



Climbing a Wall of (Justified) Worry. Financial markets performed well in the second quarter, albeit with a -6% mid-quarter decline when investors turned their attention from first quarter earnings reports to growing risks from an accelerating set of trade disputes. Nonetheless, June's rally pushed major indices to new highs, as President Trump indicated that he would postpone imposing additional tariffs on China. As another record-breaking hot summer unfolds, investors are attempting to weigh a potentially dovish turn in monetary policy in both the U.S. and Europe, against the impacts of decelerating global economic growth, fading fiscal stimulus, ongoing spats in trade policy that have spread beyond the U.S. and China, and prolonged geopolitical risks. Importantly, in our view, at current equity valuations, investors do not appear to have reconciled the benefit of an interest rate cut with the negative conditions that would generate one.

Slower Growth Everywhere. While direct fiscal stimulus from the U.S. 2017 tax reform bill is fading, the 2019 and proposed 2020 Federal budgets still entail substantial fiscal stimulus. Even so, U.S. economic growth is expected to slow by 1.1% from 2018 to 2020, reflecting the tighter monetary policy in place since 2015 and the ongoing effect of trade disruptions. Global Purchasing Managers Indices (PMIs), which have been declining for the past year, forecast a decelerating global economy as well. Worldwide economic growth is expected to slow by about 0.7% over the next two years while Eurozone growth is expected to slow by 1.3%. Slower growth across the highly integrated global economy represents a significant future headwind for all countries; trade disruptions and trade uncertainties reduce businesses desire to invest, slowing both immediate economic growth and future productivity growth.

A Little Help from the Fed. For the third time since the Great Recession, Leading Economic Indicators are declining. Currently, they are consistent with another

intra-cycle slowdown, but further declines would raise the probability of another recession. Federal Reserve President Jay Powell and the Open Market Committee have repeatedly expressed their willingness to lower interest rates if economic conditions deteriorate. Equity

markets have celebrated this expected dovish turn in monetary policy. However, we expect that any Fed reduction in interest rates will be driven by concerns about softening economic data.

Reading the Shifting Tea

Leaves. In a market environment characterized by uncertainty and shifting fiscal, monetary, and trade policy, data can be difficult

to interpret, offering fewer clear signals and more noise. Investment research provider Evercore ISI has noted that equity performance has reacted to this shift, becoming less correlated with macroeconomic data, and increasingly correlated with narrative shifts. For example, though recent updates regarding the Trump administration's trade negotiations with China may not amount to more than another delay, markets celebrated the Trump-Xi G-20 meeting with a risk-on rally. Future updates, including the long-awaited release of any specific details regarding a potential trade agreement, will likely play a significant role in near term market performance. Meanwhile, the uncertainty surrounding these developments will be compounded by tariff retaliations and the expressed frustrations of foreign leaders. We also expect that as the 2020 election approaches, investor speculation around potential changes in leadership and policy is likely to increasingly impact financial market performance.

Second Quarter Performance. Global equity markets continued to perform well during the second quarter. The S&P 500 returned +4.30% during the quarter, while the small capitalization S&P 600 gained +1.87%. The Russell 1000 Growth Index returned +4.64% during the quarter, and the Russell 1000 Value Index returned +3.84%. The MSCI All Capitalization World Index, excluding the U.S., returned +3.18%. While positive

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returns were common across all major equity indices, the outperformance of growth and domestic stocks reflects a continued market preference for stability amid ongoing macroeconomic risks. Likewise, small-capitalization stocks underperformed those of large- and medium-capitalization companies. Meanwhile, investor optimism regarding trade negotiations led cyclical sectors such as Financials, Materials, Information Technology, and Consumer Discretionary to pull ahead of more defensive sectors at the end of the quarter. Bond markets rallied as the Federal Reserve affirmed its preparedness to lower interest rates if macroeconomic conditions were to deteriorate. The Bloomberg Barclays US Government/Credit Intermediate Index returned +2.59% for the quarter, while the Bloomberg Barclays Intermediate 1-10Y Municipal Bond Index gained +1.64%. Credit spreads tightened somewhat as lower interest rates led many investors to lower quality bonds in search of yield.

Valuation and Positioning. Equity valuations also increased during the second quarter, with the price-to-

earnings ratio of the S&P 500 ending June 30 at 16.7 times next twelve month earnings. The cyclically-adjusted P/E ratio, which is based on the past ten years of earnings, climbed to 30.2, 0.5 standard deviations above its 25-year average, reflecting both increases in equity prices and downward revisions to corporate earnings expectations. If earnings forecasts continue to trend lower, these valuations may appear stretched, and could put downward pressure on equity returns moving forward. The earnings yield of the S&P 500 decreased to 6.0% during the quarter, while 10-year TIPS yields decreased to .26%, suggesting that stocks will return approximately 5.7% more than bonds in the next year. Increasing valuations, especially in the context of weak economic data, can suggest increased risks. However, as we witnessed in 2017, neither high valuations nor the presence of significant risks preclude strong equity performance. We continue to believe that a neutral asset allocation and an emphasis on companies backed by stable cash flows and strong balance sheets will best serve our clients in this environment.