SilverOak

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Second Quarter 2019 Market Summary

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Second Quarter 2019 Market Summary

As the summer season starts, many families will retreat to the lake cabin, the beach, or perhaps embark on the Great American Road Trip. But even relaxation takes planning, and lessons learned from past trips can make the journey smoother in the long-run. Before we talk about where we are going, let's take a look in the rearview mirror. The past 18 months have been a bit of a rollercoaster; however, the S&P 500 is only up 3-4% since late January 2018. The lessons outlined below hopefully will shed light on the importance of maintaining a strategy and not overacting to headline narratives.

Lesson #1: Markets are cyclical. The U.S. equity markets are currently at all-time highs, a similar peak reached in January 2018 and October 2018. All three peaks were preceded by uncharacteristically low volatility. But risk crept back into the minds of investors and markets sold off. Don't be scared of cycles.

Lesson #2: Don't get out over your skis. Investors feel empowered after a long rally and believe it will last indefinitely or fear they will miss out on future returns. That is when unnecessary risks tend to be taken. Be mindful of behavioral biases.

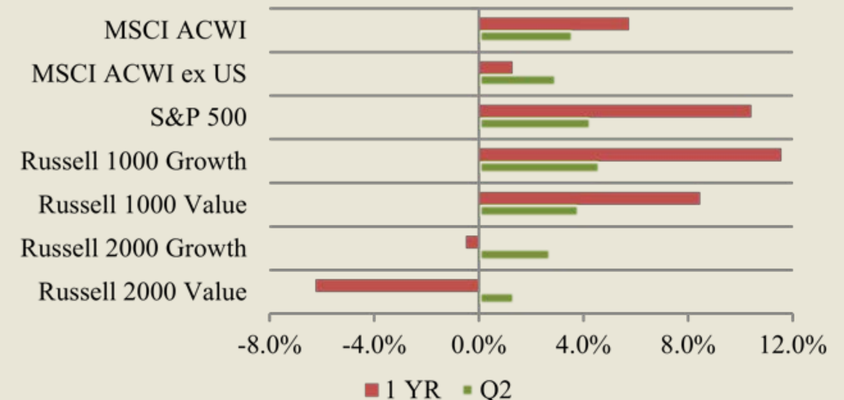
Lesson #3: Diversification matters. Bonds are integral to a well-diversified portfolio as they are the stabilizing force, especially in down markets as evidenced over the past year.

Lesson #4: Focus on what you can control – macro headlines are often just noise. There is no shortage of macro news between trade wars, Brexit, populism, immigration, Federal Reserve policies, etc. Often the market takes these events in stride. However, we have been encouraging clients to take stock of their personal financial statements and re-visit their risk tolerance.

Lesson #5: The future is uncertain but we do not have to be bystanders. We are forced to continually make decisions regarding our financial well-being. As the probabilities of future outcomes change, we can incorporate them into the decision making process.

This leads us to today as we review the second quarter and look at the roadmap for the remainder of the year.

Second quarter headlines took us down the same familiar roads we've been travelling for the last year – trade, the Fed, and weakening economic data – with no signs of detour ahead. Last quarter, we mentioned that, if the Fed remained accommodative and trade rhetoric does not ramp up, equity markets could grind higher. We generally saw this in the second quarter, as equities were positive despite a brief flair up in trade tensions in May, which have already subsided. U.S. large company stocks, represented by the S&P 500 Index, were up 4.3% during the second quarter of 2019. International stocks, represented by the MSCI ACWI ex US Index, were up 3.0%.



Bond returns were helped by the continued decline in interest rates. For the quarter, the Bloomberg Barclays U.S. Aggregate Bond Index, which represents a broad basket of bonds, was up 3.1%. The Fed did not raise rates during the quarter, and they tempered their outlook for the coming months, citing increasing concerns about economic uncertainties and persistent low inflation. In their June statement, the Fed altered language from the May statement, shifting their focus from patient observation to a close scrutiny of incoming economic data. Many investors feel that this hints toward rate cuts in the second half of the year, though the Fed's next meeting in July may further illuminate the situation.

Second Quarter 2019 Market Summary (continued)

Following the recent G20 summit, there seems to be a cease-fire agreement in the trade war between the U.S. and China. This is important, as a delay of spending by corporations and consumers due to an uncertain environment could be more impactful than the tariffs themselves. Trade scenarios will continue to shift daily with the tides as rhetoric is being employed politically on both sides. Thus, while it appears the seas have calmed for the moment, we expect that trade will continue to be a recurring headline over the next year.

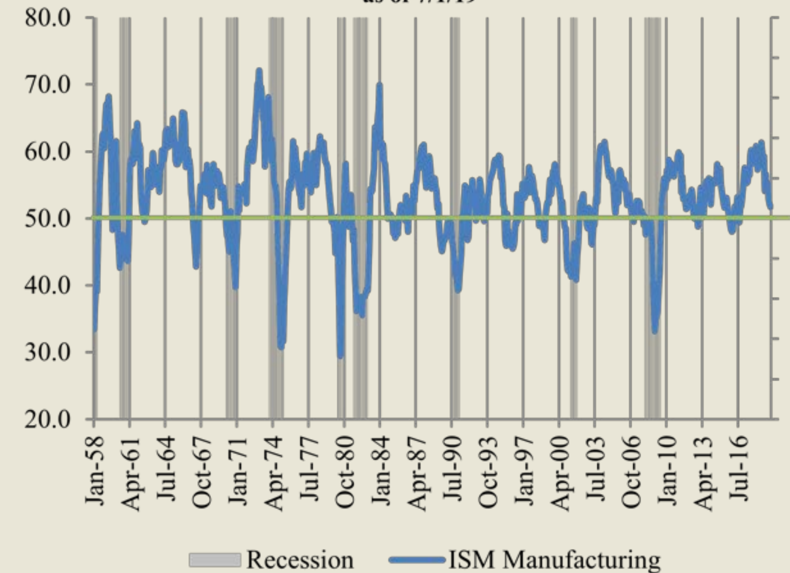
Though economic data remains mixed and trending weaker, some estimates are actually calling for a re-acceleration of earnings and economic data towards the end of the year. This optimistic view supposes that, if a trade settlement can be forged, and if the Fed cuts rates to encourage spending, then consumers and businesses will have the clarity they need for this economic expansion to continue. Some of these sunny forecasts are likely already baked into the positive equity returns we have seen year-to-date.

As it is, the current economic expansion is now the longest in history. That does not mean it has to stop, but we are not of the belief that a recession can be avoided indefinitely by engineered policies.

It is hard to perfectly plan for everything in a trip. There will be bumps in the road, detours taken and the occasional flat tire. This summer could provide similar calmness in the markets as we saw last year. But just as we apply sunscreen before we get burned, and use bug spray to avoid being bitten, so too must we prepare ourselves for the next turn in the market well-before the clouds begin to darken on the horizon.

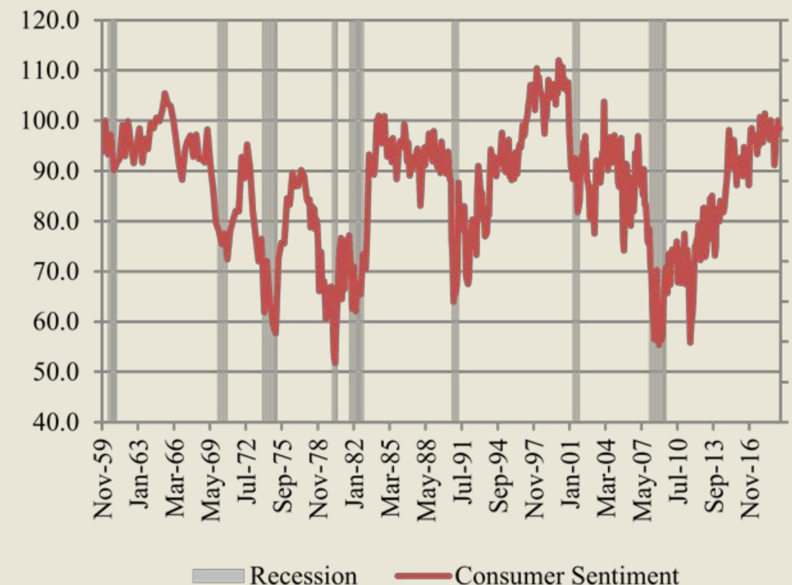
MACROECONOMICS

- The Bureau of Economic Analysis released the advanced estimate of second quarter 2019 real GDP, an annual rate increase of 2.1% from the preceding quarter. In particular, the U.S. consumer showed strong growth.
- The ISM Manufacturing Index trended lower during the quarter, finishing at 51.7 in June from 55.3 in March. Manufacturing has weakened as U.S. trade negotiations have dragged on. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In June, the Conference Board Leading Economic Index decreased 0.3% month-over-month to 111.5. The Index has remained relative flat since September 2018.
- The price of WTI Crude Oil was $58.20 at the end of June, which is 3.3% lower than $60.19 at the end of March. The price of Brent Crude Oil ended the quarter essentially flat compared to March at $67.52. Oil traded lower on global growth and trade concerns.
- In June, headline CPI increased 1.6% year-over-year. Core CPI, which does not include food and energy, had a 2.1% increase. Inflation has drifted lower over the past few months on growth concerns and has struggled to maintain at the Fed's target inflation rate of 2%.



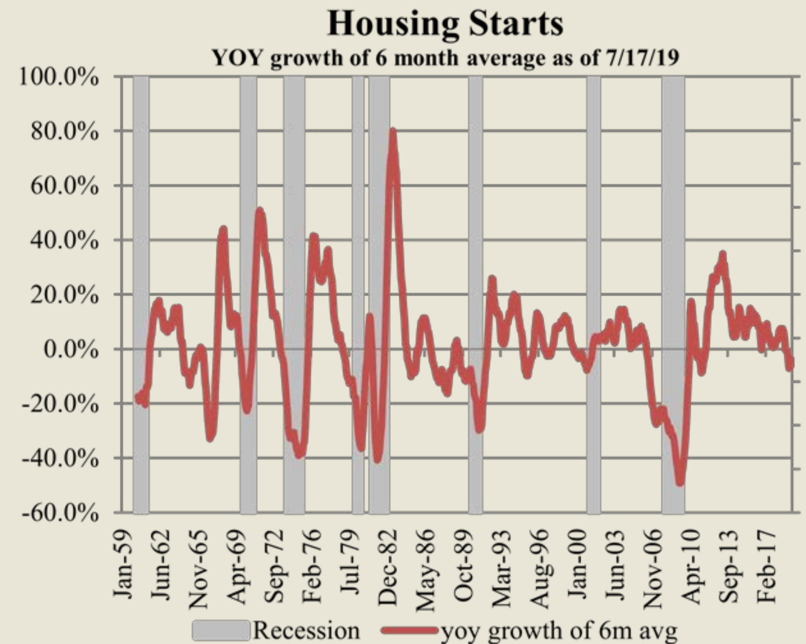
CONFIDENCE METRICS

- The University of Michigan Consumer Sentiment Index final reading for June was 98.2. For the quarter, sentiment was a bit higher than the first quarter and remains at very strong levels.
- The Conference Board's Consumer Confidence Index July reading increased to 135.7 from 124.3 in June. Consumers are optimistic about business and labor market conditions.



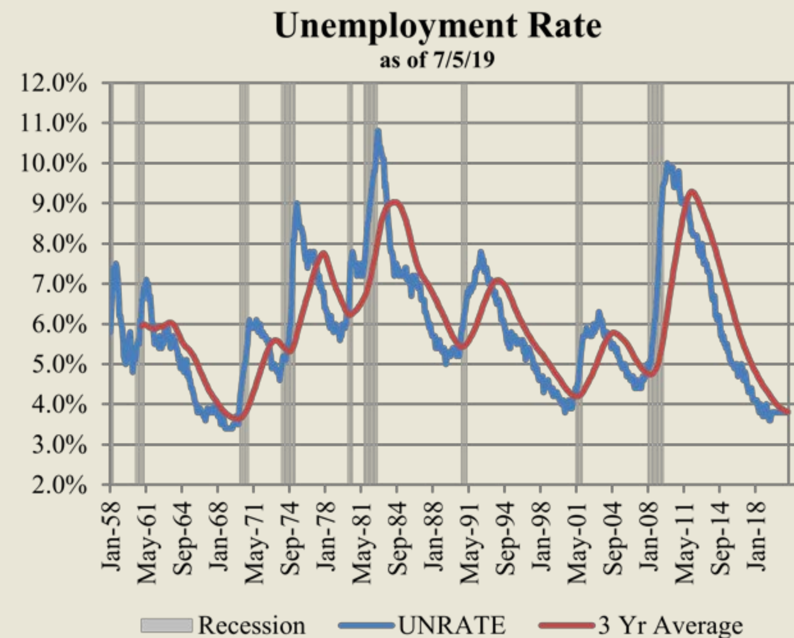
HOUSING

- The housing sector continues to soften but is generally positive. Home sales have stalled but home prices continue to rise.
- Preliminary existing home sales increased in the quarter with a monthly average annualized rate of 5.28 million units from 5.21 million units in the first quarter. Though, the June annualized rate is 2.2% lower than the 5.39 million units in June 2018. Unsold home supply remains at low levels.
- The preliminary existing home sale prices for June were 4.3% higher than the levels of one year ago. Prices have been trending up since the beginning of 2012 and reached an all-time high in June.
- New home sales were generally positive during the quarter; however, they have plateaued at these levels since late 2017. It remains to be seen if housing demand gets a pick up from mortgage rates that have fallen over the past few quarters.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose over 2.4% year-over-year in May. Of the locations in the Index, home prices in San Francisco, Seattle, Phoenix, Las Vegas, and Denver have risen the most since the 2011.
- Housing starts were slightly up during the quarter but have generally been flat over the past few year.



EMPLOYMENT

- The labor market has generally been healthy. The job growth rate has slowed slightly, as employers are having difficulty finding workers with the required skills. Wage growth is the strongest it has been in a decade, which could lead to solid consumer spending.
- During the quarter, nonfarm payrolls averaged a healthy 171,000 jobs added per month.
- The unemployment rate reduced slightly to 3.7% during the quarter.
- Initial Jobless Claims had been decreasing since 2009 and dipped to lows last seen in 1969; however, claims have flattened over the past year. The low level of initial claims reflects a tight labor market.

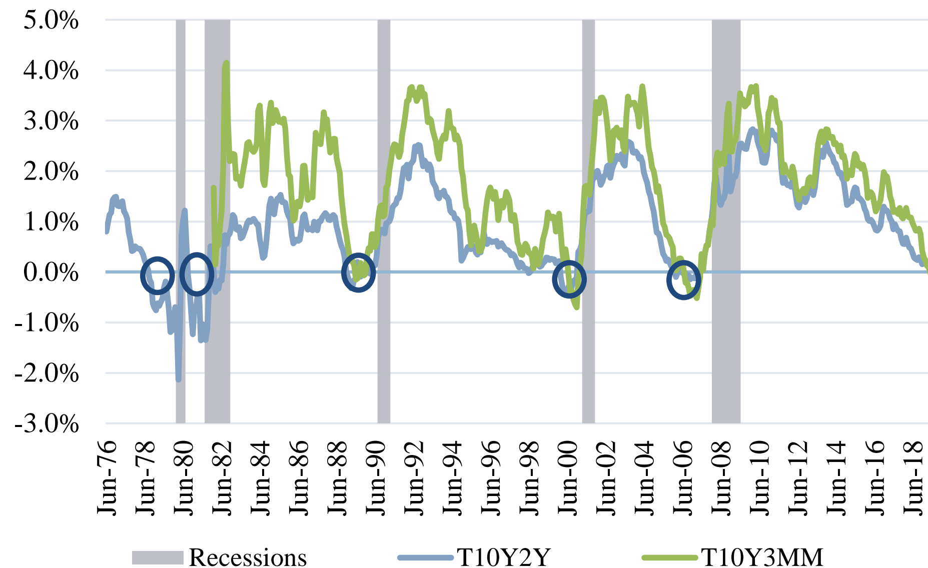


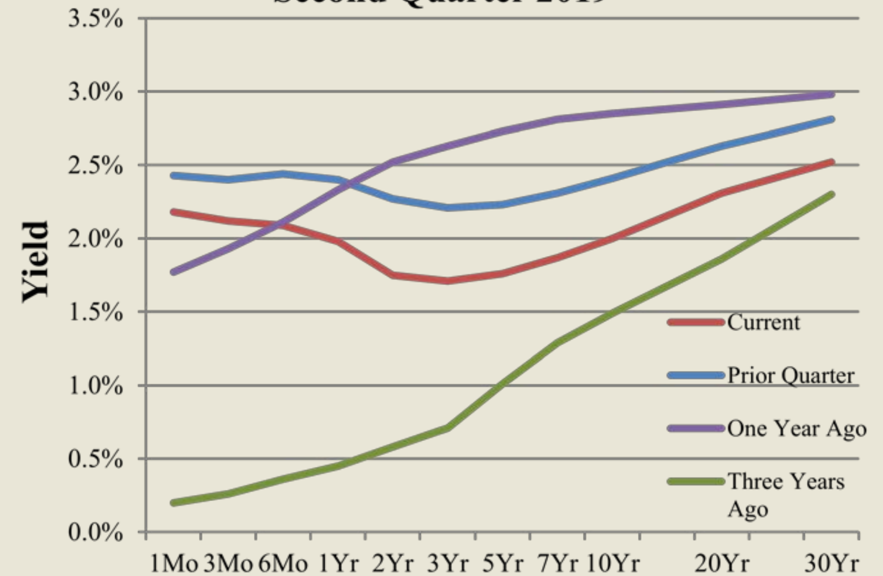
FED POLICY

- The Federal Open Market Committee (FOMC) decided to maintain the federal funds rate at a target range of 2.25% - 2.50% in their June meeting. However, the Fed's statement opened the door for them to cut rates in the second half of the year.
- The Fed cited growing global risks, a slowing U.S. economy and subdued inflation as reasons for their increased willingness to support the markets.

FIXED INCOME

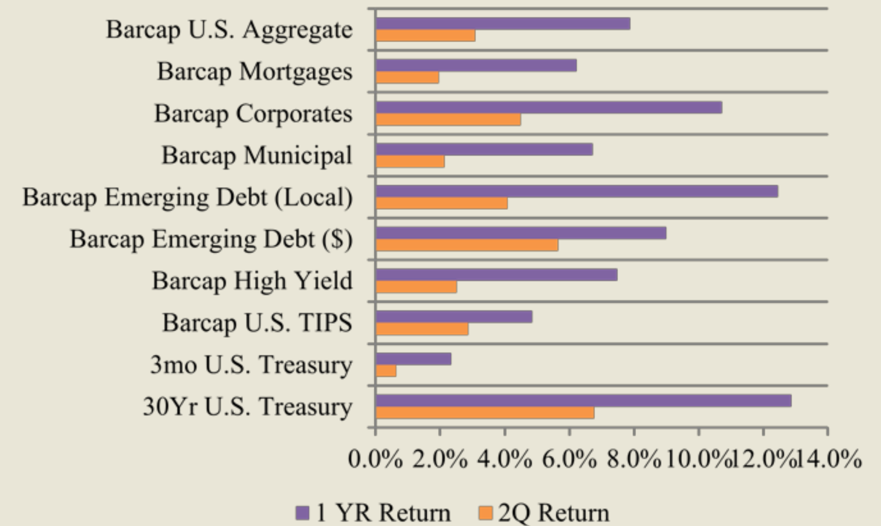
- During the second quarter, U.S. Treasury yields declined across the curve and now the short to intermediate-term bonds are inverted. The inversion is highlighting the market's view that the Fed will cut rates by 50-100bps over the next year.
- Short-term interest rates are controlled or heavily influenced by central banks, whereas long term interest rates are controlled by market forces and economic growth.
- U.S. interest rates will likely remain range bound for the foreseeable future in the 1.5% to 3.0% range. Despite limited expected returns, bonds still act as the ballast of a portfolio during times of volatility.

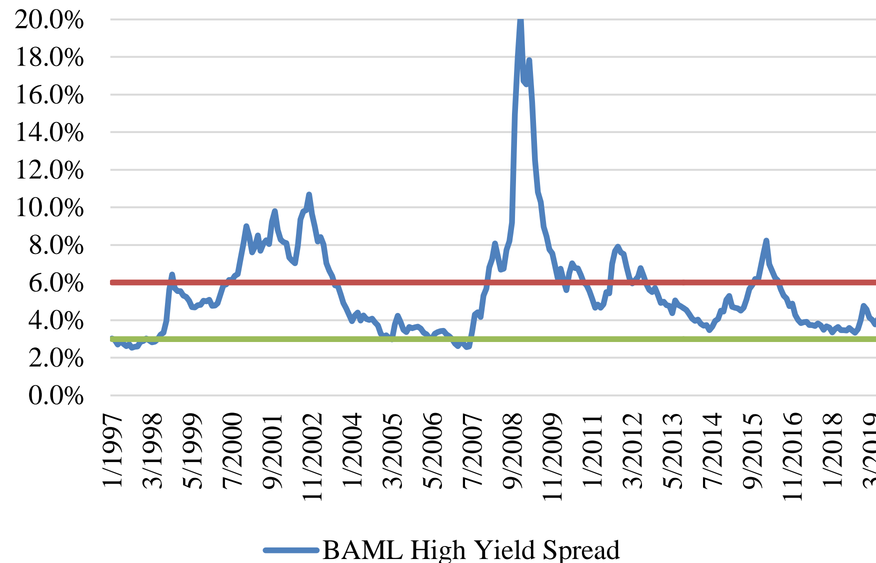


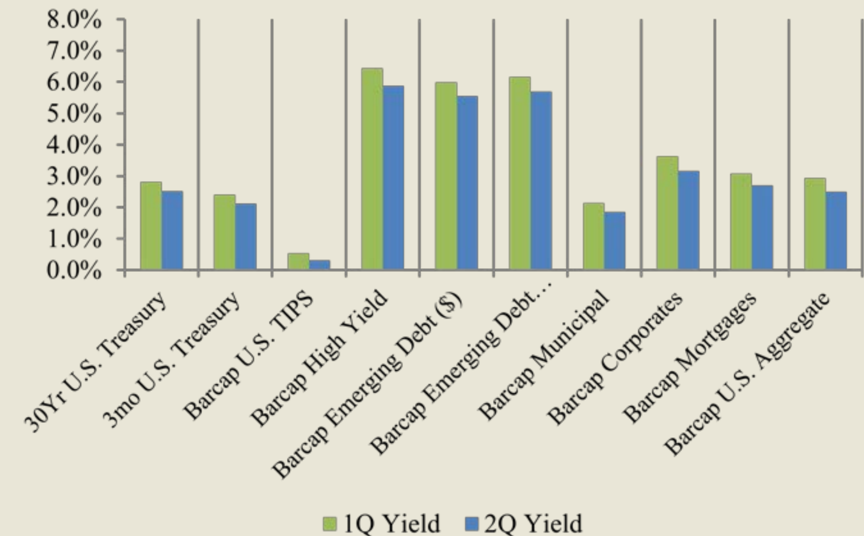


FIXED INCOME (continued)

- Fixed income returns have been impressive year-to-date. During the quarter, the Barclays U.S. Aggregate was up 3.1% as interest rates fell.
- Credit spreads continued to tighten during the quarter, signaling investors' willingness to take risk; however, the Treasury market told a different story as rates fell due to weaker growth and macro risks.
- Yields fell globally as well. Ten year German and Japanese bonds are trading at negative rates.
- Municipals continue to see above average demand while supply remains low; thus, technicals remain supportive.
- Despite investors' willingness to accept greater credit risk, fundamentals in the investment-grade corporate and high-yield sectors remain mixed. There is a high amount of leverage in the system and weakening underwriting; however, defaults remain low.



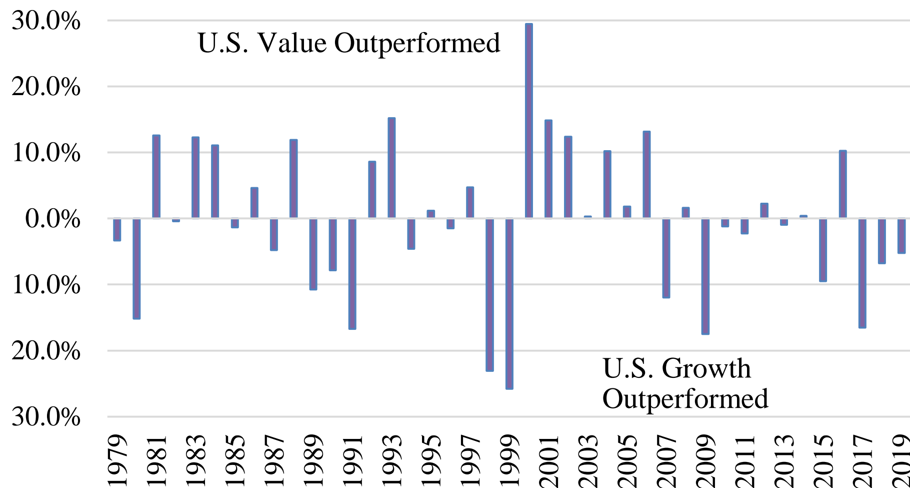




EQUITIES

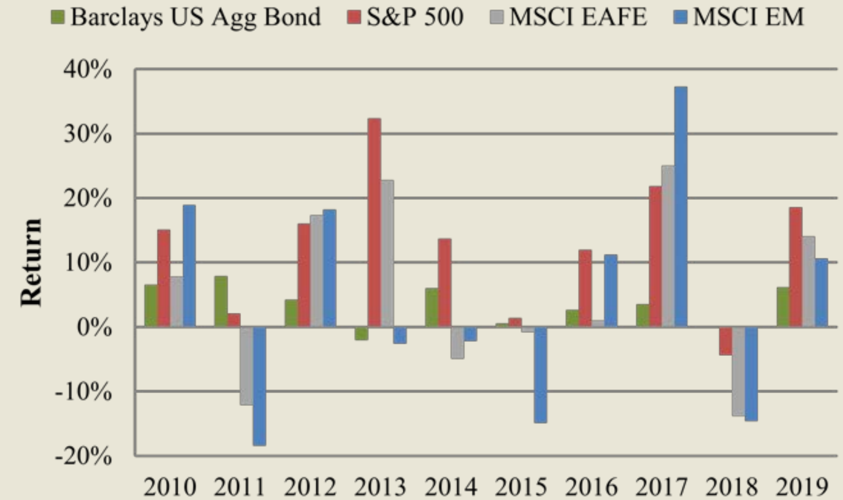
- Trade negotiations and central bank policies had the greatest impact on returns during the quarter. Equity markets mirrored the U.S./China trade narrative throughout the quarter. In April, it appeared both sides were close to an agreement and stocks rose. However, in May, markets were dismayed with an announcement that the U.S. would increase tariffs on Chinese goods and the Chinese retaliated with increases of their own. In addition, the U.S. administration threated tariffs on Mexican goods. This led to negative equity returns throughout May. But June brought a reversal of sorts, with an agreement between the U.S. and Mexico and the Fed hinting they may cut rates.
- Despite elevated economic uncertainties, equity returns have been strong globally. Falling interest rates and the potential for the Fed to cut the Fed funds rate has been cheered by equity investors.
- Economic data continues to weaken, especially in the manufacturing sectors. However, the U.S. consumer, which accounts for 2/3 of the U.S. economy, appears to be in good shape – low unemployment, rising wages and lower debt service levels. If consumer sentiment remains high, the economic cycle may extend.

U.S. Value Vs. Growth Relative Equity Performance (as of 6/30/19)

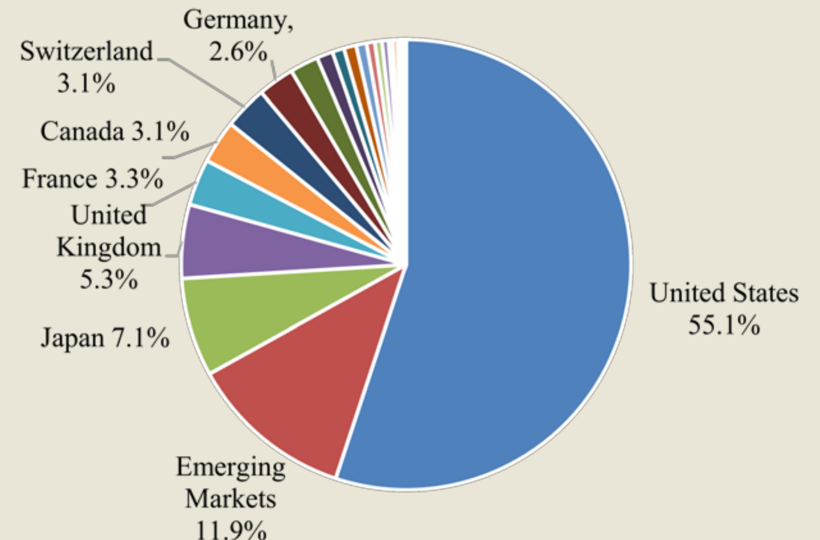


Russell 1000 Growth TR vs. Russell 1000 Value TR

Equity & Fixed Income Market Annual Returns
(as of 6/30/2019)



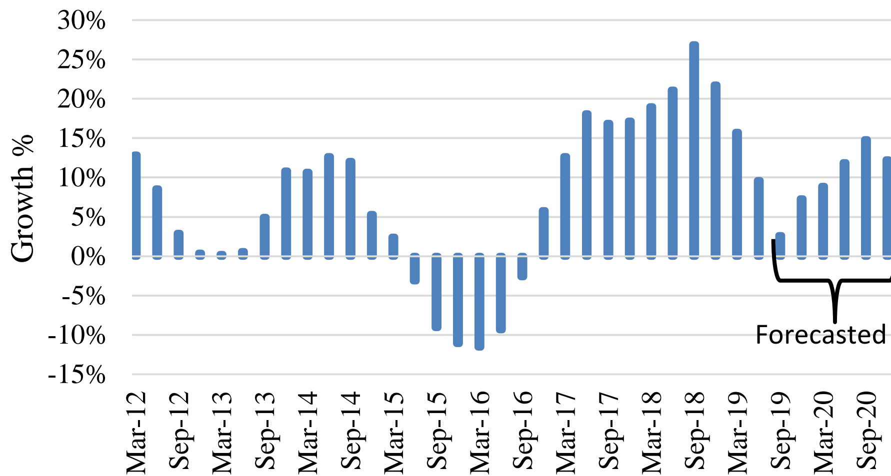
Country Weighting in MSCI ACWI
(as of 7/29/2019)

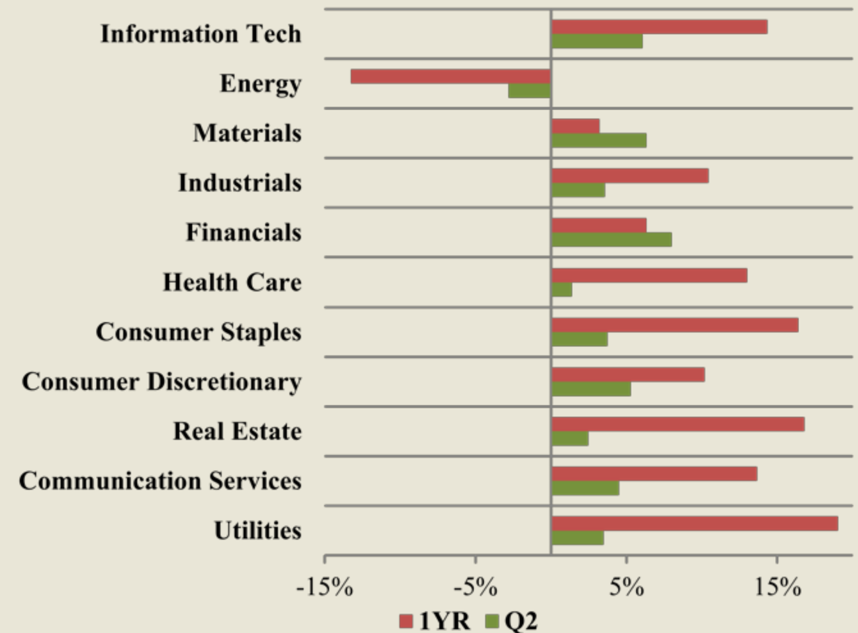


DOMESTIC EQUITIES

- The Russell 1000 Index, comprised of large and mid-capitalization stocks, posted a total return of 4.3% during the second quarter. On a year-over-year basis, the Russell 1000 Index has increased 10.0%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a total return of 2.1% during the second quarter. On a year-over-year basis, the index has decreased 3.3%.
- Corporate operating earnings in the first quarter 2018 were higher than the previous year. Estimates for 2Q and 2019 have been reduced as corporate confidence has been tempered, in part, due to China/U.S. trade discussions. However, estimates may have been downgraded too much, as the majority of companies have beaten estimates so far during the 2Q earnings season. Operating profit margins remain strong.
- U.S. equity forward P/E multiples and trailing P/E multiples are above historical averages. Multiples have been expanding in 2019 after they contracted in the late 2018 equity selloff.

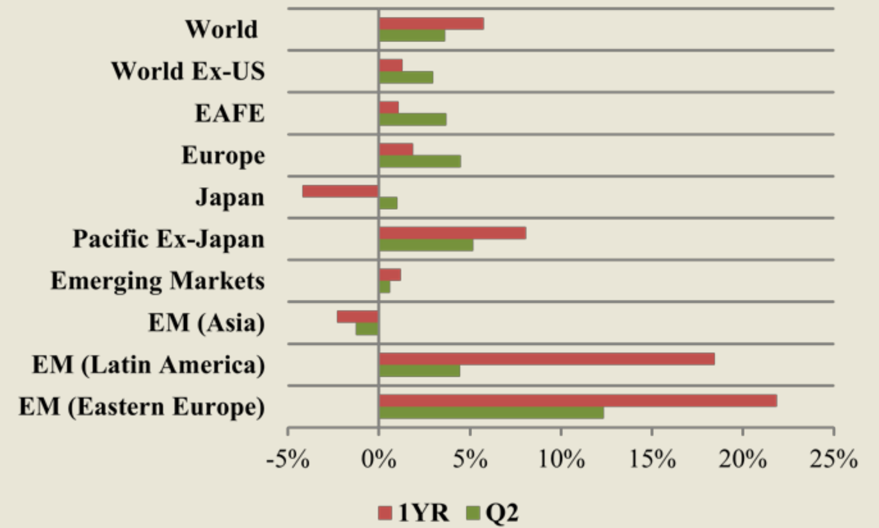
Second Quarter 2019 Returns			
	Value	Core	Growth
Mega Cap		4.2%	
Large Cap	3.8%	4.3%	4.6%
Mid Cap	3.2%	4.1%	5.4%
Small Cap	1.4%	2.1%	2.8%
Micro Cap	1.4%	0.9%	0.4%

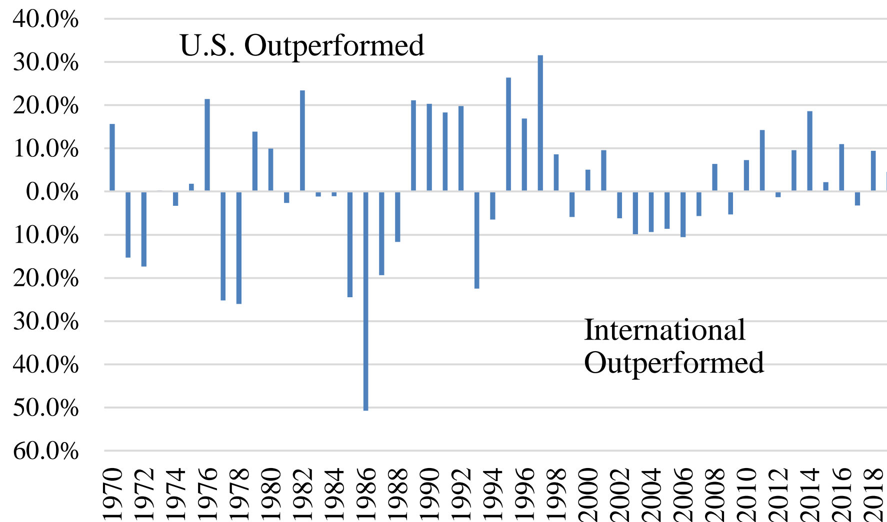




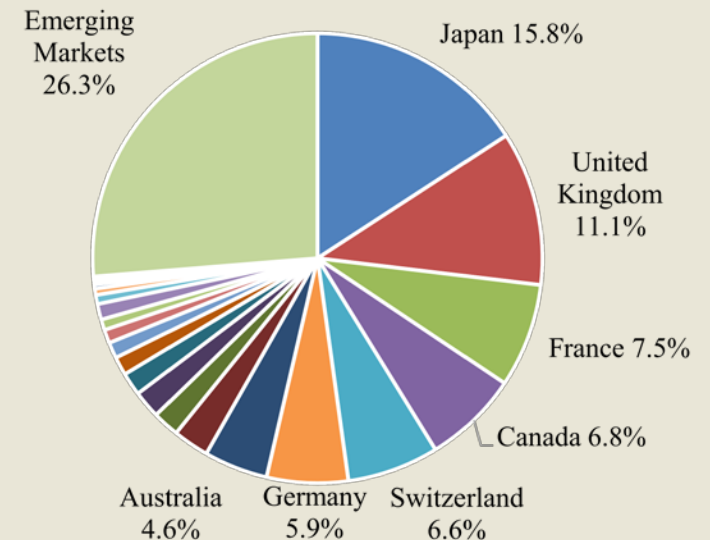
INTERNATIONAL EQUITIES

- Developed international stocks, as represented by the MSCI EAFE, were up 3.7% during the quarter. On a year-over-year basis, the EAFE is up 1.1%, performing worse than U.S. domestic equities.
- Emerging market stocks underperformed developed markets during the second quarter as the MSCI Emerging Markets Index increased only 0.6%. Many international currencies, especially those in the emerging markets, appreciated vs. the U.S. dollar during the quarter.
- Global growth has weakened especially in the manufacturing sectors as trade issues continue. Geopolitical issues continue to cloud the environment. Brexit will be a hot topic in the second half of the year with the newly elected U.K. Prime Minister, Boris Johnson, a proponent of Brexit.
- Stimulus in China has not been able to offset a weakening global economy and the impact of lower trade.





S&P 500 TR vs. MSCI EAFE NR



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