MARKET UPDATE

JUNE 7, 2019

If the year ended a couple weeks ago, we all would have agreed it was a good year, especially after U.S. equity markets hit historic all-time highs this past May. We have stated before that having an investment plan and sticking to it is a prudent approach to investing for the long term. We understand that at times, this can be a difficult strategy to follow.

The last quarter of 2018 through the current period have helped underscore that having the appropriate asset allocation (between equities and fixed income) can provide benefits during times of market volatility. While the equity side of your portfolio experienced some ups and downs in recent months, the fixed income side of your portfolio has provided stability, consistent cash flow and has helped mute portfolio volatility during this time. This is how your investment portfolio was meant to perform.

OVERVIEW

Overall, economic growth in the U.S. has been pretty steady, but a slowdown in the industrial sector and trade issues have started to raise concerns. On the positive side the U.S. consumer appears to be on pretty healthy footing, the services side of the economy continues expand and both interest rates and inflation remain subdued. However, we have started to see some weakness on manufacturing activity and business spending in recent months.

Following 3.1% GDP growth last quarter (fueled partly by a boost from inventories), U.S. growth appears likely to slow down somewhat over the next few quarters. Based on a wide range of economic indicators, we continue to believe that the odds of recession remain fairly low this year. However, rising tariffs between the U.S. and China (as well as the U.S. and Mexico) have created

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greater uncertainty as we head into the summer months.

This week Fed Chairman Powell stated that the central bank stands ready to take appropriate action (i.e. they are moving closer to potentially cutting rates) to help support the economy if necessary. Based on the Eurodollar Futures market (where traders can speculate on the direction of short-term rates), the market is now pricing in 2-3 rates cuts in coming quarters. We think the odds of rate cuts by the central bank have increased and there is the possibility the first one could come as soon as the July meeting later this summer. At RDM Financial, we will continue to monitor changes in the economy and financial markets and may make adjustments to our portfolios when appropriate.

Pullbacks and Corrections

As a reminder, it's important to point out that pullbacks and corrections are a normal part of the investing process, even in bull markets. In an average year, the S & P 500 may experience 3 or so pullbacks (declines of 1-5%) and one or so corrections (declines of 10-19%). We believe it's important to stay the course and not panic when these events occur (which is why we have diversified portfolios for most of our clients). For reference, since 1980 the S & P 500 has generated an average return of 9.7% per year while also experiencing an average intra-year decline of 15.1% along the way (source: JP Morgan Asset Management). During this time period, there have been 8 full year declines with some fairly modest and others much more significant.

Tariffs and Trade

In our last market update a few weeks ago, we wrote that an extended global trade war was not our base case. It appeared to us that it was in the best interest of both countries to try and find common ground and come to an agreement. Today the U.S. - China relationship remains strained. As we head towards the late June G20 meeting in Japan where Presidents Trump and Xi are expected to meet, we still believe there is an opportunity for both sides to work towards some kind of mutual agreement (or at least start moving in that direction).

This past week President Trump also initiated tariffs against Mexico as well (note: European auto tariffs are still on the radar). For reference, U.S. imports from Mexico were about $350 billion in

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2018 versus imports of about $530 from China. If China and the U.S. (as well as Mexico and the U.S.) cannot move closer to trade agreements, we will likely enter a period of greater economic and market uncertainty (and more subdued growth) at least for a period of time.

According to the research firm Strategas, for every two months that there is no trade agreement, U.S. GDP may be reduced by approximately 0.2% (or .5 to .6% in an annual basis). Thus, 2019 U.S. GDP may be closer to 2.1% and growth in 2020 could fall below 2%. Note, these numbers were calculated before President Trump initiated 5% tariffs on Mexico. For reference, according to economists polled by the data research firm Factset, U.S. GDP is current forecast to come in at 2.4% this year and 1.9% in 2020.

THE FED

The U.S. Federal Reserve Bank is not sure how to react yet to rising trade tensions since unemployment remains at 50-year lows, wages are rising at a 3.2% year over year rate and financial markets remain pretty close to all-time highs. If the central bank cuts rates and overstimulates the economy, this could ultimately lead to some unintended consequences. However, due to tariffs against China, Mexico and possibly Europe, we now face the prospect of slower growth and more uncertainty. Therefore, traders are currently pricing in the possibility that the U.S. central bank may cut rates once or possibly twice by the end of this year.

Fed Vice-Chairman Clarida noted last week that the Federal Reserve Bank needs to be "nimble," as they deal with a changing economic landscape, rising tariffs and low inflation. In a presentation on June 4th, Fed Chairman Powell stated that the central bank will take appropriate action to help the economy if it is needed. To us, this means the central bank is moving closer to cutting rates during the second half of the year to offset potential weakness caused by the trade fight with China and other countries.

INFLATION

Despite massive tax cuts and an unemployment rate at 50-year lows, the economy has not generated that much inflation over the past several years. In fact, some indicators like inflation breakeven spreads (which measure the different between actual inflation and real yields) point to the fact that the rate of inflation has actually been falling over the past several months. Looking

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ahead, inflation could pick up if producers pass through the cost of higher tariffs. However, if this leads to a rise in prices, this could ultimately turn out to be deflationary in the long run.

At some point consumers may have to decide between paying higher prices or switching to new products. That decision (which is unknown at this point), will help determine which companies are more successful and can still boost sales and profits in a world of greater uncertainty and higher tariffs. In this environment, we may be able to take advantage of the situation to find more attractive investment opportunities for our portfolios.

Interest Rates

The bond market has experienced a pretty sizable change in recent weeks with the U.S. Treasury 10 Year Note yield declining from a high if 3.25% last November to an intra-day low of 2.07% this week (Source: FactSet). We believe there are a number of factors at work here: 1) interest rates in Europe have fallen back to levels last seen in 2016 (for example German Bund yields are negative once again); 2) inflation here at home continues to run below the Feds target of 2%; 3) U.S. markets have started to price in one or two rate cuts by the central bank and 4) trade concerns have led to forecasts of lower economic growth. On a short-term basis, we believe the significant move lower in U.S. rates looks somewhat overdone. However, until there is greater certainty regarding trade negotiations with China and how the U.S. Federal Reserve bank may react, it will be difficult to forecast the appropriate level of 10-year yields.

Corporate Profits

Corporate profits for the S & P 500 last quarter started out with an estimated year over year decline of 4%. However, when all was said and done, profits ended up basically flat on a year over year basis. The outlook for this quarter is for a small decline of 2.1% followed by an increase of 0.3% during the third quarter and an increase of 4.3% for the fourth quarter of the year. We believe the S & P 500 could experience a mild "growth recession" i.e. a period of two consecutive quarters of negative year over year profit growth before profits likely rebound later this year into 2020. For all of 2019, earnings per share are currently forecast to increase in the low single digits followed by an increase of 11.1% for 2020 (Source: FactSet). Next year all 11 sectors are currently forecast to generate positive year over year growth and six out of 11 sectors are forecast to post double digit growth. From our perspective,

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this year's corporate profit forecast sounds reasonable while next year's estimates currently appear on the high side. Much will depend on the trade war with China and how that impacts the economy and financial markets over the next several quarters.

THE WORLD BANK

Reflecting continued economic headwinds, the World Bank provided an updated outlook and lowered its global GDP forecast for this year from 2.9% (made this past January) down to 2.6%. For reference, the World Bank forecasts a slight pick-up in growth to 2.7% next year. In its semi-annual update, the bank commented that risks are currently skewed to the downside as a result of reignited trade tensions between the U.S. and China, financial turbulence in emerging markets and sharper-than-expected weakness in advanced nations, particularly Europe. For now, we continue to maintain our foreign equity exposure at around 15% which compares with about 47% for the MSCI All Country World Index. A majority of the world's corporations are located outside the U.S. and valuation levels remain cheaper overseas. However, we continue to feel more comfortable overweighting U.S. equities in our portfolios in the current market environment.

THE BIG PICTURE

Looking at the big picture, we still believe the U.S. economy remains on reasonably solid footing. GDP for the first quarter of the year registered 3.1% (although this was partially helped by a boost in inventories), the U.S. consumer still appears pretty healthy, the Conference Board's Index of Leading Economic Indicators (LEI) continues to rise and consumer confidence is near multi-decade highs. In addition weekly jobless claims remain near multi-decade lows, the ISM Services Index for May improved from 55.5 to 56.9 (with modest gains in business activity, employment and new orders) and there is the possibility that housing (which has subtracted from GDP in each of the past 5 quarters) could start to benefit from the recent decline in mortgage rates.

However, we acknowledge that the economy is starting to face some headwinds. As a result of rising tariffs, business spending and manufacturing activity have started to slow somewhat. For reference, the ISM Manufacturing Index for May fell to a reading of 52.1 this past month representing the lowest level since October, 2016. The latest quarterly GDP report also pointed to a slowdown in business equipment spending. On a

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more positive note, the ISM Manufacturing Index remains above 50 (signaling economic expansion) and new orders increased modestly last month (possibly indicating a stabilization in demand).

Another concern is that the spread between 3-month U.S. Treasury Bills and U.S. 10 Year Notes has turned negative again and at least historically, when this spread has turned negative for several months, it has forecast an economic downturn within the next year or two. For reference, the yield curve fell as low as -60 basis points in early 2007 and to nearly -100 basis points in late 2000 compared with about minus 20 basis points today.

Turning to the job market, the economy created 75.000 new jobs last month versus estimates of an increase of 175,000 (Source: Bureau of Labor Statistics). Last month's gain compares with an average 2019 increase of 164,000 jobs per month and an average increase of 223,000 jobs per month last year. There were downward revisions to the previous two months, the year over year wage rate declined slightly from 3.2% to 3.1% and just 54.9% of all employers added to payrolls last month versus 59.9% the previous month. On the positive side the unemployment rate remains at a 50-year low of 3.6% and weekly jobless claims remain very low, reflecting a fairly tight labor market. When you look at all the moving parts, last month's jobs report was somewhat on the soft side. Its hard to break down how much of the latest jobs report is directly due to trade and tariffs issues. Our thinking is that if we can move towards some kind of trade resolution before too long, job growth should start to improve once again.

Lastly, economic growth in a number of countries overseas remains weak. While U.S. exports only represent about 12% of GDP, companies in the S & P 500 generate about one third of their sales from overseas (Source: Bureau of Economic Analysis). Thus, while growth in the U.S. remains positive, weakness overseas may ultimately lead to a slowdown in U.S. sales and profits over time.

We would love for the U.S. - China trade dispute to magically be resolved and go away. However, after listening to comments from President Trump and the Chinese president over the past several weeks, we are not holding our breath for a quick resolution. Both countries would clearly benefit from an end to the current trade war, but for now both sides appear to have dug in their heels. The next opportunity for something positive will be at the G20 meeting of world leaders which takes place at the end of June.

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In summary, tensions on the trade front have created a more uncertain environment for the U.S. and global economy as we look ahead towards the second half of the year. At this point, we continue to believe that a recession is a low probability event in 2019. Overall, the economy continues to growth although we are likely to experience a slowdown compared with last year.

Looking at different parts of the economy, the U.S. consumer (as a result of continued job growth, rising wages, steady confidence levels and a healthy balance sheet) appears to be on pretty healthy footing by manufacturing activity and business spending have started to slow somewhat. While the Fed is on hold right now, uncertainty on the trade front may lead the U.S. central bank to take out an insurance policy cuts rates once or twice (note: the first cut may be as soon as the July Fed meeting). Corporate profits have clearly slowed (following a jump after 2017 tax cuts were passed) and are likely to remain subdued or may even turn negative for a quarter or two. If trade issues can get resolved, corporate profits should start to pick up again as we head into 2020.

Looking ahead, trade talks will likely continue to dominate financial headlines and will continue to have an impact on CEO confidence levels. During the second half of the year, the economy will probably experience low to moderate economic growth (but importantly still positive growth). This will probably remain the story until bigger issues get resolved in the days ahead. We will continue to keep you posted on our latest thinking and we hope you enjoy the summer months.

As always, we welcome any comments you may have.

Respectfully,

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Disclaimer:
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VIX Volatility Index – The VIX Index is a gauge of equity market volatility.

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