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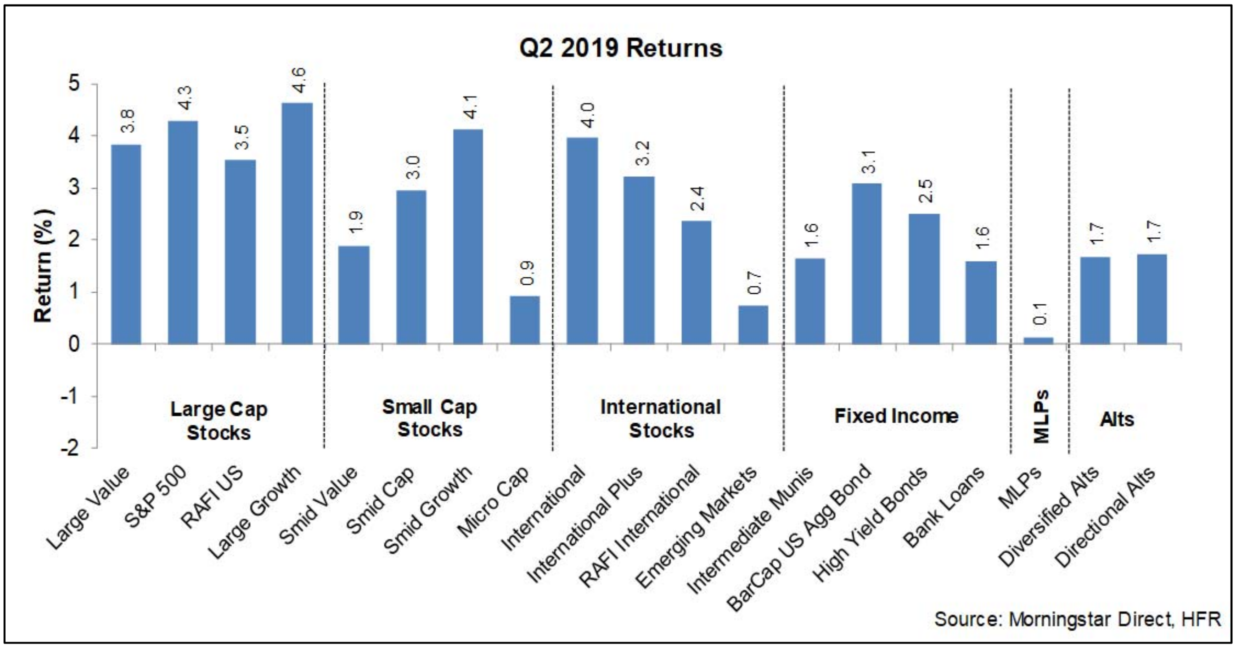
Second Quarter 2019 Investment Review & Outlook



EXECUTIVE SUMMARY

Q2 2019 Recap:

- Global stocks added onto their strong first quarter gains as the prospect of rate cuts helped boost the S&P 500 up 4.3% (18.5% YTD)
- Large cap growth stocks continued to outperform value stocks while market segments that had lagged in prior quarters, such as Financials and Materials, caught up with the broader market
- Fixed income securities and safe haven assets were in high demand with strong performance coming from high quality, longer duration bonds

NEXT Outlook:

- Fundamentals are healthy enough to carry the market forward, but investors seem increasingly focused on headline issues and thus volatility will likely continue
- Monetary policy decisions will continue to heavily influence equities as investors increasingly expect more Fed interest rate cuts moving forward
- Escalating trade tensions with China, increasing attention towards the 2020 presidential election, and uncertainty around the lack of a Brexit deal serve as significant geopolitical risks for the remainder of 2019

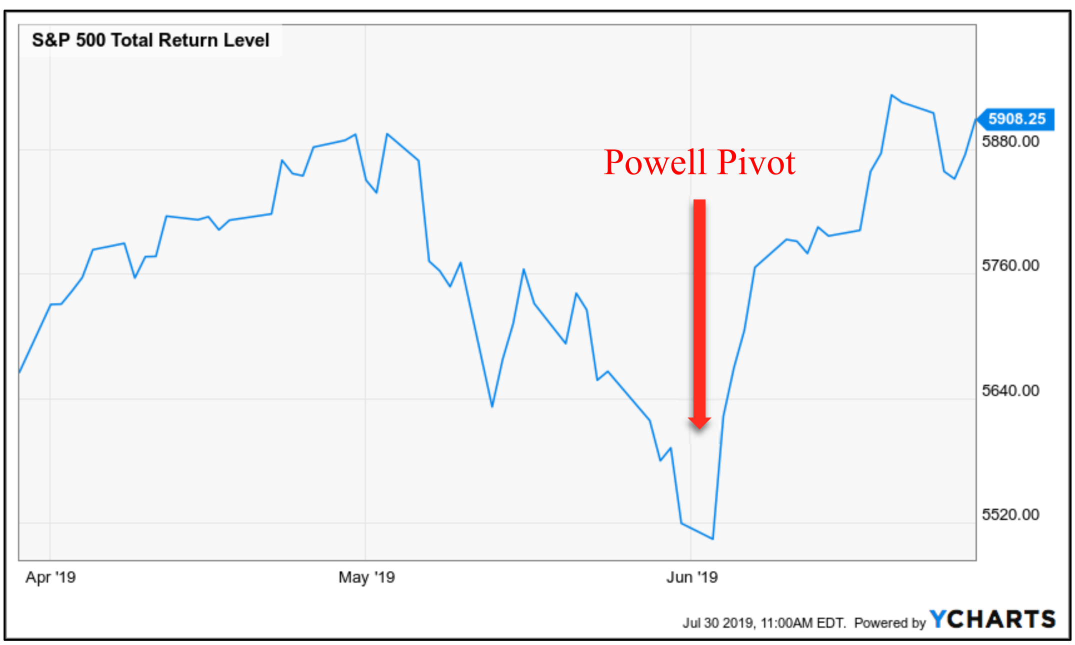
To Our Clients and Friends,

Financial markets continued to post significant gains in the second quarter, notwithstanding a "blip" in May. For the quarter, the stock market rose 4.3%, pushing performance for the year to 18.5%. With the S&P 500 continuing that rally into July, the market has officially erased its losses from the fourth quarter (recall that the S&P 500 nearly experienced a bear market last year, declining 19.9%) and has since reached new all-time highs.

We hate to repeat ourselves from previous quarters, but market performance continues to be dominated by the twin forces of: (1) Federal Reserve interest rate policy; and (2) a potential trade war with China. Those factors precipitated the significant declines late last year for the market, and the perceived "improvement" of these headwinds, especially the reversal in course by the Fed, has allowed risk assets to climb significantly in 2019.

Of course, the market's perception of these issues has oscillated throughout the year, swayed by the latest Presidential tweet or Fed official comment. In May, stocks fell more than 6% due to Trump's tariff threats against Mexican imports and a breakdown in negotiations with China. With the economy slowing, already uneasy investors were alarmed by the prospects of these issues further denting domestic growth. Unfortunately, it may be the case that the damage has already been done; uncertainty around trade has surely impacted capital spending around the world and will eventually filter its way into weaker future growth prospects.

In June, markets got back on track with a 7.1% gain, once again – you guessed it – boosted by comments from Fed Chairman Jerome Powell that the Fed would "act as appropriate" to support the economic expansion. It was the clearest sign yet that the Federal Reserve would cut interest rates in 2019 (and indeed, they did cut rates for the first time since 2008 in July). The unique phenomenon of "bad news is good news" took full effect as investors looked to the Fed to save them from future market volatility.



On balance, the fundamentals – meaning, the underlying factors driving asset prices like earnings and revenue growth – remain solid, if somewhat softer than last year. We must remember that 2018 was somewhat unusual in that it followed 2017's Tax Cut & Jobs Act, which cut corporate and personal tax rates and provided a high level of fiscal stimulus to the economy. As such, year-over-year comparisons are somewhat misleading as they are calculated off higher base numbers from 2018.

The market's psyche, however, appears much more fragile than these fundamentals would suggest. We are observing extreme sensitivity to headline news that all but ignores the fundamental strength of the economy and corporate America. Perhaps this approach will prove to be well founded; many economists and market pundits believe we are in the latter stages of an economic cycle. There is much disagreement, however, on how long the current expansion will continue. We note that there are not many signs of an economic contraction flashing: GDP growth is on trend, labor markets are extremely robust, and the economy is benefiting from the combination of fiscal and monetary stimulus.

That has done nothing to dampen the fears of an economic slowdown, as evidenced by the composition of market performance this year. Although "risk on" assets like stocks have done well, we observe that, paradoxically, "risk off" assets such as bonds have also posted very strong results. In fact, we have not seen a market where both stocks and bonds have performed this well since the first half of 1995. Investors have flocked to safe haven assets in this environment. Inflows to mutual funds and ETFs tracking bonds have reached approximately $250 billion in the first half of the year alone, an all-time record pace according to analysis by Merrill Lynch[1].

One thing is clear: investors currently seem to be held hostage to the "twin forces" described above, and volatility has increased sharply as a consequence. Already this year we have experienced three monthly moves in the S&P 500 of more than 6%. This leaves market participants in a precarious position: sit this market out, and miss potential upside, or participate and find the market suddenly undermined by an unexpected comment or tariff. Consequently, investors seem to be taking a barbelled approach – increasing allocations into safer assets, while maintaining their equities to avoid missing out on returns associated with the last leg of this record-breaking bull market.

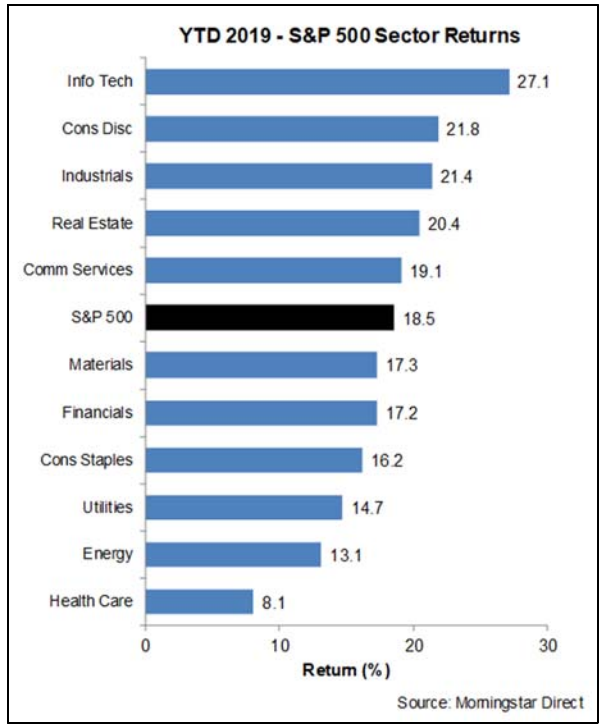
Market Review

US equities extended their year-to-date gains in the second quarter, with large caps leading performance (+4.3%). In comparison, small and mid-cap stocks recorded a 3.0% gain. Developed international markets gained 4.0% while emerging markets, suffering from weaker economic data, gained a mere 0.7%. Recent data out of emerging markets – much of which seems to be linked to a downcycle within China – has prompted many central banks to start easing cycles ahead of an anticipated cutting cycle from the Federal Reserve.

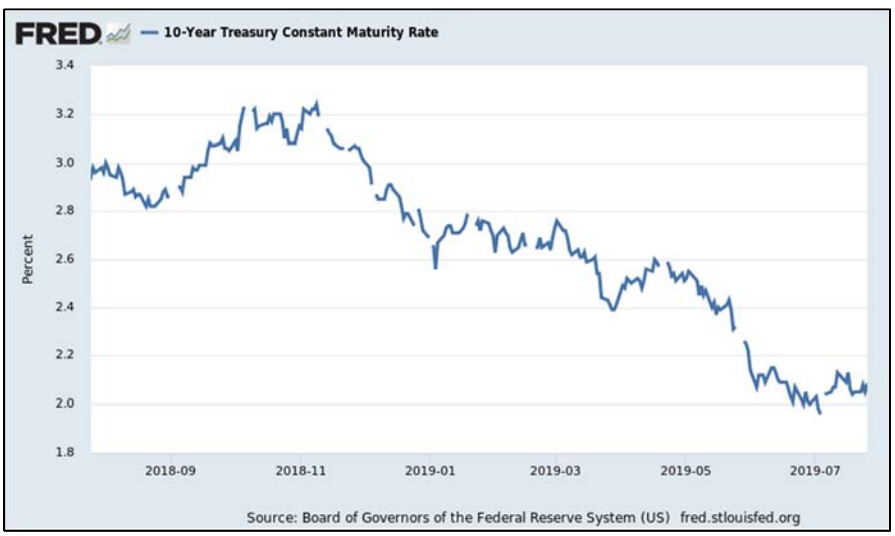
Within US equity markets, growth strategies once again prevailed over value. This trend was especially prevalent in the small and mid-cap space where the Russell 2500 Growth index return came in at 4.1%, significantly higher than the 1.9% return of the Russell 2500 Value index. Moreover, underperforming sectors played catch up in the second quarter as investors looked for attractive opportunities in a pricy

[1] Source: Menton, Jessica "Investors Pour Money into Bond Funds at a Record Pace," Wall Street Journal, July 25, 2019.

market. Financials and Materials, which had lagged the broader marker for the better part of the past year, generated 8.0% and 6.3% returns, respectively. Investors were particularly eager to add Financials, given their cheap valuations and improving dividend yields after successfully passing the Fed's latest round of stress tests. For the year, technology stocks remain the clear performance winner and remain the biggest driver of overall S&P 500 performance.

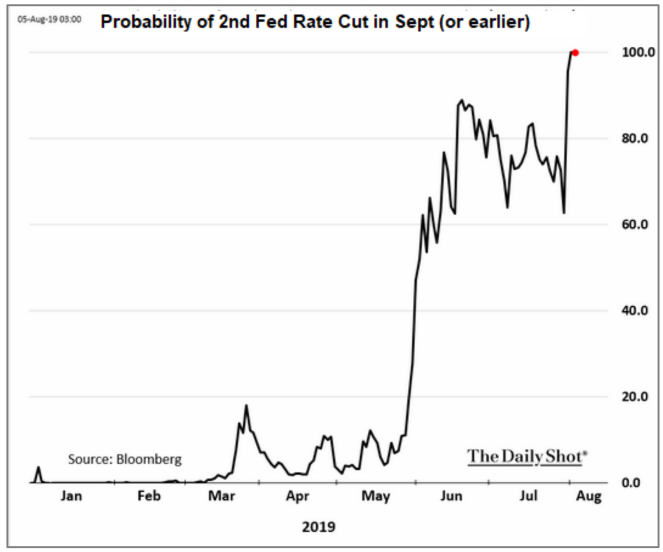


Within the fixed income markets, traditional bonds outperformed credit-related sectors amid a sharp move lower in interest rates. Since peaking in November, the 10-year Treasury yield has declined 1.24%, including 0.50% in Q2 alone. This has provided a significant boost to the Barclays US Aggregate Bond Index (the industry's proxy for high quality bonds), which retains a high degree of interest rate sensitivity. While interest rates could push lower, we are wary of the interest rate risk embedded in long duration bonds. We continue to favor shorter duration, more credit centric allocations within portfolios amid a solid fundamental environment.



Finally, diversified alternative investments posted a modest increase of 1.7% during the quarter, bringing the group's year-to-date gains to 6.1%. Managers in this sector have not kept pace with the equity markets given their tendency to hedge and own other diversifying asset classes. However, we were encouraged by performance in May when the market dropped by more than 6% and the broad alternative group declined only 0.7%. We have long maintained that these allocations will help insulate portfolios from the full brunt of equity downdrafts – which seem to be more frequent as of late – while still delivering an attractive return somewhere between stocks and bonds.

Outlook



Entering the second half of the year, we are slightly more cautious in our outlook for risk assets. After a strong run in the stock markets this year, it's fair to wonder how much good news is left to price into this market. The Fed has implemented its first interest cut, but will they surprise the market with more cuts than expected? That seems unlikely. Investors have priced in with near certainty that the Fed will cut a second time this year. Any failure to deliver will be deemed a disappointment.

A sudden trade deal would certainly provide some level of upside to the market. In the first quarter, a deal with China appeared imminent, but that presumption has changed dramatically since then. China is suffering economically from the impact of President Trump's tariffs (more so than the US), but there is strong political will within the country to resist US demands. Our sense at this point is that either no trade deal will occur until after the election is over (as the Chinese may as well wait and see if they get a more pliable president to meet them at the table), or Trump simply inks a superficial deal to score a political win ahead of next year's election.

To that end, as we move later into the year, we expect that the 2020 election cycle will increasingly dominate the market narrative. Attacks against big tech, pharmaceutical companies, and the Tax Cut & Jobs Act of 2017 are already well underway and will serve as headwinds (for equity markets) for the remainder of the year. Any threat to the tax bill, in particular, should be viewed as a significant threat to market momentum given its direct role in boosting corporate earnings during the past 18 months. Investors can also anticipate increased uncertainty around Brexit as new UK leadership seems prepared to exit the European Union without a negotiated deal in place.

In the background, fundamentals remain healthy enough for the market to trod along. The domestic economy appears resilient (bolstered by a strong consumer), corporate earnings continue to grow at moderate levels, and valuations remain reasonable. Whether the market will focus its attention on these factors, however, rather than be subjected to the whims of the news cycle, remains an unknown. Recent behavior would suggest the latter, making us more apprehensive about volatility in the last six months of 2019. While we do not advocate dramatic portfolio shifts, in general, we do believe it's important to ensure clients are not taking excessive risk in this environment.

We are, of course, long-term investors first and foremost. We prioritize the construction of diversified portfolios that are designed to weather periodic volatility and compound wealth over time. Nobody can predict with certainty who will be elected, which policies will be implemented, or how markets will react to new and developing issues. While on the margins we attempt to capitalize on clear dislocations in the market, the relatively "boring" strategy of managing a disciplined portfolio over the course of an extended period of time remains a successful one.

As always, if you feel your personal financial situation has changed or you would like to revisit your asset allocation, please do not hesitate to call or visit our offices.

Kindest regards,
Your Investment Team
7/31/2019

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