2019 MID-YEAR MARKET REVIEW & OUTLOOK

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MARKET OVERVIEW

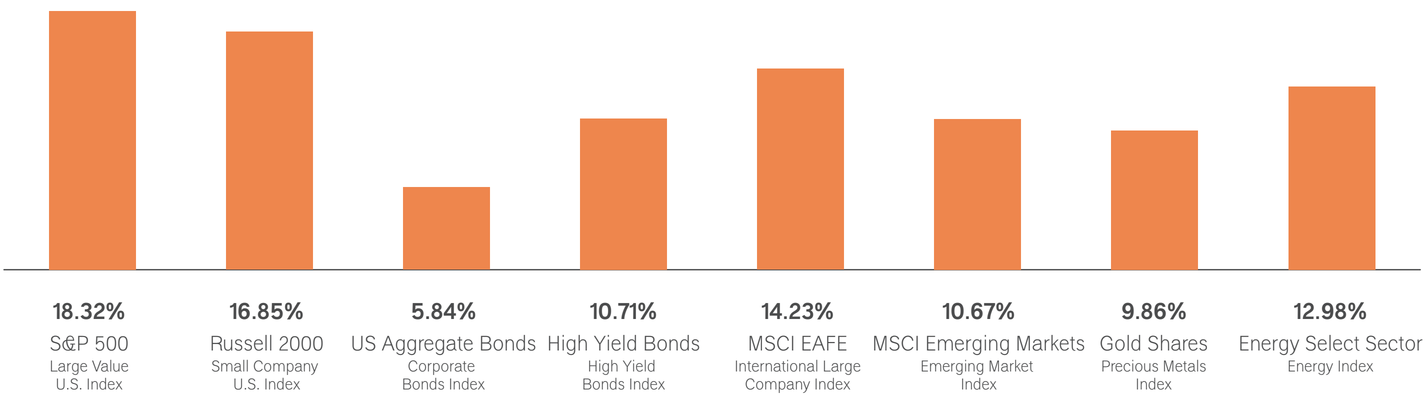
Markets are coming off a negative end to 2018, when the S&P 500 dropped 13.97% in the fourth quarter.[1] Volatility was the prevailing theme last year, and the trend persisted through the first half of 2019. We believe the markets have begun to trade less on fundamentals and more on President Trump's last tweet or Federal Reserve Chairman Powell's latest comments.

Market Performance

Figure 1 below shows how each major asset class performed through the first half of 2019. While markets have outperformed their historical averages so far this year, a look at 12-month returns tells a different story because that period includes the sell-off in late 2018. The S&P 500, for example, was up 9.20% for the 12 months ending June 30, 2019, more in line with historic norms.

Strong market gains after steep declines in late 2018

FIGURE 1. YEAR-TO-DATE TOTAL RETURNS BY INDEX (1/1/2019 – 6/30/2019)*



* The following indexes Year-to-Date total returns were found using the following tickers: SPY, IWM, AGG, JNK, EFA, EEM, GLD, and XLE respectively.

Source: Morningstar, data as of 6/30/2019.

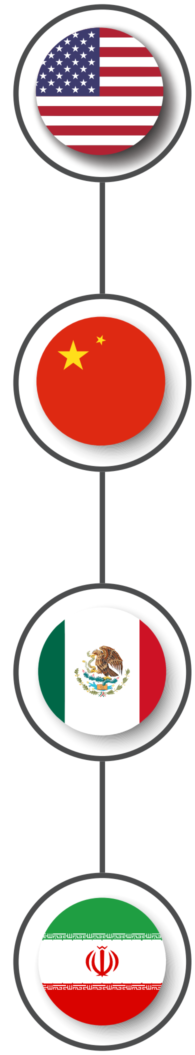
U.S. Economy

The current period of economic expansion is now the longest in U.S. history.[2] The unemployment rate sits at 3.7%[3] — full employment by Fed standards — and more than half of middle market executives say their biggest challenge is the limited supply of job candidates.[13] GDP grew 3.1% in the first quarter of 2019, exceeding the 3.0% growth target set by the Trump administration.[14]

Geopolitics

U.S.-China Trade War

Market growth slowed in the second quarter of 2019 amid a renewed flare-up in tensions between the U.S. and China. In February, following successful talks between the two countries, President Trump agreed to extend the March 1 deadline to finalize a trade deal.[4] Despite "progress,"[5] however, the U.S. increased tariffs[4] to 25% on $200 billion of Chinese goods in May. One month later, China retaliated by raising tariffs[6] to 25% on $60 billion of U.S. goods. Following successful talks between presidents Trump and Xi at the G-20 summit in Japan, the U.S. and China will resume trade negotiations and suspend the implementation of new tariffs.[7]



Mexico Tariffs

In May, President Trump announced his intention to raise tariffs on Mexican goods. The plan was to increase tariffs 5% every month beginning in June, up to a cap of 25%, if Mexico failed to stop illegal immigration at the southern border.[8] On June 7, the U.S. withdrew its plan after reaching a deal with Mexico on immigration.[8]

U.S.-Iran Political Relations

The deterioration of U.S.-Iran relations accelerated in the second quarter, triggering much of the volatility in global oil markets. In April, the U.S. announced it would end sanction exemptions for eight countries buying oil from Iran, in an attempt to reduce Iran's oil exports to zero.[9] In response, Iran allegedly attacked six oil tankers in the Persian Gulf[10] and shot down a U.S. surveillance drone near the Strait of Hormuz.[9]

Monetary Policy

The chairman of the Federal Reserve, Jerome Powell, has completely reversed course on interest rate hikes and balance sheet reductions. Before the market headwinds and heightened volatility of the fourth quarter, the Fed had signaled rate increases of another 0.5%, or two additional hikes from the current level. Powell stated in November 2018 that the Fed "had a distance to go before it would stop raising rates and reducing the balance sheet."[12]

However, more recent Fed statements suggest it plans to "act as appropriate to sustain the expansion."[11] In addition to pausing rate hikes thus far in 2019, the Fed announced it would stop reducing the number of bonds held on its balance sheet by September.[12] This program began in October 2017 and has resulted in almost $450 billion in balance sheet reduction.[12] With the Fed once again becoming a net purchaser of bonds, it will begin a new, more modest quantitative easing (QE) posture.

Conclusion

As volatility continues as the prevailing investment theme and geopolitical concerns loom on the horizon, we believe market fundamentals will triumph over the long term. However, the current late-market cycle appears to be trading more on sentiment than fundamentals. We remain hard at work focusing on risk management, portfolio diversification, and investment strategy selection as we navigate this precarious market environment for our clients.

[1] https://www.cnbc.com/2018/12/31/stock-market-wall-street-stocks-eye-us-china-trade-talks.html
[2] https://www.pbs.org/newshour/economy/making-sense/can-the-longest-economic-expansion-in-u-s-history-last
[3] https://www.bls.gov/news.release/pdf/empsit.pdf
[4] https://www.cnbc.com/2019/03/01/the-timeline-of-trump-china-tariffs-and-trade-war.html
[5] https://www.bloomberg.com/news/articles/2019-05-14/u-s-china-trade-war-timeline-what-led-up-to-the-stalemate
[6] https://markets.businessinsider.com/news/stocks/trade-war-china-places-new-tariffs-on-us-goods-2019-5-1028194689?utm_source=markets&utm_medium=ingest
[7] https://www.cbsnews.com/news/us-china-trade-talks-restarted-president-trump-suspends-new-tariffs-today-2019-06-30/
[8] https://www.reuters.com/article/us-usa-trade-mexico/trump-threatens-more-tariffs-on-mexico-over-part-of-immigration-deal-idUSKCN1TB182
[9] https://www.washingtonpost.com/business/energy/why-the-us-iran-conflict-is-now-coming-to-a-head/2019/06/17/5ae329cc-913b-11e9-956a-88c291ab5c38_story.html?utm_term=.17743f57c755
[10] https://www.usatoday.com/story/news/world/2019/06/20/us-iran-tension/1510847001/
[11] https://www.cnbc.com/2019/06/04/powell-says-the-fed-will-act-as-appropriate-to-sustain-the-expansion.html
[12] https://www.cnbc.com/2019/03/20/fed-sets-end-of-balance-sheet-reduction-for-september.html
[13] https://www.jpmorgan.com/commercial-banking/insights/2019-economic-outlook-expansion
[14] https://www.bea.gov/news/glance

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