MARKET COMMENTARY **July, 2019**

Boosted by expectations for the Fed to lower rates and a temporary cease fire in the trade war, stocks posted their best first half since 1997 and best June since 1955. The S&P 500 gained 18% in the 1H 2019 and 4% in the 2Q19 on a total return basis.

New market highs are always worth cheering, but we should also keep in mind that the movement in stocks has been limited since the S&P 500 made new highs in January 2018. The last 18 months have been something of a roller coaster, with a significant correction in early 2018 followed by new highs in early October, and finally a "mini bear" market drop of almost 20% in late 2018 before the Federal Reserve made its dovish pivot. The S&P 500 made new highs again in early July almost reaching 3,000, but this level is only about 4% above the high seen in January 2018 and early October 2018. And while the market has certainly been in rally mode thus far in 2019, an ugly May correction was a reminder that stocks remain vulnerable to trade developments and dependent on a friendly Fed in a slowing economic environment.

As we look into the second half, much of course depends on some progress in our trade dispute and geopolitical standoff with China. The global economy has been struggling and this is starting to be reflected in slower growth at home. Our outlook remains constructive, continued slow but steady growth (2% - 2.5% in U.S.), low inflation and low rates with the next recession still a number of years away.

On the positive side, the Fed has turned decidedly dovish and acknowledged the weaker and more uncertain economic outlook. It recently set the stage to cut rates more than once over the balance of the year and do "whatever it takes" in order to sustain the U.S. economic expansion. This is supportive of the market and vitally important given the trade uncertainties.

Fed Policy Turns Dovish

We believe the Fed will follow through with rate cuts in the second half even if some progress is made on trade and tariffs. There are a number of compelling reasons that rate cuts are not only appropriate but necessary:

- The yield curve has inverted. The 10-year U.S. treasury is at roughly 2%, 50 basis points below the fed funds rate. An inverted yield curve is indicative of monetary policy that is too restrictive, and a prolonged inversion can be a harbinger of recession.
- The U.S. Fed Funds rate is high relative to other global central bank rates. In fact, U.S. rates could be 75 basis points lower and still be well above the competition. The ECB (0.0%) and Bank of Japan (-0.10%) remain zero bound and the German and Japanese 10-year bonds are both negative (-0.352% Bund and -0.15% JPN).

- U.S. policy makers do not want the dollar to be too strong relative to our trading partners. A relatively strong dollar over the past few years has been a headwind to U.S. trade and exports. Given the current tariff wars, a cheaper currency is particularly advantageous. All things being equal, rate cuts and easier monetary policy should weaken the dollar.
- Given trade uncertainties and a synchronized slowdown in global growth, rate cuts represent a necessary insurance policy against recessionary forces. The Fed does not want to risk getting "behind the curve". Moreover, trade tensions have by no means been resolved despite the welcome truce at the June G20 gathering.

In conclusion, we believe there is more than ample justification for rate cuts, but they also represent a low risk insurance policy against a host of challenging conditions: inverted yield curve, trade uncertainties, a slowing global economy, a strong dollar, and global central bank rates that are well below the U.S.

U.S. Recession Still Years Out

We continue to believe that the U.S. economic expansion has considerable room to run. Recessions typically occur after inflation has accelerated significantly, after the Fed has tightened aggressively (the Fed arguably over tightened in 2018, but policy has now taken a clear dovish turn), after a bubble has developed (the tech bubble of the late 1990s and the housing bubble leading up to the 2008 financial crisis), and after the yield curve has inverted for a number of months (roughly 12 months according to ISI). The most pressing current risk indicator is the inverted yield curve, which the Fed is now poised to address as discussed above.

A More Volatile Second Half

Volatility could resume in the second half of the year and gains prove more difficult to come by. If further progress is not made on trade, or the Fed does not deliver on rate cuts, growth will weaken further and recession risks increase. We think trade will improve over time and Fed policy will not disappoint, but our conviction is much higher in the latter.

The good news is that in response to slowing growth and rising trade tensions and geopolitical uncertainties, policy makers are responding around the world: China, India, the ECB, Japan, and now the U.S. are all moving to monetary and fiscal stimulus. This is positive for assets and equity markets, and a powerful offset to the trade and tariff wars.

The 2020 Election Underway: Is Capitalism under Siege

The 2020 US Presidential Race started in earnest in the last few weeks. So far, Trump appears to be the sole Republican candidate. There are over 20 Democratic candidates at this time; the process will likely ensure lots of fireworks. As we write this, it has been announced that Ross Perot passed away, reminding us that there is always the possibility of an independent candidate or a late entrant with significant funding and appeal that could potentially impact an election, although such a candidate doesn't exist at this time. We would note that party primaries and campaign rhetoric are generally not business friendly or positive influences on the market.

For the first time in our memory, there are potentially viable candidates who openly espouse socialism over capitalism. If one of these socialists were to win, it would likely have a significant impact on the market, as government involvement in every aspect of American life and business would potentially impact future growth, wealth and standard of living. Less freedom and more regulation and taxation in business and our personal lives means slower growth, less investment and innovation, lower profitability and profits, and lower asset values. The market will begin to handicap the outcome of this election as time passes. For now, the impact of the early political volleys appears to be negligible or at least not yet taken at face value.

Global Economic Outlook & S&P Earnings - June 2019 (S&P 500 @ 2,942)	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019e**
Global Real GDP Growth (y/y rate)	3.3%	3.4%	3.1%	3.0%	*3.7%*	**3.8%**	***3.4%***
U.S.	2.2	2.4	2.4	1.6	*2.3*	**2.9**	***2.0***
Euro Area	-0.4	0.8	1.5	1.8	*2.4*	**1.9**	***1.2***
Japan	1.5	0.0	0.6	1.0	*1.8*	**0.8**	***1.0***
Developing Asia	6.6	6.4	6.2	6.2	*6.4*	**6.3**	***5.9***
China	7.7	7.3	6.9	6.7	*6.8*	**6.6**	***6.1***
Latin America	2.5	1.0	-0.5	-1.2	*1.2*	**0.8**	***1.8***
Emerging Market & Developing Economies	4.7	4.6	4.2	4.1	*4.7*	**4.7**	***4.5***
S&P 500 Aggregate EPS	109	118	117	118	*131*	**162**	***166***
Earnings (y/y rate)	12.6%	8.3%	-0.8%	0.9%	11.0%	**23.7%**	***2.5%***
PE Ratio (June 2019 price @ 2,942)						**16.9**	***17.7***

Sources: IMF, ISI Group, BAML