Investment Commentary

July 16, 2019

2nd Quarter Recap

Stocks continued to move up during the 2nd quarter on hopes the Federal Reserve will lower rates at their next meeting July 30-31. The stock market is currently near an all-time high.

Interest rates moved down during the 2nd quarter. The 10 year U.S. Treasury Note started the quarter at a rate of 2.50% and dropped below 2.00% on a few occasions. The current rate is 2.05%. Short term rates on bank savings accounts and certificates of deposit have also started to move down, ahead of potential rate decreases by the Fed.

The Current Economic and Investment Environment

The economy continues to grow, although at a slower pace. The last jobs report (July 5th) was good with 224,000 new jobs created and an unemployment rate of 3.7%.

The end of June marked the 10th anniversary of the current U.S. economic expansion, matching the longest on record. While this has been a long expansion, the pace of growth has been more modest than most. The growth rate for the last 10 years has been 2.3%, the lowest pace of the last 10 expansions.

Recessions often begin with an overheated economy and the Fed raises rates to curb growth due to inflation fears. That is not the case today so it is likely the current expansion will continue for a period of time.

Corporate Profits

The current earnings season is likely to reflect decent corporate profits although lower than previous quarters. The second half of the year could result in more volatility in corporate profits due to the uncertainty created by trade issues and slowing global growth.

Trade Issues
A resolution of the trade issues with China do not appear to be in sight anytime soon. China's economy is beginning to suffer and growth has reached a 27 year low due to trade tensions along with problems in the financial system.

In the U.S. certain industries have experienced setbacks due to trade tensions but so far, there has not been a noticeable effect on the overall economy. Supply chains are adjusting and manufacturing has moved to other Asian countries, noticeably Vietnam. The intended effect of using tariffs to bring manufacturing back to the U.S. has not happened and will not happen. Global supply chains have a way of circumventing government actions.

But ultimately, trade tensions will have a detrimental effect on the economy if not resolved in the near term.

Student Loan Debt
American families are carrying about $1.6 trillion in student loan debt, an amount that equals about 8% of national income. And since the mid-2000s that amount is nearly double. This debt burden has a negative effect on the overall economy and could be a reason why economic growth is slower than past expansions. Here are the ways the economy is affected:

- Student debt is delaying marriage and family formation – This is a very important catalyst of economic growth.
- The growth of small business is being hampered – Small business is responsible for 60% of employment in the U.S.
- Home purchases are being delayed - Lack of a down payment and reduced credit scores make mortgages harder to qualify for.
- Student debt reduces the ability to weather a financial crisis
- Those with student debt are unable to save much for retirement

Student loan debt is starting to have an effect on the economy and could be a cause of the current slow growth.

Pension Plans
A number of multi-employer pension plans (plans created by collective bargaining agreements) are running out of money. Legislation is before Congress to resolve the issue but it remains to be seen what will eventually pass. The Pension Benefit

Guarantee Corporation (PBGC) is on track to run out of funds by 2025 if something is not done.

This is another issue that will begin to have a detrimental effect on the economy at some point.

Retirement Legislation
The House recently passed retirement legislation and it has now gone to the Senate. Two of the provisions are as follows:

- Beginning in 2020, the age at which required minimum distributions (RMD) start is 72 rather than 70 1/2.
- Inherited IRAs can no longer be "stretched". Upon the death of an IRA owner, for beneficiaries other than a surviving spouse, the IRA must be completely distributed in 10 years.

This legislation is likely to pass the Senate in some form over the next few months.

Recession Watch
A recession does not appear to be imminent and the slow growth environment could certainly continue well into next year and possibly into 2021. The economy is simply too strong and the employment picture too favorable to see a downturn in the economy anytime soon. And the Fed is at the end of the cycle of rate increases and will likely begin to lower rates. This could have the effect of keeping the economy propped up for the foreseeable future.

Review of Asset Classes

Domestic Stocks
Year to date the overall stock market is up 18.7%, nearly erasing the 20% drop late last year. After such a strong move up gains will likely be more modest for the remainder of the year.

Growth stocks continue to outperform value stocks as investors are willing to "pay up" for growth. A big part of the growth sector consists of "big tech" such as Apple, Amazon, Alphabet (Google) and Facebook. Those types of companies are currently experiencing some backlash due to privacy concerns, possible antitrust investigations and calls from politicians to break them up. This appears to be nothing more than political posturing and very little is likely to happen that will effect the stock prices of these companies over time.

Stock Sectors
Here are some stock sectors to watch:

- Energy – This sector has performed poorly over the past year but is compelling from a valuation standpoint. Company insiders are buying in record amounts which is a good sign. Performance will likely improve over the next few months.
- Health Care – This sector is undervalued but performance has not been good for the last few years. It is compelling from a valuation standpoint but the political environment continues to place downward pressure on stock prices. Potential changes to the healthcare system and the current discussion of high drug prices are preventing upward movement in this sector.
- Utilities – This sector performs well in a down market, something we saw last December. However, this sector is overbought and valuations are not compelling.

International Stocks
If the Fed lowers rates the U.S. Dollar will likely move down against other currencies. This will provide a boost to the investment returns of international stocks for U.S. investors. Otherwise, there does not appear to be much upside for international stocks overall as compared to the U.S stock market. In a few months we will see the economic effects of a "hard Brexit" as the UK leaves the European Union without an agreement in place.

Investment Grade Bonds
Bonds have provided a decent return for the first half of the year as interest rates have moved down. But going forward, over the next several months, investment returns are likely to be in a range of 2.0% to 2.5% for investment grade bonds. And interest rates are not likely to move up anytime soon.

Credit quality is becoming more of a concern now due to slower economic growth and as we get closer to the end of the current economic cycle. Lower rated bonds with higher yields will come under stress during the next economic downturn.

Going Forward
Unless there is an unexpected shock the financial markets are likely to provide a modestly positive return over the next several months. But there do not appear to be many catalysts to create a significant move up with the possible exception of interest rate reductions by the Fed.