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Second Quarter 2019

Resiliently Complacent

Just as volatility seemed to be dissipating throughout the first quarter it quickly returned in the second quarter. Uncertainty regarding US-China trade relations, future Federal Reserve interest rate policy, and the state of the US and global economies caused a more-than 6% pullback in the S&P 500 during May. Stocks broadly recovered in June and finished the quarter near all-time highs.

In sharp contrast to the quiet, steady gains of the first quarter, stock market performance in Q2 was one marked by extremes. The S&P 500 logged a 4% gain in April thanks to solid first quarter corporate earnings reports which further reduced concerns we discussed in previous updates that earnings growth had peaked in 2018. Additionally, due in part to statistics that showed inflation well below the Fed's target, investors' expectations for a 2019 Fed interest rate cut rose in April which added fuel to the bullish fire. The S&P 500 ended April near new all-time highs.

The threat of additional tariffs on China at the beginning of May led to the initial weakness. The US actually followed through on the threats on May 10 and increased tariffs on more Chinese goods. China retaliated by hiking tariffs on $60 Billion of US goods. The US then increased tension by banning US companies from doing business with Huawei, a giant telecommunications company in China. In addition, these trade tensions caused large pullbacks in US tech stocks; many of whom do business in and with China. The month ended with President Trump threatening to apply tariffs to Mexican goods if they didn't stop the migrant flow at the Southern border. All this added up to a very bad month of May for markets.

Following the record high and subsequent pullback, the S&P 500 returned 3.79% in the second quarter and is now up 17.35% year-to-date. The NASDAQ was hit the worst in the May pullback, falling nearly 8%, but came back strong and outperformed other major indexes in June to end the quarter up 3.58% and is now up nearly 21% on the year. The Dow Jones lagged most major indexes returning 2.59% in Q2 and is up 14% in 2019. In a reversal from Q1 when small caps outperformed, large cap stocks again showed their resilience and outperformed small caps as they tend to offer more downside protection in a slowing economy. Additionally, if a trade deal is not worked out, small cap companies could feel the pain more than large caps as higher input costs from foreign suppliers could squeeze their already tight margins.

International markets were positive for the quarter, fueled by the anticipation of further stimulus from the European Central Bank, but international stocks once again underperformed domestic stocks. A strong dollar weighed heavily on emerging markets until late quarter weakening helped give the index a boost, though it still ended the quarter down 0.31%. The MSCI EAFE returned 2.5% and is up 11.77% year-to-date.

In the fixed income markets, the 10-year treasury yield fell another 40 basis points (0.40%) after already being down 30 basis points in Q1, falling to the crucial psychological yield of 2%. The expectation of no rate hikes and instead rate CUTS, as well as fears of a slowing economy, led longer-dated bonds to outperform shorter-dated bonds. As rates fall bond prices increase and the longer the duration on the bond, the greater the increase in price for the same drop in yields. Additionally, as confidence in the economy begins to fall, rates tend to follow which means that investors are more willing to lock themselves into higher yielding, long-term rates to help weather the pain of a potential slowdown. The Barclays US Bond Aggregate was up 2.98% for the quarter and is up over 6% for the year.

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As we move into the second half of the year with all three major indexes at all-time highs and consumer confidence at almost two-year lows it reminds us again to not get complacent in these types of market environments.

Reductions in interest rates by the Federal Reserve, while welcome, are not a panacea for the US and global economies. And as we start the third quarter, we face macroeconomic uncertainty on multiple fronts.

First, the US-China trade situation remains delicate and very uncertain. Until there is a final agreement on a new US-China trade pact, lack of clarity will act as a headwind on economic growth and likely create temporary periods of volatility like we experienced in the second quarter.

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Looking at the global economy, growth metrics underwhelmed in Q2, although the impact on global stocks was muted by rising market expectations of more stimulus from global central banks, including the Fed. However, if we see further deterioration in global and US economic indicators, that will also likely be a source of elevated volatility across markets.

Additionally, there are several unsettled geopolitical situations that must be monitored including Brexit (the deadline is October 31), North Korea (relations are still unsettled despite the recent Trump/Kim meeting) and Iran (the chances of a US-Iran military conflict are as high as they've been in years).

2019 Performance Figures

	2nd Qtr.	2019
DJIA (Dow)	2.59%	14.03%
S&P 500	3.79%	17.35%
NASDAQ COMP	3.58%	20.66%
MSCI EAFE	2.50%	11.77%
Russell 2000 Small Cap	1.79%	16.17%
Barclays US Aggregate Bond Index	2.98%	6.11%
MSCI World All Cap	3.35%	15.63%

Finally, while the Federal Reserve has signaled it will begin to reduce interest rates in the coming months, the situation remains very fluid and the Fed could cause short-term volatility in the markets if it does not meet market expectations by cutting rates.

It remains unclear how, or when, these events will be resolved and what those implications will be for markets. Yet as 2019 has shown us so far, uncertainty is not by itself enough to offset the still-strong fundamentals in the US economy and corporate America. Some of these issues like the slowing global economy and central bank policy can have long-term impacts on the economy while others such as the up and down relationships of the US with both North Korea and Iran and the on-again/off-again trade tensions between the US and China will continue to drive short-term swings driven by emotion unless something material evolves.

Markets always face uncertainties at the start of a new quarter, but over the long term it is core economic and corporate fundamentals that drive market returns—not the latest sensational headlines. Having a long-term view of the markets and the economy remain pertinent to both portfolio construction and financial planning.