SECOND QUARTER FINANCIAL MARKET COMMENTARY

"NINETY DAYS IN NINETY SECONDS"

JUNE 30, 2019

SITUATIONAL AWARENESS

- The investment backdrop is always a complex web of knock-on effects and feedback loops. That is the consequence of interaction between a dynamic real economy and sophisticated capital markets, which is to say, the interplay between current activity and future expectations. We often isolate issues and simplify narratives for the benefit of clear communication. But right now, everything feels related to everything else, so it is worth thinking about how each of the sections in this commentary depend on each other.
- The second quarter of 2019 must be considered in the context of the fourth quarter of last year and the first quarter of 2019, a period that could jokingly be referred to as the "pivot divot." Stock prices declined sharply late last year on concerns that Fed policy was too tight thus slowing the economy and then rebounded as the Fed signaled willingness to ease policy if necessary. The result for stock prices was a lot of action with no progress. The second quarter did progress with respectable stock market gains, but alongside a continuation of volatility.
- The issues important to financial markets remain the same: an aging economic cycle with both strengths and weaknesses, high corporate profitability but slowing earnings growth, uncertain Fed policy, and oscillations in trade war intensity that are wearing on the economy. Each issue pulling and pushing on the others.

HISTORIC EXPANSION

- The current economic expansion has lasted 40 quarters, tying it with the 1991 to 2001 expansion for the longest on record. If no recession begins in the third quarter, which is highly likely, then the current expansion will be the longest since at least 1854 according to the National Bureau of Economic Research. The average economic expansion in the period since World War II has been 21 quarters.
- Industrial activity has slowed. Various purchasing manager indexes (PMI) provide a timely look at manufacturing activity by surveying thousands of companies regarding new orders, production, supplier deliveries, inventories, backlogs and other variables. Changes in PMIs are closely linked with activities ranging from semiconductor sales to containerboard production. The most popular PMI from the Institute of Supply Management, and one we watch closely, has declined from robust levels, but is still consistent with a slow expansion. The combination of a considerable drop in trade volumes and low levels in corporate confidence, as measured by the Morgan Stanley Business Conditions Index, suggests that concern over trade tensions is causing businesses to act with caution, which means slower growth.
- In spite of this slowdown, the job market remains very strong. The unemployment rate has been below 5% for 30 months, on par with the booming periods of the late 1960s, late 1990s, and mid 2000s. As a result, wage growth has picked up and the consumer feels good with Consumer Confidence near all time highs.

The FED Inches Toward Easing

- Following the last Federal Open Market Committee meeting, the word "patient" was removed from the post-meeting statement – a sign of the maniacal attention given to Fed pronouncements. That is consistent with signaling by Chairman Powell that the Fed stands ready to reduce interest rates if trade tensions continue to drag on the economy.

- The bond market expects two 25 basis point cuts by the end of this year. President Trump, with his usual colorful tweets, is calling for interest rate cuts (although electoral motivations no doubt play a role). But, the members of the Federal Open Market Committee are decidedly split with eight members favoring cuts, eight members favoring no action, and one preferring an increase.

- So, what is the evidence to support an interest rate cut? First, the Fed appears to be achieving the part of its "dual mandate" to promote maximum employment, but not quite meeting its standard of stable prices. The Fed has indicated that stable prices means 2% inflation as measured by the Core Personal Consumption Expenditures Deflator, which is current running at 1.6% year-over-year, although other measures show higher inflation. Second, bond markets are signaling that monetary policy is too tight. The yield curve is inverted. See our March 31, 2019 Commentary for a full discussion of the yield curve. The 10-year US Treasury yield dipped below 2%, the lowest level in nearly three years, and the German 10-year bond yield went negative for the first time since 2016.

- From a historical perspective, it is noteworthy that the small mid-cycle interest rate cuts of 1995 and 1998 had the effect of re-steepening the yield curve temporarily, with little impact on inflation, while seeming to be successful in extending the economic cycle.

Contrarian Inflation Watch

- The University of Michigan Long-Term Inflation Expectations Index declined to a new low of 2.2%, which is an indication of how little inflation matters to investors. While we are not predicting an imminent surge, a closer eye makes sense for several reasons.

- On a cyclical basis, unemployment is below its natural level resulting in upward wage pressure that, if sustained, will likely flow through to higher prices. Longer term, the deconstructing of global supply chains that is a consequence of the on-going trade war will also likely result in higher prices for manufactured goods.

- Additionally, as is often the case, stubbornly low inflation is itself forcing reactions that will likely sow the seeds of higher price levels. As one example, the Fed is undergoing an in-depth review of its monetary policy framework expected to be concluded in 2020. Early rumblings are that the Fed is considering average inflation targeting, which could result in the Fed taking a systemically easier stance toward monetary policy at exactly the time price pressures have been built into the system.

Conclusion

- We believe the market is likely to slowly grind higher, as opposed to either a steep decline or a "melt up" scenario that some pundits have discussed. Equity valuations are at near median historical levels, which should offset decelerating earnings growth, and both of these factors are occuring against the backdrop of a newly accommodative Fed. We expect a continuation of elevated volatility.

- While a rate cut this year seems likely, enthusiasm regarding Fed easing may be a bit overdone. In fact, one of the biggest "doves" among the Fed Governors, James Bullard, who has favored lowering interest rates, suggested that the current situation doesn't require the 50 basis point cut that the market seems to be expecting.

- Valuations of cyclical stocks, which are sensitive to economic activity, are very depressed relative to defensive stocks, such as utilities and some consumer companies that are less sensitive to changes in economic activity. That likely means that stock prices are already "pricing in" a significant slowdown.

- Finally, trade policy is influencing the decision making of the Fed and corporations, which both influence the real economy and feed back into future decision making. We do not know if a trade resolution is likely or not but feel certain any progress would be very positive for both markets and economic activity.

Holt Capital
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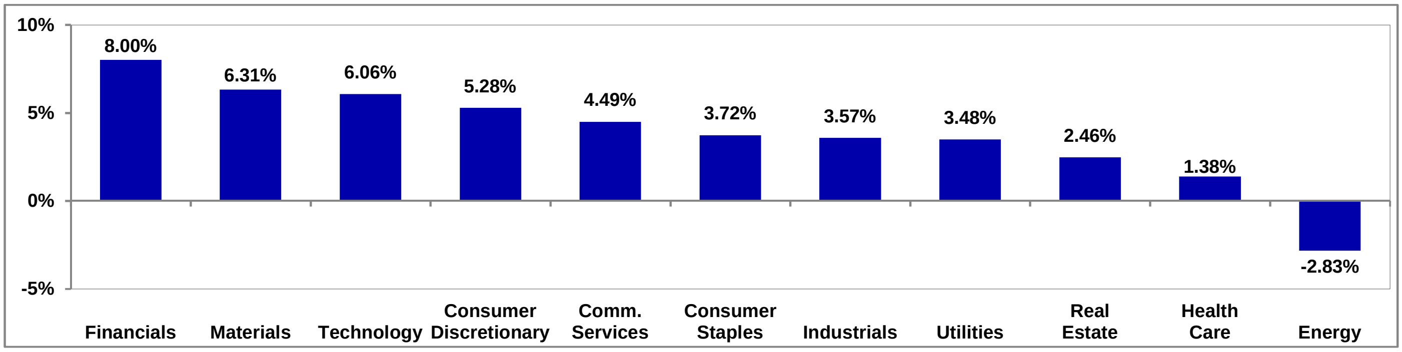
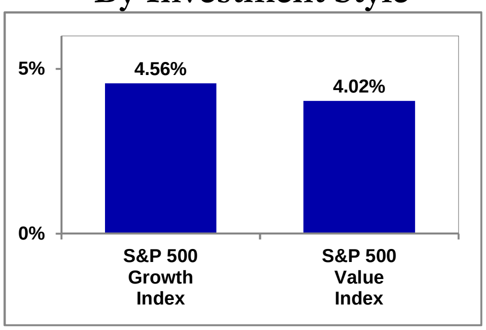
Second Quarter Investment Performance (including income)

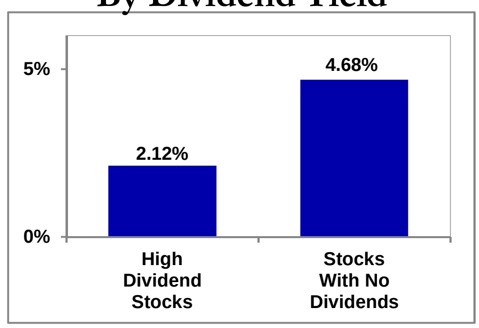
By Economic Sector



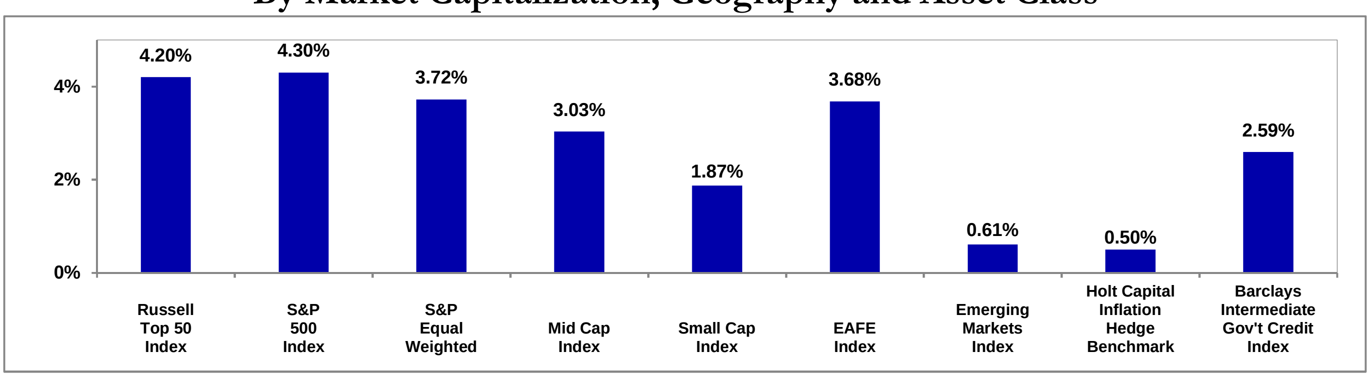
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Leadership broadened out in the second quarter with strength in the financial and materials sectors, joining technology shares with market leading gains.

- Value stocks were competitive with growth stocks during the quarter and outperformed during the month of June. The lowest quintile of stocks in the S&P 500 Index are valued at a price to earnings ratio that is about one-third of the P/E of the most expenseive quintile. This is the widest valuation gap in at least five years and is a positive indicator for future returns from value strategies.

- The sharp decline in interest rates produced a second consecutive quarter of strong total returns from bonds.