Financial Advisory Service, Inc.

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FAS Monthly Economic & Market Update

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As of May 31, 2019

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Economic Conditions

The purchasing managers' index (PMI) is an index driven by a monthly survey of supply chain managers of major economies that gauges current and future business conditions for companies, investors and economists. The index reading falls between 0 and 100 – a number below 50 indicates a contracting environment while a number above 50 indicates an expanding one. PMI is considered a leading indicator of economic conditions. Through the end of 2018 all developed markets' and most emerging markets' PMI readings were above 50, indicating a growing global economy and was confirmed by the JP Morgan Global Manufacturing PMI which is essentially the same indicator on a global scale. As of the latest May reading about half of global economies are in contraction territory including the Euro area, Korea, Taiwan and Germany, the third largest global exporter, with the lowest reading. US PMI was at its lowest level since 2009 at 50.5 – still in expansion territory, but trending downward. The JP Morgan Global PMI reading came in at 49.8 – its lowest reading since 2012 which indicated global manufacturing deteriorated into contraction. PMI is just one indicator and by no means does this necessarily correlate to a global recession, but it could have an effect on the Fed's decision making when it comes to interest rates in 2019. The bond market is currently pricing in between two and three rate *cuts* (not hikes) before year-end. It's something to monitor and keep in mind as we head into the second half of the year.

Market Conditions

After the S&P 500 hit a record high on April 30 the markets were quickly spooked by the three main culprits that caused the decline in late 2018 – trade tensions, Fed policy, and economic growth/earnings – and trended down the rest of the month. The S&P and Dow ended the month down just over 6.5% and the NASDAQ down nearly 8%. Bond yields plummeted with the US ten-year treasury yield falling 37 bps from 2.51% to 2.41%.

Index Returns	May '19	YTD
S&P 500	(6.58%)	9.78%
DJIA	(6.69%)	6.38%
NASDAQ	(7.93%)	12.33%
MSCI EAFE	(5.42%)	5.67%
Barclays Aggregate	1.44%	4.80%

The 10-year – 2-year treasury yield spread shrunk to 14 bps – its lowest level since Dec 2018 giving investors increased fear of an inverted yield curve. The Barclays US Bond Aggregate rose 1.4% in May and is up almost 5% for the year. Consumer spending rose in April, albeit at a slower pace, which is a positive sign as consumption drives nearly 70% of GDP. While headlines suggest that tariffs could increase prices for consumers, we haven't seen it take effect just yet as the cost of goods declined 0.5% in April year-over-year. If tariffs remain in place it could weaken the Yuan making the US dollar stronger relative to its Chinese counterpart, keeping a lid on prices. And in the age of Amazon and muted retail prices it could be a while before the US consumer begins to notice significant price increases on their televisions and clothes, which is another positive for consumer spending, the largest contributor to GDP, and for the markets.

Value Investing Is Not Dead

There was an article written recently in Barron's titled *Why Value Investing is Broken*. The author stated his case as to why he believes that undervalued stocks aren't rebounding like they have in past decades, mainly due to the fact that tech stocks have overtaken the market once again as they did in the late 90s but that "this time it's different." E-commerce and digital advertising drive the majority of revenue for behemoth companies like Amazon, Facebook and Google, yet still have a small share of their global market (even though digital advertising spend is expected to account for two-thirds of all US ad spending by 2023, according to eMarketer). Yes, while Amazon accounts for nearly half of all online retail sales they still only account for about 5% of all retail sales so there is quite a bit of room to take more market share. However the idea that value investing – investing with the mindset of carrying little debt, using fundamental analysis when analyzing stocks, having a buy and hold mentality, and most importantly maintaining diversification – is failing investors is a bold stretch.

Over the last decade since the financial crisis, with interest rates hitting rock bottom, growth stocks have handedly outperformed value stocks; and not by a small margin. Over the past decade the Russell 1000 Growth index has delivered about 3.25% of annual outperformance compared to the Russell 1000 Value index. The gap is wider over the last five years and even wider over the last three. But does

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ten years of data over the course of a centuries old market mean value investing is dead?

Growth stocks tend to have higher valuations than value stocks meaning, in short, they have a higher price-to-earnings (P/E) ratio. It essentially means that investors are willing to pay more (P) for $1 of earnings (E) expected to come in the future. As interest rates decline growth stocks tend to fair better as their future expected cash flows are over exaggerated when discounted back into today's dollars using lower interest rates. Additionally, when debt is cheap it helps fuel the growth companies may not otherwise experience if their debt service was higher, which is part of the reason why the market sold off late last year when the Fed indicated it would continue on its interest rate hiking plan. They quickly reversed course and more recently noted they would do what needed to be done should global growth begin to falter.

During the selloff in Q4 2018 the S&P was down just under 20% from its late September high. Each of the FANG stocks (Facebook, Amazon, Netflix and Google) with the exception of Google was down more than 20%. From September to December 24, Amazon fell by 34%, Netflix by 38%, Facebook by 26% and Google by 18% – although Google reached a high earlier in July last year and was down 23% from there. Facebook had issues of its own and was down over 40% from its July high. We are not at all

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saying these companies haven't been great buys over the last decade, because they have, and if you avoided them you most likely got left far behind in the recovery. We are also not saying these are bad companies. All four of these companies are engrained in the lives of nearly every US consumer. What we are saying is that now is not the time to abandon value investing and chase returns. Netflix burned through half a billion in cash in just the first quarter this year. Facebook is currently facing legal issues regarding security and the Department of Justice and Federal Trade Commission are setting their sights on Google and Amazon. These companies may seem impervious, but they do face significant headwinds in the midst of a fragile market environment.

Value investing is not just buying cheap stocks. There are countless stocks that are cheap for a reason – they are failing companies. Value investing is buying sound companies with solid cash flow, growing earnings, and a competitive advantage over its peers. There is a place for growth and value in a diversified portfolio because we want to participate in the upside when times are great. But we must be prepared for the downside if and when the time comes, especially as we continue through what is going to become the longest economic expansion in post-WWII history. Past performance is not indicative of future returns but there's one saying that has an almost perfect failure rate – "This time it's different."

Disclosures & Index Definitions

Under style performance boxes, indexes referenced in the equities section for large, mid and small reference the Russell 1000, Russell MidCap and Russell 2000 stock indices, respectively. The Barclays US Government, Barclays Credit and Barclays High Yield fixed income indices refer to Gov't, Corp, and HY, respectively. Short, Intermediate and Long refer to the time frame of the investments and their positions on the yield curve.

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Investments in bonds will be subject to credit risk, market risk and interest rate risk. Interest rates will have an inverse effect on prices of bonds. Bonds of lower credit ratings, also known as High Yield bonds which hold a rating of less than investment grade (BB+ and below), will have greater risks attached than will those of investment grade bonds and will experience greater volatility.

All dates are as of May 31, 2019 unless stated otherwise.

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Index Definitions

The **S&P 500 Index** is based on the market capitalizations of 500 large companies whose stocks are listed on the NYSE and NASDAQ. This is widely regarded as the single best gauge of large cap US Equities.

The **Dow Jones Industrial Average** is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials. It is used as a barometer of how shares if the largest US companies are performing.

The **NASDAQ** is a market capitalization weighted index of the more than 3000 common equities listed on the NASDAQ Stock Exchange. These securities include American Depository Receipts, common stocks, real estate investment trusts, and tracking stocks.

The **MSCI EAFE (Europe, Australasia, Far East) Net Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America, Europe, Australia, and the Far East.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 822 countries, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **Barclays US Aggregate Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS, ABS, and CMBS.

All index information has been gathered from public sources who are assumed to be reliable, although we cannot guarantee the accuracy or completeness of those public sources.