GEMMER ASSET MANAGEMENT LLC
LOCAL PARTNER | GLOBAL INVESTING

MARKETS IN FOCUS

SECOND QUARTER 2019 JULY 18, 2019

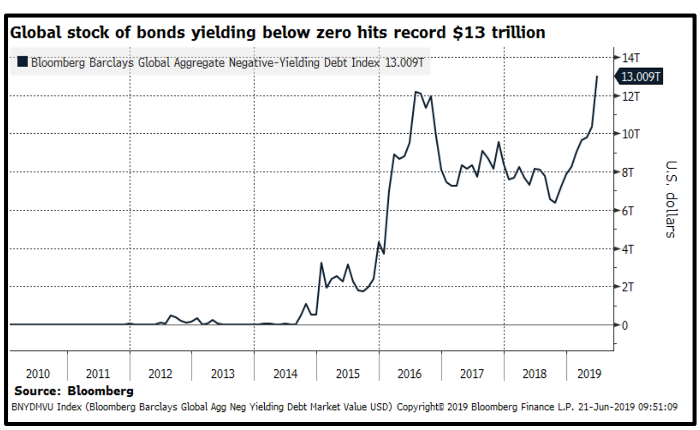
Market Benchmarks			
Market Indices	**2nd Qtr**	**YTD**	**3-Yr An**
S&P 500 Index	+4.3%	+18.5%	+14.1%
Russell 2000	+1.9%	+16.9%	+12.3%
Global Equities	+3.5%	+16.1%	+11.6%
Int'l Index (EAFE)	+3.5%	+14.2%	+8.8%
Emerging Mkts	+0.7%	+12.1%	+9.4%
Other Indicators	**6/30/19**	**3/31/19**	**12/31/18**
Fed Funds Rate	2.25%-2.5%	2.25%-2.5%	2.25%-2.5%
2-Year Treasury	1.75%	2.26%	2.49%
10-Year Treasury	2.00%	2.41%	2.69%
S&P 500 P/E Ratio*	16.7	16.4	14.4
Crude Oil	$58.01	$60.16	$45.84
Core Inflation	1.6%	1.7%	1.9%

*Forward 12-month operating earnings per S&P

Quarter-in-review – The advance in equity prices during the second quarter actually masks a fair amount of volatility. Stocks hit a high in early May but then proceeded to correct roughly 7% as jitters set in that an expanded trade war with China and a new dispute with Mexico would lead to recession. However, emotions were calmed by soothing words from central bankers in Europe and the U.S. and stocks rallied back in June. For the quarter the S&P 500 notched a +4.3% return brining the YTD gain to +18.5%. Small-cap equities lagged large-caps, as did both the developed and emerging markets. But in general, it was a good quarter for stocks.

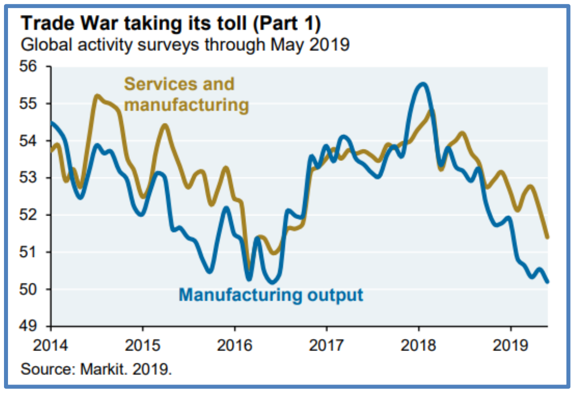
It was also a strong quarter for fixed income. Yields declined materially as inflation slowed and global central banks signaled a willingness to cut rates in the second half. The 10-year Treasury yield fell 0.41% in the second quarter to close right at 2.00%. Rates were lower overseas as well. For example, the German 10-year bond yield fell from -0.07% to -0.33% during the quarter, close to a record low. Greek 10-year bond yields fell from 3.74% at the end of the first quarter to just 2.18%, only 0.18% higher than comparable rates in the U.S. Yes, these are the same Greek bonds that were yielding over 35% in 2012 when fears of Greek default were at their highest. In total, the amount of government debt with negative yields surged to a record in the second quarter (see chart below).

Portfolio Update – It was a good quarter for the portfolios with returns roughly in line with what you would expect from a combination of global equities and bonds. Our active and socially conscious allocations outperformed their benchmarks in all Risk Zones due to solid manager performance. For example, Goldman Sachs Small/Mid-Cap Growth beat it's benchmark by +4.0% while Matthew's Asian Growth & Income, Tweedy Browne, and the SPDR S&P 500 Fossil Fuel Free ETF beat their benchmarks by between +1.0% and +1.6%. Our exchange traded fund portfolios were essentially in line with the benchmarks, but the Dimensional portfolios lagged due to the underperformance of both value and small-cap stocks relative to their larger/growthier brethren. But even here the underperformance was modest.



We made one tactical allocation change during the quarter and added one new fund. Tactically, we reduced our weighting to Japanese and international equities and added to U.S. large-caps. This wasn't a large allocation move (roughly 2% to 3%), but it did increase our overweight to U.S. stocks. In terms of fund changes, we added a new sustainable fixed income fund from Dimensional to the social allocations.

Trade Wars Batter the Global Economy - Investors Fixate on Policy (again) – As we noted earlier, investors had to grapple with the on-going trade war with China as well as a temporary spat with Mexico during the quarter. The critical issue was whether these disputes threatened to sink the manufacturing sector of the global economy and possibly lead to recession. This is a dramatic change from the situation twelve months ago. If you think back then, the prevalent debate was about economic overheating, not the threat of a global downturn. In the U.S., at least, we were in the midst of a mini-economic boom with GDP growth running above 4% and unemployment pushing to new cyclical lows. The economy was being boosted by the administration's tax cuts and the housing market was strong. This positive backdrop supported the view that the Fed would hike rates twice in 2018 and three-to-four more times in 2019. Certainly, trade issues were starting to percolate, but in general the consensus was solid growth, rising inflation, and higher interest rates.

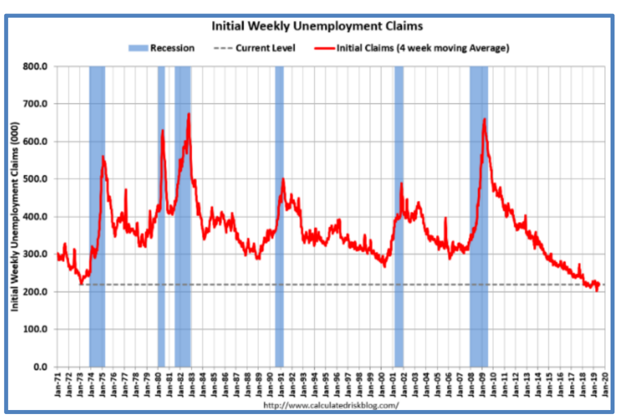


My how things have changed. The themes that dominated investor's minds so far this year are almost the exact opposite:

1) The possibility of a global manufacturing recession, triggered in part by a much larger trade war than originally expected.
2) Subdued inflation despite the longest economic expansion in history in the U.S. and very low unemployment levels.
3) Global central banks that are either contemplating easing policy in the second half of the year or have already cut rates.

How each of these themes plays out over the coming months will be critical for the markets. More on each below.

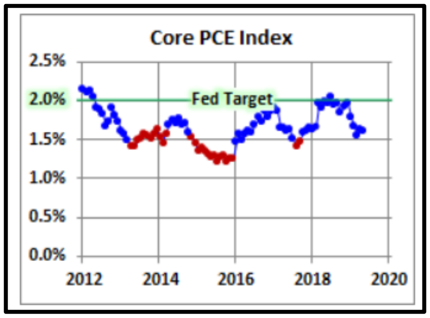
<u>Trade Wars – A Flesh Wound or Something More Serious?</u> – There was a point in early May when the trade war looked like it was escalating rapidly. First, the administration threatened to slap tariffs on all of our imports from China. Then Mexico came into the crosshairs. For the first time tariffs were going to be used to achieve a purely political goal, namely slowing or stopping the flow of Central and South American migrants moving through Mexico. As you would expect the markets sold off as tensions ratcheted higher. However, the situation was short lived. Mexico agreed to a compromise and both the U.S. and China decided to keep talking. But all the uncertainty is starting to have a real impact, especially on the manufacturing sector. The chart above shows global manufacturing output falling significantly since early 2018. While this global measure isn't in recession territory (anything below 50 would indicate contraction), at the individual country level the picture is more problematic. Chinese manufacturing contracted in May while European manufacturing has been shrinking since February. Another knock-on effect is that uncertainty concerning trade is disrupting supply chains and corporate investment plans are being put on hold. This is pulling down capital expenditures and in general, global trade volumes are shrinking.



How big of a problem is this? It depends on the country and region. For China and Europe, it is a bigger issue. Both are far more dependent on exports than we are in the U.S. Specifically, exports account for less than 12% of GDP in the U.S. compared to 20% for China, 31% for France, and 47% for Germany. But nonetheless, we are feeling the pain in areas such as agriculture and semiconductors.

But we shouldn't push the negative narrative too far, at least domestically. The odds of a recession in the U.S. remain relatively low despite the trade headwinds. Consumer spending remains resilient, and without an uptick in layoffs we don't anticipate it changing. And so far, at least, the jobs backdrop remains solid. Weekly unemployment claims remain close to the lowest levels since 1971 (see chart below) and the number of job vacancies continues to exceed the number of unemployed. The housing market is also in decent shape. Mortgage rates have fallen from a high of close to 5% late last year to roughly 3.8% today. This will go a long way to supporting both home sales and housing prices nationwide. What does all this mean in terms of headline economic growth? In the U.S., second quarter growth should soften from the +3.2% pace in the first quarter to around +1.5% in the second quarter. This is a significant slowdown, but certainly not recession-like. Europe and Japan are more exposed, and both may flirt with contraction in the second quarter. Chinese growth will also slow.

However, what matters for markets in the second half of the year won't be what happened in the second quarter but what is likely to change at the margin in the coming months. Trade will be an ongoing uncertainty, but our base case is that the dialogue continues, and we avoid a more damaging outcome. We are also likely to see governments do more to support their local economies. For example, Chinese authorities are likely to continue to ease credit availability, cut interest rates, and increase fiscal spending. Europe is tentatively moving in the same direction. The decision by the European Commission not to penalize Italy over the size of their deficit sends a message that austerity isn't in the cards anytime soon. Fiscal policy in the U.S. is unlikely to change much near-term as it is hard to envision Congress and the Administration agreeing on much. However, lower long-term interest rates in the U.S. will provide an important support for interest rate sensitive sectors of the economy. As we mentioned earlier, housing in particular should receive an important boost in the second half of the year. Japan is the sole outlier. They are still contemplating increasing the VAT rate later this year.



The bottom line is somewhat nuanced. The domestic economy looks like it can weather the current trade issues while Europe and Japan look more at risk. China is struggling with a manufacturing slump, but they have the policy tools to tackle the slowdown. So, we end up with something of a muddle through scenario, but there is a case for optimism. The lagged effect from lower long-term interest rates combined with fiscal policy easing in certain countries could provide the catalyst for a modest economic rebound in the second half. And this fits with the dynamics of the recovery ever since 2009. Global growth has moved two steps forwards and one step backwards ever since the financial crisis ended. We suspect the growth scare in the second quarter will end up being a single step backwards, not something more serious.

Inflation is Still MIA – If there is one area where the consensus has been consistently wrong it has been on the issue of inflation. If you think all the way back to when the Fed started quantitative easing you might remember pundits saying inflation was going to surge. Then when the unemployment rate fell below 4% again the call was for inflation. Similarly, the recent tax cuts were thought ill-timed in part because inflation risks were elevated.

However, inflation continues to underwhelm. Core inflation softened again in the second quarter and is still running below the Fed's target of 2%, as you can see from the chart above. We won't go through all the reasons why inflation might be soft, but the old Philips Curve relationship whereby falling unemployment rates leads to higher inflation is clearly breaking down. Further, the optimism that the tax cuts would lead to 4%+ growth was clearly misplaced. As we noted in the prior section, growth around the world is softening and this will keep inflation rates subdued around the world into next year.

There is also an interesting dynamic playing out that may compound the issue. As you can see to the right, worker productivity has increased noticeably the last few months. While clearly not on the scale of what we saw in the late 1990s, it does help explain why we are not seeing more inflation at the moment despite very low unemployment. What is taking place is that the utilization of technology is allowing workers to produce more with the same inputs. If this continues it is a welcome development. It means production and wages can grow without the Fed having to worry about rising price pressures. This last point is key from a market perspective. The equity sell-off in the fourth quarter last year had much to do with the Fed feeling like it had to hike rates to get ahead of rising inflation. If the world isn't seeing any inflationary pressures it means policy can stay easier for longer.

Central Banker About Face – Thinking back to this time last year again, it was the general consensus that the Fed would probably hike rates at least three times in 2019. Even as recently as early May Fed Chairman Powell argued that the recent fall in the rate of inflation was likely to be transitory. The implication was that the Fed would be back hiking rates before the year was out. However, opinions can change quickly. As the trade situation deteriorated during May and the markets sold off, the Fed started to openly mull the need for rate cuts. By the time the Fed met at their periodic meeting on June 18th and 19th the markets were pricing in at least two rate cuts this year. The Fed said nothing at their meeting to dissuade the markets of this view. Chairman Powell testified in front of Congress in early July and basically set the stage for a quarter point cut in July.

We are also seeing a change of heart overseas. The European Central Bank is lining up their own rate cuts this summer as well as contemplating a resumption of large-scale asset purchases (quantitative easing by another name). Other central banks have already started cutting (Russia, India, and Australia to name just three).

From an economic perspective the impact of rate cuts is hard to ascertain. It is tough to make the case that high interest rates are standing in the way of corporate or consumer spending. After all, yields have been plummeting around the world. As we noted on the first page, the amount of government bonds with negative yields hit an all-time high in June. Austria recently issued a 100-year bond at a yield of just 1.171%. If anything, negative rates in Europe are undermining Europe's banking sector. The chart on the next page shows that Deutsche Bank's stock is at the lowest level since 1999. The bank is being forced to rapidly downsize, and

while some of its problems are due to poor management decisions, a clear contributing factor is the fact that negative government rates are severely undermining the bank's profitability. The charts for other European banks are equally ugly.

But outside of European financials, the implications are more constructive. Global central bankers have gone from a headwind for the markets to a tailwind. The Fed, for example, is no longer trying to normalize policy (raise rates, end QE). Their focus is now on prolonging the expansion. This is a major change of heart.

<u>What Does it Mean for the Markets?</u> – While it is easy to focus on the latest news concerning the trade war, the fact that inflation remains subdued and central banks can err on the side of easing remain key positives. The lack of inflation means a bond bear market isn't imminent and the Fed doesn't have to take a hard line like they did in the fourth quarter last year. Corporate spreads can also remain tight in a world where investors are grappling with negative rates on government bonds. This helps prevent a credit crunch at the corporate level.

When it comes to the equity markets investors need to make a judgement call. Are we on the cusp of a recession triggered by the trade war? Or is the current period more akin to 1998 where an exogenous shock hit global growth but accommodative central banks averted a severe slowdown? We still lean towards the latter scenario. Low inflation gives policymakers ample room to take an accommodative approach to policy. Whether we like it or not, the weaker growth gets the more liquidity central bankers will throw at the economy. While the effect of this on the real economy is open to debate, there is no question it will support the markets for the time being. Lower bond yields, all other things equal, means the net present value of any cash flows is higher than it once was. This is another way of saying that stocks can trade at a higher multiple of earnings in a lower rate environment.

A quick word on equity valuations. In the U.S. the S&P 500 trades at 16.7 times forward 12-month earnings. This is modestly expensive (the 25-year average is 16.2 times), but valuations shouldn't provide much of a hurdle to higher prices. Earnings growth estimates for this year have plunged to roughly +2% from close to +12%. It wouldn't be shocking to see actual earnings growth beat these reduced estimates in the months to come. Furthermore, if we avoid recession like we think, earnings growth of +8% to +10% in 2020 should provide a decent backdrop.

<u>Looking Ahead</u> – We think it would be a mistake to extrapolate the market performance in the first half of 2019 into the second half, but we also think it would be a mistake to succumb to the bearish headlines and get defensive today. Without question the on-going trade issues will cause more volatility in the weeks and months to come. Nothing was solved at the G-20 meeting in late June and China and the U.S. appear locked in a struggle over more than just arcane points of import/export law. There is something to the idea that this is far more of an ideological clash that will not easily be resolved. Furthermore, the economic softening we have seen around the world in the second quarter is likely to persist into the third quarter. Part of Europe and Japan could contract at some point, and we are worried about the banks in Europe (we are underweight this area).

However, the negatives shouldn't be pushed too far. We still believe we are not on the cusp of a global recession. Similar to what we experienced in 2015 and 2016, we think we are seeing a global slowdown that will be offset by countervailing forces. The fall in long-term interest rates around the world is naturally stimulative. For example, lower 10-year Treasury rates will flow through to mortgage rates, and this will help the housing market. Furthermore, upcoming central bank rate cuts will provide more liquidity for the global economy. Finally, China in particular is likely to push more stimulus into their economy through both fiscal and monetary measures. Taken together, these reflationary impulses will gain some traction in the second half of the year. This should be supportive for financial assets despite any short-term volatility tied to trade.

David L. Gemmer
Charles Blankley, CFA