Investment Perspective

Few investment strategists predicted the market would increase 20% by mid-July. Last December's swoon rattled investor confidence and most investors expected only a modest rebound. However, the S&P 500 defied expectations and hit new highs on July 24. The stock market continues to confound those in doubt and reward those with patience. At this juncture, the odds favor meaningful returns this year as momentum is sustained by the prospect of interest rate cuts. Is there anything to worry about? Yes, doubt is inevitable, but favorable opportunities often emerge in the absence of major problems. Today, markets continue to thrive on skepticism. News associated with politics or trade policy may jostle the markets, but the fundamental underpinnings of the economy and corporate earnings remain solid despite moderate growth. Although a correction may occur, the investment outlook favors equities due to the combination of moderate earnings growth, low interest rates and mild inflation. Importantly, confidence in the financial markets has been restored. A summary of index returns for the year-to-date ending June 30, 2019 is as follows:

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Dow Jones Industrials	15.4%	Russell 2500	19.3%
MSCI EAFE	14.0%	S&P 500	18.5%
NASDAQ Composite	21.3%	Wilshire 5000	18.7%

GLOBAL ECONOMY

World economic growth (ex. U.S.) is slowing toward a 3.4% pace in 2019 after two years of higher growth. The global economic outlook is softening and may reaccelerate to 3.7% in 2020, but uncertainties from trade negotiations are creating hesitancy. We have a moderate growth environment without strong headwinds or tailwinds. China and the U.S. are engaged in an uneasy truce of elongated trade discussions that will eventually impact the economic environment. China's growth is expected to slow to 6% and authorities have responded with measures to support the economy, but high debt levels are a long-term problem. Japan is growing slowly — below 1% — and the Euro area is expected to grow 1.2% this year after 1.8% in 2018. Developed economies are not expected to accelerate much next year while emerging markets may show some improvement. The fear of deflation and slow growth continues to define the European and Japanese economies — two large engines in the global outlook. As a result, their monetary policies continue to stimulate as inflation and interest rates are negative or near zero. Meanwhile, the U.S. is pivoting back to an accommodative stance after experiencing an interest-rate tightening cycle. The resumption of synchronized monetary easing among the major central banks will aid the global outlook. A few confidence boosters might get everything back on track to 4%-plus global growth next year.

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The U.S. economy is expected to advance 2.4% this year following 2.9% in 2018. Next year depends upon the outcome of trade negotiations. Surprisingly, the first quarter GDP growth of 3.1% was solid. However, exports and inventory building lifted the number and those may not be sustained. The consumer sector's contribution may be maturing, but capital spending and nonresidential investment have helped support overall growth. However, manufacturing is weakening due to trade uncertainty. The ISM manufacturing index has declined to 51.7 from levels above 60 last August. Furthermore, the ISM new orders index has fallen to the lowest level since the manufacturing slowdown in late 2015. Consumer confidence has dropped from the recent highs, but remains consistent with levels observed in 2015 and double what was witnessed during the Great Recession. Positively, the employment situation is healthy with employment growth at 1.6% and an unemployment rate of 3.7%. Average hourly earnings rose 3.1% y/y in June indicating a tighter labor market. Strong employment supports the expansion in many meaningful ways. Overall, the economy is growing moderately in a balanced manner without risky excesses despite the prevailing skepticism.

FED POLICY, INFLATION & INTEREST RATES

The Fed is likely to reduce short-term interest rates once or twice by year end

The Fed is closely monitoring the implications of new information for the economy and will act appropriately to sustain the expansion. In response to a softening outlook, the Fed recently pivoted to an accommodative stance from its prior policy of monetary tightening because of slowing growth signs. This shift is a substantial change in tone from last fall and the stock market has responded favorably. In fact, the Fed is likely to reduce short-term interest rates once or twice by year end. In addition, the Fed is modifying the pace at which bonds are reinvested from the quantitative easing program. In response, the 10-year Treasury yield has declined from 3.24% last fall to 2.04%. This decline in long-term interest rates reflects subdued inflation, slowing growth and the prospect for lower short-term interest rates. The worries of an inverted yield curve have diminished as investors see short-term rate relief in the future. Importantly, inflation trends in the U.S. are subdued with all measures in the Fed's target range of 2%. The consumer price index (CPI) is up 1.7% y/y and core inflation (excluding food and energy) is 2.1% y/y. The Fed's preferred inflation gauge, the core personal consumption expenditures (core PCE) price index, is up 1.6% y/y. The Federal Reserve is successfully extending the expansion with these tactical changes in policy.

HOUSING & REAL ESTATE

The housing sector is experiencing a period of softness after a rebound following the last recession. The combination of sluggish housing starts, slower existing home sales and moderating home prices is dragging on the residential investment component of GDP. This is expected to be a headwind for 2019 and 2020. In addition, the real estate tax law changes have made homeownership more expensive for many buyers, particularly in high tax states. Existing homes are selling at a 5.2 million annual rate, down 6% y/y, and down from the recent peak of 5.6 million units in early 2017. The S&P/Case-Shiller Home Price Index is up 2.5% y/y – a slowdown from recent years. National home prices

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had been steadily rising around 4% since 2012, but started moderating in mid-2018 because of higher mortgage rates, capped real estate tax reductions and the changing preferences among younger households to rent versus own. Housing starts are likely to be 1.25 million this year and improve to 1.30 million in 2020. For perspective, there were 2.0 million housing starts 15 years ago. The decline in housing starts suggests that the current pace of housing has slowed in response to the oversupply. Longer-term, household formation should drive an improvement in the demand for housing, but this may be offset by the home sales of "baby boomers." In the near-term, mortgage rates have declined significantly in the last nine months from approximately 5.00% to 3.75%, which may motivate prospective homeowners to take advantage of the buyer's market. Cheap financing and oversupply are favorable attributes for buyers, but stringent lending standards are deterring new purchases. While there are no clear signs of immediate improvement, we are not in a housing downturn. At present, the housing and real estate markets appear stable.

INVESTMENT OUTLOOK

We believe that we are in a secular bull market with a favorable equity outlook supported by moderate growth, low interest rates and improving investor confidence. Investor sentiment has recently been influenced by the improving prospects for monetary policy and trade negotiations. President Trump's tariff battle with China has subsided and both sides appear moving toward some form of agreement. Additionally, the Fed's pivot is near completion with current expectations of one or two interest rate cuts occurring during the balance of 2019. This has boosted confidence that growth can decelerate without significant recession risk. The central bank will do what is necessary to help the economy and asset prices. The stock market is reasonably valued at 18.0x estimated S&P 500 operating earnings of $166 per share for this year, especially considering a 10-year Treasury yield of 2.04% and core PCE inflation of 1.6%. Looking ahead, the market is trading at 16.8x next year's operating earnings estimate of $178.

Investors remain alert for economic data that is "troublesome" for fear this may hurt the outlook for earnings and increase volatility

Despite improving sentiment, skepticism remains high as the market continues climbing the "wall of worry" that has underpinned this bull market. Investors remain alert for economic data that is "troublesome" for fear this may hurt the outlook for earnings and increase volatility. Corporate earnings in the first quarter experienced the first year-over-year decline since mid-2016 – albeit a negligible decline of 0.3%. Similarly, earnings may not grow or may even decline modestly during the second quarter, with better growth expected during the second half of the year. Earnings growth is likely to be 2% in 2019 with prospects for further improvement as the economy benefits from monetary easing and less tariff noise. Bull markets do not die of old age, they die primarily from financial shock and severe recession. We are watching for these possible developments.

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Today, it is interesting that many bonds in the international debts market are priced to deliver a negative return. Negative-yielding bonds totaled $13 trillion in June or 40% of all global sovereign debt. In Germany, 85% of the government debt outstanding carries a negative yield. In contrast, the U.S. has $16 trillion in debt outstanding and none of it carries a negative nominal yield. The differences reflect Europe and Japan's deflationary headwinds compared to more moderate growth in the U.S. This low interest rate environment may persist longer than many investors expected and reduce borrowing costs for governments, businesses and consumers. In addition, higher valuations for stocks may result as the discount rate used by long-term investors trends down. Investors are willing to pay more for high-quality growth assets during periods of low growth for the average company.

Technically, the equity markets are on solid ground. Breadth, momentum and confirmatory indicators suggest the advance is durable and sustainable. Cumulative net up volume breakouts confirm the market's new highs. Global breadth is also breaking out — a bullish sign. The May indicator is also positive. For example, when the market declines over 5% in May —14 times since 1928 and 6.58% this year — it produced an average return of almost 17% over the next 12 months with an 85% probability. Also, following outside up months during secular bull markets such as June, the S&P 500 experienced an average gain of 15% over the next year 90% of the time. We look forward to double digit returns in the year ahead. One minor drawback is the lagging transport sector which has not confirmed a Dow Theory buy signal even as the Dow Industrials hit new highs. Dow Transports have been weaker than usual due to the economic impact of trade policy, so this may explain the non-confirmation.

Healthy skepticism enables the market to strengthen amidst the backdrop of relatively constructive healthy fundamentals

The trauma of 2008 created widespread fear that kept a lid on speculative excesses. As a result, investor sentiment remains "skeptical", but healthy skepticism enables the market to strengthen amidst the backdrop of relatively constructive fundamentals. A key issue will be the health of the U.S. economy amid the concerns about the spillover effects of a slowdown in global growth. The odds favor higher prices through year end, but the market may experience a modest correction after its recent strength. U.S. equities, particularly small and medium-sized growth companies, remain likely to achieve double-digit returns over the next few years. The key risks include Brexit, China's recent slowdown, disappointing earnings, European deflation, inflammatory presidential tweets, military conflicts, political feuding in Washington, terrorism, trade wars and unexpected inflation. We remain alert in monitoring these ongoing trends.