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SECOND QUARTER OF 2019: MARKET REVIEW & OUTLOOK

After an explosive upward move in the first quarter, the second quarter of 2019 produced positive but more moderate performance. The S&P 500 rose by 4.3% while U.S. small and mid-cap stocks continued to lag. The developed international index rose by 2.7% and the emerging markets index was flat. The best performing sectors had a cyclical flavor with Materials, Technology and Financials leading the way. The worst performing sectors were Energy and Health Care. Crude oil prices fell by 2.1%, broad commodities fell by 1.1% and gold rose by nearly 9% to its highest price per ounce in six years. Bonds were another stand-out performer rising 2.9% as the Federal Reserve suggested that the beginning of an interest rate cutting cycle was imminent during the June FOMC meeting.

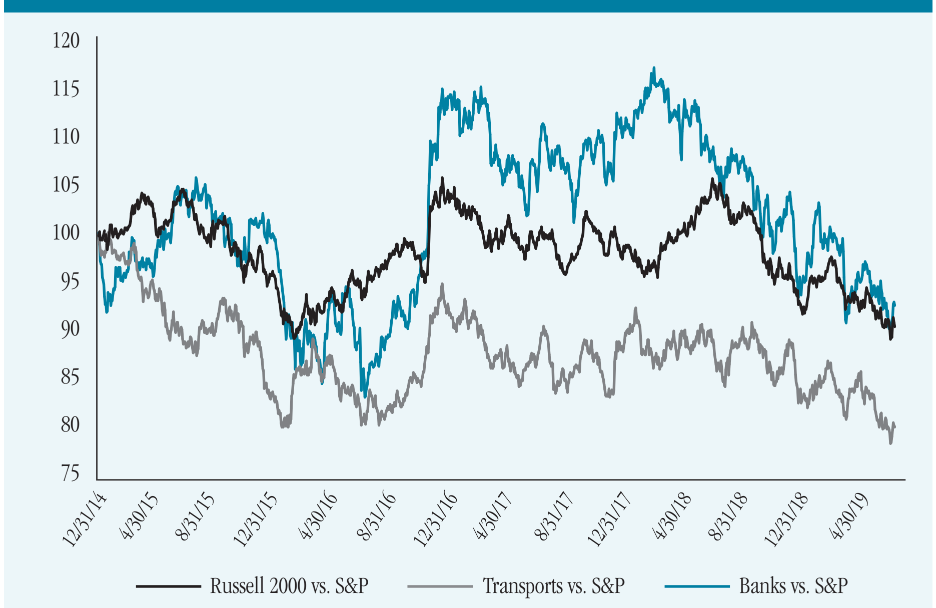
For the first half of 2019, performance figures remain impressive with the S&P 500 up 18.4%, developed international stocks up 14.4%, and emerging markets up 10.6%. The best performing sectors this year have been Technology, Consumer Discretionary and Industrials. The worst performing sectors have been Health Care and Energy. The broad bond index rose nearly 6%. Crude oil prices have risen 27.5% for the year while broad commodities and gold prices are up 5.7% and 9.7%, respectively. The U.S. dollar has risen by 1.6% against a trade-weighted basket of global currencies. Balanced portfolios just had one of their best performing six-month periods in history.

In recent weeks, we've seen gold and bond prices make new, recent highs alongside the S&P 500. This is a highly unusual occurrence. Despite strong performance for the broad market, several sectors that are typically indicators of the health of the economy are struggling. Small-cap, banking and transportation stocks have all recently hit fresh 52-week lows relative to the S&P 500. This is atypical behavior, especially when all three are weak at the same time. It is quite rare to have the broad equity market at new all-time highs with small-caps 10% lower.

CHINESE CHESS:

The economy in early May was encouraging for President Trump. The President's approval ratings had never been higher, particularly amongst his Republican base. The jobs report released on May 3rd indicated that the economy added 263,000 new hires, beating analysts' expectations. The unemployment rate

Three Blemishes - Small-Caps, Banks & Transportation Stocks All Underperforming



Source: Strategas Research Partners

fell to 3.6%, the lowest since December 1969. First-quarter GDP grew at 3.2%. The major U.S. stock indexes enjoyed their best four-month start to a year since 1999.

This positive sentiment likely provided Trump the confidence to pivot from his successful pro-growth policies to the more controversial parts of his agenda - immigration, tariffs and potential anti-trust action against technology companies. In early May, Trump tweeted that the Chinese had reneged on critical provisions within the trade agreement, that any deal was off and that he intended to raise existing tariffs to 25% and impose new ones. In a bold and surprising move on immigration policy, Trump threatened to escalate tariffs on Mexico in early June. Finally, we learned that the Department of Justice is launching an official probe of Google. The Federal Trade Commission may focus on Facebook and Amazon.

The Trump administration certainly appears to become more pugnacious on trade negotiations as equity markets rise. One explanation is that Trump's approval ratings rise when he is more aggressive with China. The second is likely because he believes that strong markets give him an upper hand in negotiations relative to the domestic Chinese equity market which has performed poorly over the last few years as the PBOC has intentionally slowed its economy.

There was no trade deal struck last weekend at the G20 in Japan though the two parties agreed to restart negotiations. Our base case scenario for the outcome of the meeting played out. Going into the weekend, we believed that both parties would make positive comments upon exiting the meeting, that no common statement would be published, and that no material progress would be achieved on core trade issues. We believe that Trump will implement the remaining 25% tariff tranche quickly if a deal fails to materialize.

While President Trump and Premiere Xi have starkly opposing goals, there is one outcome that they both desire. Both countries would benefit from a material move lower in the Federal Funds rate before any deal is finalized. China needs a lower U.S. dollar to finance its incremental trade deficit while Trump needs a lower dollar to boost the prospects of multi-national companies and keep the economy going into 2020 elections.

TRUMP VERSUS POWELL: RATE WARS

Many argue that Trump's repeated public criticism of the Fed makes it more difficult for Fed Chairman Powell to do what Trump wants (cut interest rates) to preserve the image of the Federal Reserve as an independent institution. Because no president has ever tried to fire a Fed chair who was unwilling to resign, there is no precedent to serve as a guidepost for whether the protection from arbitrary firing extends to the role of board chair.

Trump knows that his reelection odds are heavily correlated to the performance of the American economy and jobs in particular. The president is using Powell as a scapegoat to deflect political attacks on his handling of the economy. Many speculate that Trump is escalating the trade risk uncertainty to force the Fed to lower interest rates knowing that he can undo trade tariffs faster than the Fed can raise interest rates. Many also believe that the Fed will be reluctant to raise interest rates immediately after having cut and could feel political pressure to keep interest rates flat heading into the 2020 election to avoid the perception of political interference.

While Trump likely cannot fire Powell, Powell can indirectly fire Trump by raising interest rates over the next year and slowing the economy into the 2020 elections. This is unlikely to happen, but it is possible.

READING OUR CRYSTAL BALL:

During the first half of 2019, there has been a nearly perfect inverse correlation between economic fundamentals and the S&P 500 index's performance as a bounce back from the December 2018 lows combined with policy optimism outweighed slow global growth. The investor narrative suggests that the U.S. economy has peaked and is approaching a recession, that there is no threat of inflation and that the Federal Reserve has no choice but to cut interest rates in an aggressive fashion to extend the business cycle. As a case in point, we note the markets' euphoric response to the poor May 2019 jobs report. Bad news is good news again. From our perspective, it is difficult to imagine the Fed aggressively cutting rates with unemployment so low, cryptic inflation readings, a strong U.S. consumer, a benign credit market and stocks at all-time highs. Today there are 100% odds in the futures market of a Fed rate cut in July. Anytime that the odds are this asymmetric, there is bound to be disappointment.

There is an epic disconnect between the message being sent by U.S. equities, which are close to all-time highs, and the performance of the bond market, which is suggesting that growth has ceased, and a recession may be imminent. Stocks are hoping that the Fed has the desire and ability to cut interest rates aggressively in order to head off a recession, while bonds are reacting both to the promise of a return to accommodative policy and the economic weakness which necessitated the dovish pivot in the first place. Either stocks need to fall, or bond yields need to rise. The two markets could ultimately meet in the middle, with stocks retreating from near record highs to reflect legitimate concerns about the global economy and bond yields rising a bit in a begrudging acknowledgement that the decline in rates has run too far, too fast.

On the other hand, if interest rates are low in part because bond investors expect a reset of monetary policy, rather than due to economic anxiety, then it is perfectly natural for equity markets to remain well supported, if the Fed delivers the rate cuts that investors are expecting. This is the critical point. Historically, it is common for equities and bonds to rally together after dovish Fed shifts in policy.

Nearly every leading economic indicator reported over the last two months has declined and missed expectations. The Global Economic Surprise Index is at a six-year low. The U.S. Economic Surprise Index is at fresh new lows. Bank of America's most recent global fund manager survey showed respondents are the most negative on the global economy since the Global Financial Crisis in 2008 and 2009. A record percentage of survey participants think that the global economy is late cycle. Euphoria amongst investors, one of the key markers of a pending sell off, is nowhere to be found. Institutional and retail investors alike are not buying into this rally. Again, is sentiment so bad that it is actually good?

We expect the coming earnings season to be full of misses. We are also set to have a much lower U.S. GDP report for the second quarter. Once we get through a difficult summer of weakening fundamentals, we can reassess the situation. Today, we do not believe that a recession is imminent unless we start to see weekly jobless claims accelerate and the Federal Reserve disappoints investors by cutting interest rates much more gradually than is currently expected.

The back half of 2019 should make for one of the most interesting market environments in recent memory given heightened political fervor, a historic economic negotiation by two world superpowers, melting economic fundamentals, and an increasingly dovish group of central banks around the world. Can monetary policy and politics overcome deteriorating economic fundamentals? Will there be a catalyst that turns global growth higher? No one has all of the answers. In this tenuous period, our portfolios are positioned defensively with cash on the sidelines and exposure to high quality, less economically sensitive sectors and companies.

MARKET DATA

Index		*YTD 2019*	*2018*	*2017*	*2016*
S&P 500	*U.S. Large-Capitalization Stocks*	18.54%	-4.83%	21.83%	11.95%
S&P 400	*U.S. Mid-Cap Stocks*	17.97%	-11.08%	16.24%	20.73%
S&P 600	*U.S. Small-Cap Stocks*	13.69%	-8.48%	13.23%	26.46%
Russell 1000	*U.S. Large- and Mid-Cap*	18.84%	-4.78%	21.69%	12.04%
Russell 1000 Growth	*Growth Stocks broken out*	21.49%	-1.51%	30.21%	7.07%
Russell 1000 Value	*Value Stocks broken out*	16.24%	-8.27%	13.66%	17.33%
MSCI EAFE Index	*Established International Markets*	14.49%	-13.36%	25.62%	1.59%
MSCI Emerging Markets	*Developing International Markets*	10.69%	-14.25%	37.75%	11.27%
		6/30/19	12/31/18	12/31/17	12/31/16
90 day T-Bill	*Short-Term Interest Rate*	2.12%	2.45%	1.39%	0.51%
10 Year US Treasury Rate	*Longer-Term Interest Rate*	2.00%	2.65%	2.43%	2.45%
VIX Index	*Risk Measurement*	15	25.4	11.0	14.0

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