation helps you ride out the inevitable ups and downs that come with investing. On days when equity markets turn more volatile, the fixed income side of your portfolio is meant to provide steady cash flow and help mute volatility somewhat.

We have identified five market-related topics that we would like to briefly discuss.

(1) Trade – trade tensions between the U.S. and China continue to have the largest impact on financial markets so far this year. In the latest development, President Trump announced an additional 10% tariff on $300 billion in Chinese exports that were not previously taxed. This caught the market by surprise (again) as it appeared the two sides were once again ready to re-engage in trade talks.

Following the latest round of U.S. tariffs, China allowed their currency (the Chinese Yuan) to depreciate this week and it fell through the 7.0 level against the dollar for the first time since 2008. Depreciation in the Yuan may benefit China over the short-term because their exports will become more competitive overseas. However, there are also potential negatives. A weaker Chinese currency may lead to 1) capital flight out of the country and 2) difficulty servicing the country's growing U.S. dollar-based debt load. President Trump has recently stated that he wanted to see a stronger and not a weaker Yuan versus the U.S. dollar. The prospect of trade wars turning into currency wars has helped contribute to the market's rise in volatility this week.

(2) The Federal Reserve Bank – last month the central bank cut short term rates for the first time in more than a decade (as widely expected). Chairman Powell has acknowledged that cutting short term rates by a quarter point will probably not help companies decide to build a new plant, or higher additional workers. Instead, the goal of the Fed is to 1) take out an insurance policy to help offset the impact from President Trump's trade policy and 2) help reverse the negative yield curve where 10-year U.S. Treasury yields now trade below the yield on U.S. 3-month Treasury Bills.

The Fed can't directly control the yield on 10-Year Treasury Bonds but it can change the rate on short term treasury bills. Therefore, if trade tensions continue to rise, we believe that additional rate cuts appear likely over the next several Fed meetings. For reference, according to the CME website (which tracks institutional traders who speculate on the direction of short-term rates), there is currently a 100% likelihood that the Fed cuts rates by a quarter point at its next meeting and a 94% chance of two quarter point rates cuts before the end of this year.

(3) Consumer and Business Spending – second quarter GDP was released recently and came in at a level of 2.1% versus estimates of 1.8% - source: FactSet. On a positive note, consumer spending (which represents about two thirds of the overall economy) posted a healthy increase and grew 4.3% last quarter versus a three-year average of 2.7% - source: FactSet. With the unemployment rate at multi-decade lows, weekly jobless claims close to the lowest in 50 years, wages growing at a solid 3.2% rate, and consumer confidence near cycle highs (for now), the U.S. consumer appears to be on pretty healthy footing heading into the second half of the year. This should help support further growth in the services side of the economy which currently represents about two thirds of the U.S. economy.

On the other side of the coin, non-residential fixed investment (i.e. business investment) fell 0.6% last quarter compared with a three -year average growth rate of 4.8% - source: FactSet. Despite lower tax rates and less regulation, trade war concerns have started to have an impact on CEO confidence levels and the rate of business spending. If this were to continue, it could ultimately lead to a slowdown in hiring, a weaker consumer and a more widespread slowdown in the overall economy.

(4) Corporate Profits – with 77% of U.S. companies having reported second quarter results, EPS for the S&P 500 are currently forecast to decline 1.0% last quarter. For reference, this compares with estimates of a decline of -2.7% as of June 30, 2019 (i.e. companies have generally been beating estimates when they reported their results). Looking at the second half of 2019, analysts currently forecast a small decline of 2.2% in EPS this quarter followed by mid-single digit growth of 4.5% in the fourth quarter.

Looking ahead to 2020, analysts currently forecast earnings growth of 10.7% and revenue growth of 6.5%. In 2020, all 11 sectors of the market are currently forecast to post positive EPS growth and six out of 11 sectors are currently forecast to generate double digit growth (note: the source of all EPS data comes from FactSet).

These are certainly encouraging numbers. However, due to the trade war with China combined with weak economic growth overseas, we believe EPS estimates for next year are too high and likely to come down somewhat in the months ahead. Even if EPS growth estimates for next year were to be cut in half, that would still represent improvement, compared with 2019. Within our diversified equity portfolios, we will continue to look for pockets of opportunity where we uncover multi-year growth opportunities that we want to take advantage of.

(5) Fixed Income – fixed income yields have come down considerably over the past few weeks due to investors concerns about the outlook for trade and weak economic growth overseas. For reference, the U.S. Treasury 10-Year Bond Yield peaked at 3.23% last November as the Federal Reserve Bank threatened to keep raising short term rates. Largely as a result of President Trump's tariffs against China in 2019, the Federal Reserve Bank abruptly changed course and shifted into easing mode this year. Combined with investor concerns about the trade war, weak economic growth overseas and approximately $15 trillion in government bond securities around the world with negative yields (source Bloomberg), U.S. Treasury Bond yields have declined sharply in recent weeks with the 10 briefly fallings below 1.70% earlier this week.

Based on extreme fund flows into fixed income ETF investments like TLT (the iShares 20+ Year Treasury Bond ETF), for example, the recent move in fixed income yields looks somewhat extended. However, bond yields may fall further over the intermediate term due to the prospect of weaker growth, the ongoing trade dispute and expectations of further Federal Reserve Bank easing. For RDM clients that have fixed income exposure within their investment portfolios (note: this represents most RDM clients), the decline in bond yields has represented a tailwind for corporate bond returns recently and has helped cushion client portfolios somewhat during periods of higher equity market volatility.

With rates on German 10-year Bunds now around minus 60 basis points (yes you read that correctly), it is difficult to project where U.S. bond yields will go over the near term. Overall long periods of time (5-10 year periods), U.S. Treasury yields have tended to track the year-over-year growth rate of nominal GDP (which currently stands at 4.2% - source: www.bea.gov). However, due to weak economic growth overseas, the ongoing trade conflict with China and the fact that the Fed is now cutting rates, U.S. interest rates appear unlikely to rise significantly over the near term.

SUMMARY

In summary, while volatility in financial markets may persist in coming months, we believe there are also reasons to remain somewhat constructive. The U.S. consumer remains in a pretty healthy position, corporate profits are forecast to rebound in 2020 after weak results this year, and interest rates and inflation remain low. After raising rates from late 2015 through the end of 2018, the Fed is now reducing rates as it focuses on soft economic growth overseas, trade uncertainty between the U.S. and China and weak inflation data here at home.

Since the first tariffs were announced back in March 2018, the S&P 500 has advanced more than 40% compared with a decline of 5% for the MSCI World Index (excluding the USA). Part of this performance was the result of President Trump's tax cuts that helped fuel stronger growth in 2018. Ultimately, we need China and the United States to come to the table and strike a deal on trade. We remain hopeful that the two sides will eventually come to an agreement, but the timing at this point remains somewhat uncertain.

As always, we welcome any comments you may have.

Respectfully,

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S&P 500 – The S&P 500 Index includes 500 leading U.S. companies and represents approximately 80% of the available U.S. market capitalization

Russell 2000 Index – The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984.

Dow Jones Transportation Index - The Dow Jones Transportation Average is a U.S. stock market index from S&P Dow Jones Indices of the transportation sector, and is the most widely recognized gauge of the American transportation sector.

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