Economic Update

A Review of Second Quarter 2019

The U.S. economy has now grown for 121 consecutive months starting in June 2009. That is the longest uninterrupted expansion in American history. The U.S. stock market has been a beneficiary of this economic growth, as the S&P 500 index increased over 110%, not including dividends, during those same 121 months. As of this writing, that index now trades at a record high. Overall household wealth has also followed suit. The total estimated value of homes, stock portfolios and bank accounts minus mortgages and debt has increased 80% during the time period.

Unfortunately, our GDP growth may now be slowing down. After growing at an annual rate of 3.1% during the first quarter of 2019, future estimates are lower. As of this writing, the St. Louis Fed expects just 1.3% growth during the second quarter. Leading economic indicators across the globe tell a similar story. Economic growth is expected to slow in most countries throughout the world.

Persistent yield curve inversion in the U.S. bond market is also troubling. The yield curve has now been inverted for over three months. While short-term inversions have been inconsistent economic predictors in the past, those that are sustained for longer periods have been worth paying attention to. In fact, per Duke economist Campbell Harvey, each of the last seven times that we experienced an inverted yield curve for more than three months, it was followed by recession during the subsequent nine to 18 months.

U.S. Economy

The most recent Chicago Purchasing Managers Index is telling a similar recession story, as it declined to 49.7 in June. Readings below 50.0 predict economic contraction. This is the first time that the survey has fallen into contraction territory since January 2017. The index reading had been 52.6 in April and 54.2 in May, and also reached as high as 64.7 just four months prior. Actual construction spending also fell in May, as investment in private construction projects dropped to its lowest level in over two years.

Major auto makers also saw new vehicle sales drop during the first half of 2019. Analysts are now expecting less than 17 million cars to be sold in the U.S. for the first year since 2014. However, it is hard to say whether this drop is due to a slowing economy or if it merely represents the end of an industry cycle. For years, auto makers have benefited from pent-up demand following the end of the financial crisis.

Jobs numbers, on the other hand, have been mixed during the past few months. It was just announced that 224,000 jobs were created during June. This follows 72,000 new jobs created in May and 216,000 created during April. The unemployment rate is now 3.7%. The tight labor market has been good for wage growth. The Federal Reserve Bank of Atlanta’s three-month moving average hourly wage for May showed a 3.7% increase from May 2018. This is consistent with readings throughout the last six months and higher than we had been seeing for most of the past decade.

Retail sales are also still healthy. May sales increased 0.5% versus April and 3.2% year-over-year versus May 2018. The year-over-year figure is down slightly from the month before, when it was 3.7%.

Inflation remains under control. As of the end of May, the Consumer Price Index for All Urban Consumers (CPI-U) was up 1.8% year-over-year. However, lower energy prices contributed to that headline number. Instead, the Fed seems to prefer focusing on the inflation rate excluding food and energy. That reading was right on target with the 2.0% annual rate for which the Fed looks.

The next Fed meeting will be held on July 31. Once again, there seems to be a genuine disconnect between what the Fed expects to do over the next six months and what the market expects them to do. As of this writing, the market is factoring in a 98% chance for a 25 basis point cut at that meeting, followed by multiple additional rate cuts throughout the remainder of the year. However, based on the Fed's last guidance from just a few weeks ago, they collectively expect to make just one 25 basis point cut total over the next six months. There could potentially be market volatility ahead if the market does not get what it wants.

International Economy

Ongoing uncertainty concerning global trade has resulted in weak manufacturing purchasing managers surveys throughout the world. In addition to the aforementioned Chicago PMI in the U.S., manufacturing PMI for Japan, China, South Korea and the Euro area were also in contraction territory during June. Additionally, Japan's Tankan confidence index has now dropped to a three-year low.

U.S./China trade negotiations have been rocky over the last three months. First, there was optimism at the beginning of the quarter, followed by pessimism as the U.S. accused China of reneging on previously made promises and threatened another round of tariffs, followed by optimism once again as Presidents Trump and Xi Jinping agreed to a tariff truce during the G20 Summit. Global businesses remain skeptical, however. For instance, Bank of America Merrill Lynch warns that this current reprieve is likely temporary, saying that the truce is just the "eye of the storm" and that trade troubles should continue through the rest of 2019 if not beyond.

Trade negotiations with the EU are contentious as well. In two separate announcements during the second quarter, the U.S. revealed additional proposed tariffs on $25 billion of EU exports in response to a dispute over aircraft subsidies. The European Central Bank has taken notice. Goldman Sachs predicts that the ECB will lower its deposit rate by 20 basis points and restart quantitative easing in September.

If Goldman Sachs is correct about the ECB and quantitative easing, it could give a boost to international markets, which have substantially underperformed the U.S. during recent years.

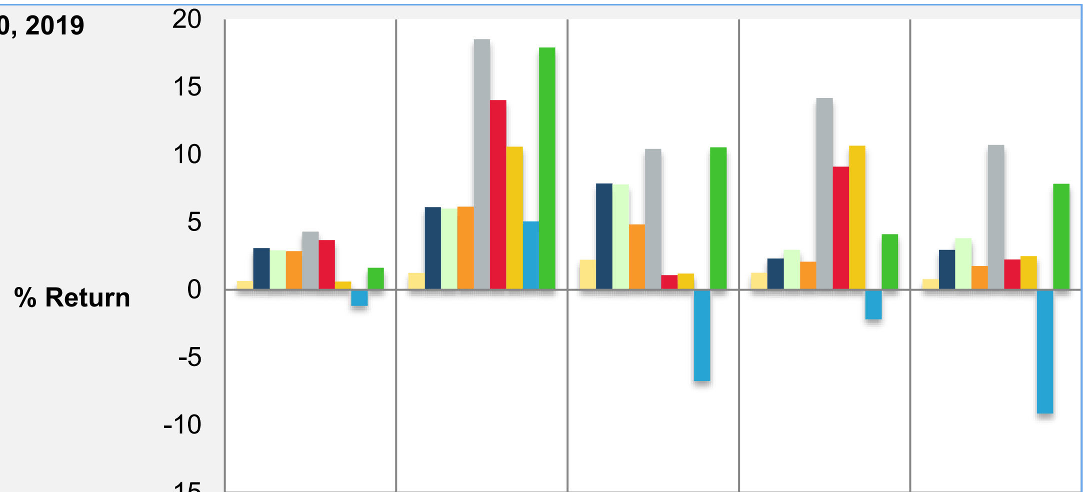
Markets

The second quarter of 2019 was a little choppy but ultimately good for most markets throughout the world. U.S. large-cap equities, as represented by the S&P 500 Index, gained 4.3% for the quarter and are now up 18.54% year-to-date. This represents the best first half of the year for the U.S. stock market in over 20 years. Developed international equity markets, as represented by the MSCI EAFE Index, finished the quarter up 3.68% and the first two quarters up a total of 14.03%.

Emerging markets generally failed to keep up with developed markets as U.S./China relations soured. The MSCI Emerging Markets finished the quarter up just 0.61%. They are up 10.58% year-to-date. Alternatives such as commodities and real estate were mixed. The Dow Jones UBS Commodity Index lost 1.19% for the quarter. The Wilshire REIT Index was up 1.63% during the period. For the year, the two indexes are up 5.06 and 17.92% respectively.

Lower interest rates throughout the world allowed bonds to flourish. All of the benchmarks that we track had comparable returns during the quarter and for the year thus far. The Barclays U.S. Aggregate Bond Index gained 3.08% for the quarter and is up 6.11% for the year. The Barclays U.S. Inflation-Linked Bond gained 2.86% for the quarter and is up 6.15% for the year. The Barclays Global Aggregate Bond Index gained 2.92% during the quarter and is up 6.0% for the year.

Through June 30, 2019



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.65	1.25	2.22	1.26	0.79
Barclays US Agg Bond Index	3.08	6.11	7.87	2.31	2.95
Barclays Global Agg Bond Index	2.92	6.00	7.80	2.95	3.82
Barclays US Infl Linked Bond Index	2.86	6.15	4.84	2.08	1.76
S&P 500 Index	4.30	18.54	10.42	14.19	10.71
MSCI EAFE Index	3.68	14.03	1.08	9.11	2.25
MSCI Emerging Markets Index	0.61	10.58	1.21	10.66	2.49
DJ UBS Commodity Index	-1.19	5.06	-6.75	-2.18	-9.15
Wilshire REIT Index	1.63	17.92	10.53	4.11	7.84

Source: Morningstar. Past performance does not guarantee future results. An investment cannot be made directly in an index.

(Refer to the end for index definitions.)

Outlook

The U.S. market continues to register all-time highs while data seems to be weakening. This makes us a little more cautious than we had been previously. While the potential for upcoming Fed rate cuts would be supportive, market expectations are high and the Fed generally seems to move more deliberately than the market wants. It is easy to imagine a situation where the stock market does not get as many rate cuts as it expects over the upcoming six months and reacts negatively.

International stocks still look relatively attractive as compared to the U.S., but caution is warranted here as well if the U.S./China trade negotiations linger for as long as Bank of America Merrill Lynch predicts. On the other hand, a more accommodative ECB could provide significant international stock support.

Longer duration fixed income continues to look unattractive right now due to the state of the yield curve. Cash, stable value and short duration bonds are good fixed income alternatives in the meantime.

On a more positive note, markets as a whole do not necessarily look overvalued given that we appear to still be in an indefinite low interest rate period. So equities could very well still continue to climb from here. As a result, we do not advocate making substantial allocation changes. Rather, this could be a good time to review your portfolio and potentially take some gains if it has recently become overweight to equities as a result of the strong market performance during the first half of the year.

Barclays US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Barclays Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized subindices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Barclays Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

DJ UBS Commodity Index: Dow Jones-UBS Commodity Index^{SM} and Dow Jones-UBS Commodity Index Total Return^{SM} The DJ-UBSCI^{SM} family includes both the DJ-UBSCI^{SM}, which is calculated on an excess-return basis, and the DJ-UBSCITR^{SM}, a total return index based on the DJ-UBSCI^{SM}. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.