# The Reluctant and Enduring Rally in Stocks & Bonds


DT INVESTMENT PARTNERS

## Second Quarter 2019 Financial Markets Commentary

*July 2, 2019*

## RISK-BASED ASSETS PERFORMANCE SUMMARY

- An exceptional month of June (strongest in over 60 years) following a miserable month of May enabled stocks to post strong gains for the second quarter. Despite growing fears of an economic slowdown and an escalation in trade tensions between the U.S. and China, the historically long and very reluctant bull market in stocks powered on as the Fed indicated a readiness to cut rates for the first time in more than a decade to help the economic expansion continue. As quarter-end approached, trade tensions between the U.S. and China appeared to be easing.

- All major stock market indexes rallied in the second quarter led by U.S Large Cap stocks (See page 5) as more than 60% of the companies in the S&P 500 and Dow rose. With the exception of Energy, all primary sectors of the S&P 500 index rose during the quarter led by Financials, Materials, and Technology. Outside of the manufacturing sector, the U.S. economy continues to grow at an above trend pace, while the unemployment rate is at historically low levels and inflation remains tepid.

- International Developed Market stocks were the second best performing equity asset class during the quarter as concern over the global economy's prospects led the Fed, European Central Bank and other central banks to raise the possibility of interest rate cuts or other stimulus to offset the negative effects of tariffs between the U.S. and China.

- Gold was the top-performing Risk-Based asset class for the quarter thanks to geopolitical risks (U.S. – China tariff war & Iran), easy monetary policies from central banks, and a weakening U.S. dollar (See page 5). As a safe-haven asset class, Gold performs well during times of uncertainty and turmoil.

## BOND PERFORMANCE SUMMARY

- For the second consecutive quarter, U.S. Treasury securities rallied across the yield curve (maturity spectrum) due to growing anxiety about the health of the world economy, trade tensions between China and the U.S., and thanks to the Fed's indication that it is ready to begin cutting interest rates for the first time in more than a decade. The yield on the 10 year maturity U.S. Treasury Note, used as a reference point on mortgages and student debt, declined from 2.41% at the start of the year to 2.01%. Investment Grade Corporate Bonds once again generated the highest total returns for the quarter thanks to significant spread tightening (See page 5).

- Municipal bonds had another strong quarter. Performance in the market has been driven by an influx of cash into the market and a lack of supply. While Municipals trailed Corporate and Treasury bonds for the quarter, their performance should continue to trend in a positive direction so long as the supply and demand imbalance exists.

## CONTRIBUTORS & DETRACTORS TO PERFORMANCE

- Performance contributors versus the Global Stock/Intermediate Maturity U.S. Bond blended benchmark index during the quarter included our overweight allocations to U.S. Large Cap stocks and Investment Grade Corporate bonds, and our outside-of-benchmark allocation to Gold.

- Detractors to performance versus the Global Stock/Intermediate Maturity U.S. Bond blended benchmark index included our underweight allocation to risk-based assets, specifically International Developed stocks, our taxable bond duration shorter than bond benchmark index duration, and our overweight to Bonds and Cash.

## GLOBAL MARKETS & ECONOMY

- As we entered the second quarter, we identified four keys to financial market performance for the remainder of the year. They included Fed interest rate policy, U.S.–China trade policy, Chinese economic growth, and U.S. dollar strength or weakness.

- The second quarter began with first quarter earnings beating expectations and investors believing that the U.S. and China were close to reaching a trade agreement. However, that optimism disappeared in early May when President Trump raised the tariff rate from 10-25% on $200 billion in goods imported from China because he was displeased with how trade negotiations were proceeding. As a result, both sides threatened higher tariffs causing investor and business confidence to weaken.

- In early June, Fed Chairman Powell acknowledged that an escalation in trade tensions could hurt the U.S. economy and indicated that the Fed could respond with interest rate cuts if needed. Investors responded by pushing stock prices higher. Then at his news conference on June 19th following the FOMC (Federal Open Market Committee) meeting, Chairman Powell indicated the willingness to cut rates for the first time in over 10 years, perhaps as soon as the July 31st meeting. The rally continued through quarter-end with many stock indices reaching all-time highs in price.

- President Trump and Chinese President Xi Jinping met at the G-20 Summit in Osaka, Japan on June 28th-29th and reached a cease fire in their trade battle. Both sides said bilateral talks would resume and the U.S. would indefinitely shelve plans to raise tariffs on $300 billion of Chinese imports that aren't currently covered by 25% tariffs. In addition, President Trump said he would let U.S. firms sell high-tech equipment to Huawei Technologies Co. and China would start buying large amounts of American farm products.

## GLOBAL MARKETS & ECONOMY

- The commitment by the U.S. and China to continue trade talks won't provide much confidence that a deal is imminent given past experience. But it is good news that the trade tensions are not escalating. With less than a year to go before the 2020 presidential campaign kicks off, President Trump needs to prove to the American public that he can actually negotiate a trade deal. Therefore, we believe some sort of an agreement is more likely than not. In the meantime, uncertainty facing the stock market and business spending remains.

- As for Fed interest rate policy, a stabilization on the trade front between the U.S. and China may reduce some of the impetus for a July rate cut. The problem for the Fed is not that the U.S. economy is floundering. It's that the U.S. economy is doing less well than forecast. The outlook is for very mediocre economic growth with very low unemployment, yet moderate wage increases with little inflation. ***We still believe that deflation is a greater risk than inflation and the Fed would be justified in cutting rates sooner rather than later as economic data is a lagging indicator and continued trade uncertainty deters corporate investment and weighs on growth.***

- China's growth improvement has halted since late last year. Second quarter growth may have slowed to the lower end of the government's growth target for 2019. As a result, we believe Chinese policymakers need to increase both monetary and fiscal policy stimulus.

- The U.S. dollar weakened slightly during the second quarter as economic indicators in the U.S. began softening, inflation expectations resumed falling, and the Fed opened the door for interest rate cuts as soon as July. A weaker U.S. dollar could be good for U.S. Large-Cap multinational companies because it makes American goods cheaper overseas. If the U.S. dollar continues to depreciate, then it could also have a positive long-term impact because those overseas consumers may begin to purchase more American goods and services.

## PORTFOLIO STRATEGY & OUTLOOK

- ***Going forward, we are expecting low nominal economic growth, low inflation, and no recession.*** Financial conditions remain supportive, the Fed is accommodative, bank balance sheets are sturdy, and unemployment is historically low.

- The next move higher in global stock prices will likely require some combination of a rebound in global economic growth, a weaker U.S. dollar, lower interest rates, and a clear resolution to trade policy between the U.S. and China. All four could serve as catalysts for stronger corporate earnings. This in turn would help prolong the earnings cycle and could push stock prices higher. In the meantime, financial markets are likely to trade sideways until such catalysts materialize.

- For now, we remain cautious as we await signs of a firming in global economic growth and corporate earnings along with a resolution to trade policy negotiations between the U.S. and China before increasing our allocation to risk-based assets. We are slightly underweight risk-based assets and overweight bonds and cash.

- In terms of specific asset classes, International Developed and Emerging Market stocks look more attractive than U.S. stocks based upon cheaper relative valuations. The slowdown in global economic growth has already been reflected in current pricing. If global growth accelerates later this year, the Fed does indeed begin to cut interest rates, and the U.S. dollar weakens, international and emerging markets stocks could greatly benefit. We'll continue to be neutral on International Developed and Emerging Market stocks until China's government embarks upon significant policy stimulus and a trade resolution is reached with the U.S.

## PORTFOLIO STRATEGY & OUTLOOK

- As for bonds, much of the economic weakness, geopolitical risks, and trade uncertainty have already been reflected in U.S. Treasury prices (higher prices/lower yields). Central banks have become more dovish which may limit the upside for bond prices in the months ahead. Rates in many countries are already at or near zero and the U.S. bond market is currently pricing in 3 interest rate cuts by year end. Although not unquestionably attractive at current yield levels, bonds still provide a stable source of income and act as a low-risk diversifier in balanced, asset allocation portfolios.

- We will continue to favor U.S. Investment Grade Corporate bonds and Mortgage-Backed Securities over Government bonds and keep portfolio duration near benchmark index duration (4 years). We expect the performance of the Municipal bond market to continue to trend in a positive direction so long as the supply (lack of) and demand imbalance exists.

- Last month the Fed indicated its willingness to begin cutting interest rates (expansionary monetary policy) from very low levels because global growth is slowing, the unresolved trade war between the U.S. and China has negatively impacted business and consumer confidence, and inflation expectations have fallen in the U.S. and across the globe. Recessions rarely happen when monetary policy is expansionary. Stock bear markets and recessions almost always overlap. In other words, stocks rarely enter a bear market without a recession. ***The rally in Risk-Based Assets is not over.*** It may just need a breather.

Andrew Zimmerman, Chief Investment Strategist

# Asset Class Total Rate of Return Performance Summary as of 6/30/2019

| Stock Indices | Asset Class | QTD Return | YTD Return | 1 Year Return |
|---|---|---|---|---|
| MSCI AC World Daily TR N | Global Equities | 3.61% | 16.23% | 5.74% |
| S&P 500 INDEX | U.S. Large Cap Equities | 4.30% | 18.54% | 10.41% |
| S&P 400 MIDCAP INDEX | U.S. Mid Cap Equities | 3.03% | 17.96% | 1.34% |
| RUSSELL 2000 INDEX | U.S. Small Cap Equities | 2.09% | 16.97% | -3.35% |
| MSCI EAFE | International Developed Market Equities | 3.93% | 14.53% | 1.70% |
| MSCI EM | Emerging Market Equities | 0.69% | 10.69% | 1.54% |
| FTSE E/N All Eqty ReitTR | Real Estate (REITs) | 1.79% | 19.27% | 13.01% |
| **U.S. Large Cap Sector Stock Indices** | | | | |
| S&P 500 ENERGY INDEX | U.S. Large Cap Equities - Energy Sector | -2.83% | 13.13% | -13.25% |
| S&P 500 HEALTH CARE IDX | U.S. Large Cap Equities - Health Care Sector | 1.38% | 8.07% | 12.99% |
| S&P 500 CONS DISCRET IDX | U.S. Large Cap Equities - Consumer Discretionary Sector | 5.28% | 21.84% | 10.17% |
| S&P 500 CONS STAPLES IDX | U.S. Large Cap Equities - Consumer Staples Sector | 3.72% | 16.18% | 16.39% |
| S&P 500 INFO TECH INDEX | U.S. Large Cap Equities - Information Technology Sector | 6.06% | 27.13% | 14.34% |
| S&P 500 UTILITIES INDEX | U.S. Large Cap Equities - Utilities Sector | 3.48% | 14.70% | 19.03% |
| S&P 500 INDUSTRIALS IDX | U.S. Large Cap Equities - Industrials Sector | 3.57% | 21.38% | 10.39% |
| S&P 500 COMM SVC | U.S. Large Cap Equities - Telecom Sector | 4.49% | 19.09% | 13.66% |
| S&P 500 MATERIALS INDEX | U.S. Large Cap Equities - Materials Sector | 6.31% | 17.26% | 3.20% |
| S&P 500 FINANCIALS INDEX | U.S. Large Cap Equities - Financials Sector | 8.00% | 17.24% | 6.30% |
| S&P 500 REAL ESTATE IDX | U.S. Large Cap Equities - Real Estate Sector | 2.46% | 20.42% | 16.80% |
| **Commodities Indices** | | | | |
| ISHARES GOLD TRUST | Gold | 9.05% | 9.85% | 12.31% |
| S&P GSCI Tot Return Indx | Broad Commodities | -1.42% | 13.34% | -11.49% |
| **Bond Indices** | | | | |
| U.S. Aggregate | Core Bonds | 3.08% | 6.11% | 7.87% |
| Intermediate | Intermediate Government & Corporate Bonds | 2.59% | 4.97% | 6.93% |
| U.S. Corporate High Yiel | High Yield Debt | 2.50% | 9.94% | 7.48% |
| U.S. Treasury | U.S. Treasuries | 3.01% | 5.18% | 7.24% |
| U.S. TIPS | U.S. TIPs | 2.86% | 6.15% | 4.84% |
| U.S. Agency | U.S. Government Agencies | 2.32% | 4.17% | 6.13% |
| U.S. MBS | Mortgage-Backed Securities | 1.96% | 4.17% | 6.22% |
| Corporate | Corporate Debt | 4.48% | 9.85% | 10.72% |
| Municipal Bond Index | Municipal Debt | 2.14% | 5.09% | 6.71% |

*Notes: The DT Investment Partners' Commentary and Outlook discusses general developments, financial events in the news and broad investment principles. It is provided for information purposes only. The material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. I investments in various asset classes entail different investment risks. For example, small cap stocks tend to be more volatile than large or mid-cap stocks. International and emerging markets stocks have exposure to currency fluctuations, foreign taxes, political instability and the possibility for illiquid markets. Fixed income investments involve interest rate and credit risks among others. Real estate investing includes risks such as declines in value of real estate, changing economic conditions, tax laws or property taxes. Commodities' investing is highly volatile and subject to changing economic conditions and the vagaries of speculators among other risks. One cannot invest directly in an index. Past performance does not guarantee future results.*