GFP*Outlook & Strategy*

Second Quarter 2019 Commentary

Solid Q2 but slowing economy

A volatile but ultimately positive quarter

The second quarter of 2019 started well, with solid market returns in April. However, as May rolled in, volatility and risk returned. An unexpected tariff threat from President Trump directed towards Mexico came at the same time the U.S.-China trade situation took a large step backwards. As a result, the S&P 500 was down over 6% in May. In June, however, trade issues with Mexico were generally resolved, the Fed Funds futures started predicting three rate cuts (dovish policy seen as bullish for the markets) and some hope, however transient, emerged for the China trade situation. This led to an attractive June for the S&P 500, offsetting the losses from May and ultimately leading to a positive second quarter for the markets. The U.S. 10-year Treasury yield's move towards 2% was also a big catalyst for stocks to go higher.

Our current view is that Gross Domestic Product (GDP) growth in the United States will slow down materially from last year's tax-related stimulus infused growth. However, we do not see a recession coming imminently, just slow growth. Inflation is below target and the low level of interest rates (and seemingly more dovish Fed policy over the coming months) should support stock valuations for now. Currently Europe and Emerging Markets in general are providing significant stimulus to the global markets.

Equity Outlook

Despite the notable appreciation in the market this year after a challenging fourth quarter, the equity markets are essentially flat over the last 18 months, and we are currently at the upper end of this extended trading range. Our view is that with economic growth slowing and earnings comparisons becoming more difficult, U.S. equity market gains should be limited in the second half. The S&P 500 index currently trades at over 17 times earnings. We believe this is close to fair value for the market. We are comfortable that a multiple higher than the historical average of 15 times earnings makes sense considering low interest rates and modest inflation. Globally, Emerging Markets equities also had a solid quarter but still trade at a discount to the U.S. If the U.S. dollar has peaked, we would expect equity markets in the rest of the world to outperform the U.S. in the second half. This is helped by the large European and Emerging Markets stimulus mentioned above.

Fixed Income

At present, and broadly speaking, there is very little value in more traditional fixed income strategies. Credit spreads (the difference in yield between two bonds of similar maturity but different credit quality) on high yield and corporate bonds are at very tight levels. Also, with rates so low it is hard to see significant price gains going forward. That being noted, portfolio diversification in the name of risk management dictates having exposure to this asset class. As the cycle continues to mature, we are actively looking for and finding more attractive yields in areas of fixed income that have less economic sensitivity and less duration (interest rate) risk. This is our fixed income focus for client portfolios.

Alternatives

As we suggested last quarter, we are increasing the use of investments that have, in our opinion, a somewhat idiosyncratic return stream that can generate returns with low correlations to broad equity or fixed income performance. We encourage you to speak with anyone on the investment team or your client advisor for more specific details and a 'deeper dive' into these types of investments.

PoliticaltiClimate

The 2020 Presidential election is on the horizon and the political rhetoric is starting to heat up on both sides of the aisle. As of this writing, there are 24 Democratic Presidential candidates, with Joe Biden, for now, the leader. It is too early to predict who will face Donald Trump, much less tailor investments based on next year's election. However, we will continue to be proactive and monitor risk in the context of potential election outcomes as it relates to trade, regulation and taxation. Relative to earlier in the year, the perceived probability of President Trump finishing out his term has risen and that near-term uncertainty has largely dissipated. Nine to twelve months from now, however, the political process will be center stage for the markets and how we structure client portfolios in the context of risk-return.

Conclusion

We did not reduce client portfolio risk during the difficult month of May in the markets and we were rewarded in June for this approach. Part of our thinking at the time was that Mexican trade issues presented a very different situation than those with China, and we expected them to be resolved, leaving our strategic portfolio approach intact.

However, the general uncertainty surrounding U.S. policy, beyond even trade policy, we feel merits a more conservative approach overall. In addition, expectations around (the number and size of) rate cuts from the Federal Reserve may or may not be accurate. Until there is clarity around the Fed's stance in later July, the market is likely to remain range bound.

We continue to believe there are pockets of opportunity in equities, particularly globally. Within fixed income, investments focused on credit are able to generate yield and reasonable risk-return without an imminent recession. In any case, our investment team is focused on investments that emphasize risk management, while still able to participate in market upside.

Please let us know if you have questions or comments. We look forward to being in touch.

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