FINANCIAL MARKETS COMMENTARY

2ND QUARTER, 2019

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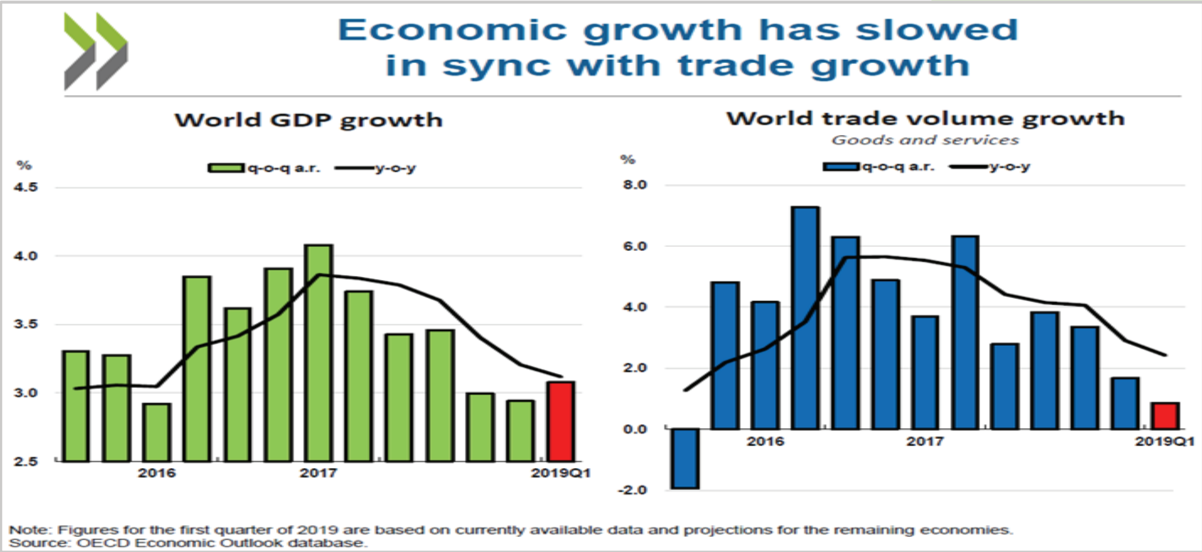
SECOND QUARTER HIGHLIGHTS

"WHAT GOES AROUND, COMES AROUND."

- The U.S. economy continued to chug along albeit at a slower pace in Q2 as the ongoing trade battle with China and others took its toll. Around the globe it was pretty much the same story as economies around world are all increasingly connected and as a result affected.
- The abrupt cessation of quantitative tightening (QT) and the resumption of quantitative easting (QE) continued to buoy financial markets.
- Equity markets in the second quarter, despite a brief trade related sell-off late in the quarter, continued to perform reasonably well led by strength in the U.S. markets.
- Fixed income markets globally enjoyed positive returns in Q2 as the Fed and most major central banks have reversed course and hit the pause button on any further interest rate increases and QT.
- The U.S. dollar weakened marginally against a basket of foreign currencies in the second quarter on the back of lower U.S. interest rates and worries of slowing economic growth.
- Oil prices fell sharply for most of the second quarter on concerns over the supply and demand for crude. Renewed tensions with Iran contributed to a rally late in the quarter. Gold performed well, rising primarily in June as investors sought out safer havens. Most other commodity prices declined slightly for the quarter but finished off their lows.

ECONOMY

The global economy continued to chug along in the second quarter, albeit at a slower pace and with plenty of help. As evident in much of the headline economic data being reported in the U.S. and elsewhere, President Trump's trade war is not only affecting global financial markets, it's chilling business investment, confidence and trade flows across the world, a development that most foreign leaders and business executives say is worsening a global economic slowdown that was already underway despite years of central bank stimulus.



In Europe, Australia and other parts of the world recent weakening of economic conditions coincides with the intensified trade negotiations with China and our other major trading partners. Most economists warn that further escalation by President Trump — like tariffs on more Chinese goods or levies on foreign autos from Europe — could slow global growth to a crawl. Weakness in China, driven in part by fallout from the trade war, has spread to Germany, Australia, India and other nations, raising supply chain costs, chilling exports and worrying political and economic leaders alike.

The president's approach to our trading partners comes as developed and developing nations alike are already pulling back on the rapid economic globalization that dominated the last two decades of policymaking. President Trump has made steady use of tariffs, or the threat of them, to influence trading partners, like China, India, Europe, Canada and Mexico, whom he believes have impacted American jobs through either cheap products or unfair trade practices.

ECONOMY

Another major theme for the global economy this year, especially in the U.S., is the level and the direction of interest rates. To start the second quarter Federal Reserve officials were already worried about slowing economic growth abroad and the fading effects of President Trump's tax cuts which were reflected in their decision in March to pause interest rate increases and cut economic growth forecasts for 2019. They became even more dovish as the second quarter progressed. At the most recent meeting, held in mid-June, the Fed left interest rates unchanged, but signaled it was closely monitoring if more stimulus may be warranted. The FOMC also cut the word "patient" from its policy statement and eight participants in the process signaled lower rates would be appropriate this year. As a result of the Feds policy shift and more dovish stance the often quoted 2 year note yield fell from roughly 2.34% to 1.75% during the quarter and the 10 year note yield dropped from approximately 2.50% to 2.01%.

Source: Eikon. Q2 2019 change in bond yields.

ECONOMY

Major central banks elsewhere have also turned more dovish to address inflation shortfalls and extend the weakening global expansion. As an example, in a recent speech the European Central Bank's Mario Draghi said interest rate cuts and other options were on the table to support the Eurozone unless growth and inflation pick up soon. Asset prices in European markets immediately reflected the dovish tone. The short dated German bond yield dropped to an almost unbelievable -0.75% after the news. About the same time the Bank of Japan signaled it stands ready to move to a more accommodative stance if warranted and move even further into negative territory. The prospect of an ECB and/or BoJ going even more negative on rates and/or restarting quantitative easing has helped drag the share of developed market government bonds with negative yields back to 2016 highs this quarter.

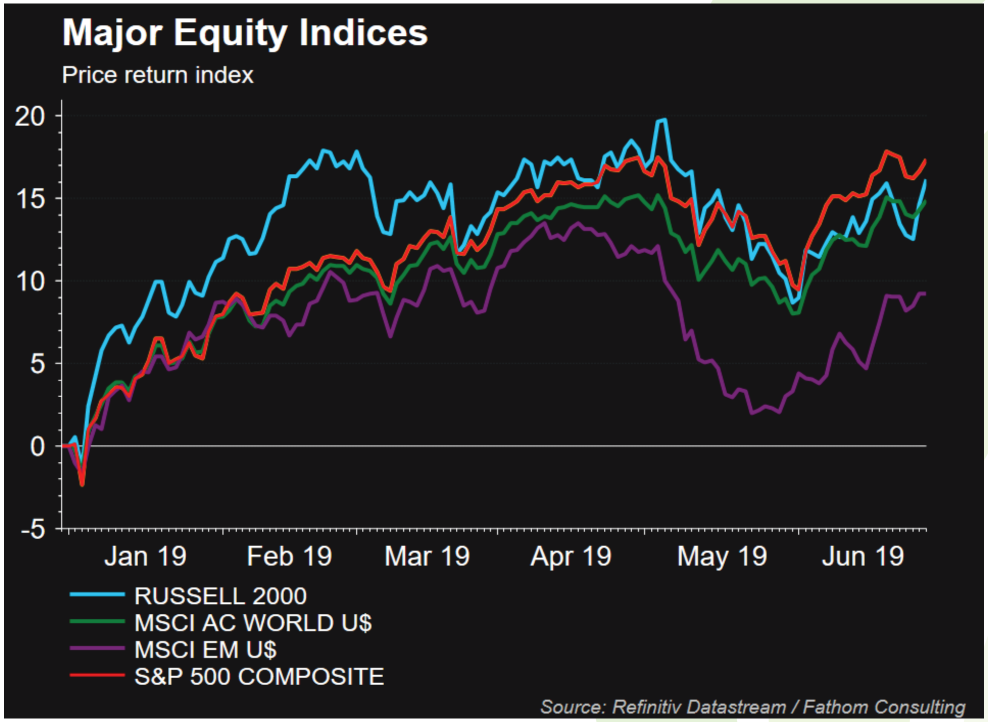
Lastly, as we have mentioned previously, the world is suffering from a changing demographic landscape, with the older population now growing at a faster pace than the younger population, at the same time global population growth is slowing. While these trends are more long term in nature they are weighing on global growth nevertheless.

EQUITIES

It was a tale of two cities for the global equity markets in the second quarter. After a relatively strong start in April stock markets around the world fell in May on trade talk concerns only to reverse course in June. For the quarter the S&P 500 gained 4.30%, the Dow Jones Industrials gained 3.20%, the Nasdaq gained 3.87% and the Russell 2000, which represents small-cap stocks, brought up the rear gaining 2.10%. Surprisingly small cap stocks have fallen over 3% over the past year while large stocks have gained 10%.

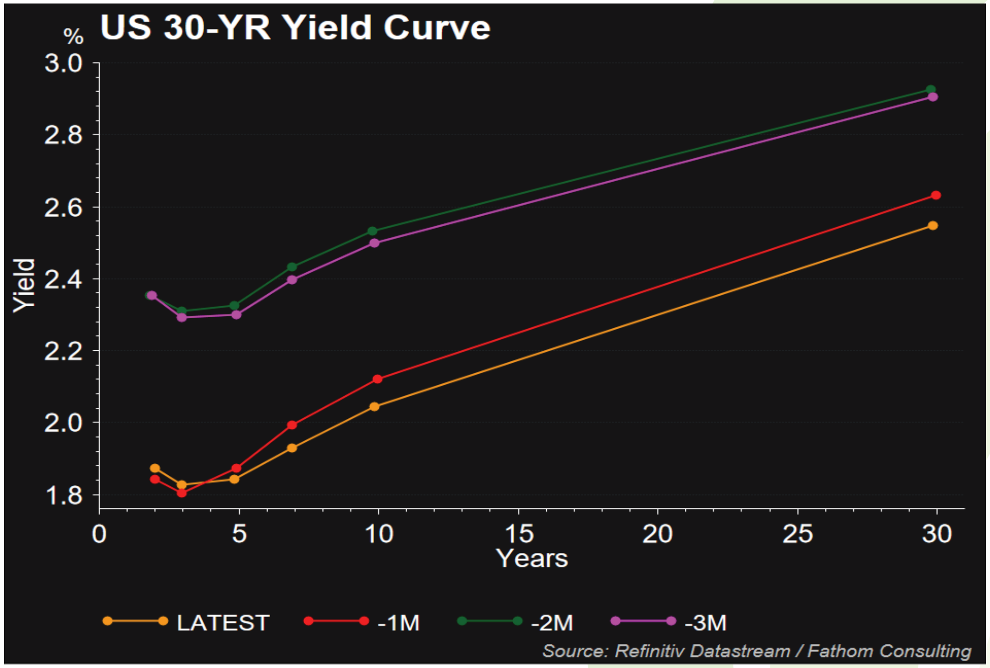
Growth stocks have once again led the way domestically, continuing a trend that has been in place most of the last decade. The Russell 1000 Growth Index gained 21.49% compared to the 16.23% gain of the Russell 1000 Value Index year to date.

Overseas the MSCI All Country World Index – ex U.S. rose 3.61% and the MSCI Emerging Markets Index increased 0.61%. Faster economic growth in the U.S. and a supportive Federal Reserve has skewed investor interest in favor of the U.S. equity markets generally speaking this year.



FIXED INCOME

Given the Feds recent stated intention to not raise interest rates it's no surprise that fixed income returns were positive across the board in the U.S. in the second quarter. As to maturity, the longer the bond the better. For the quarter the Morningstar US Short Core Bond Index rose 1.67%, the Intermediate Core Bond Index gained 2.21% and the Long Core Bond Index increased by 5.64%. As to sector the junkier the credit the better. The Morningstar Government Bond Index rose 2.92%, the Mortgage Bond Index rose 1.64%, and the US Corporate Bond Index rose 4.21% during the quarter, and the BofA/ML US High Yield Index rose 1.90%. Mortgage bonds have been penalized as a result of the drop in mortgage rates and the subsequent large numbers of refinancing taking place.



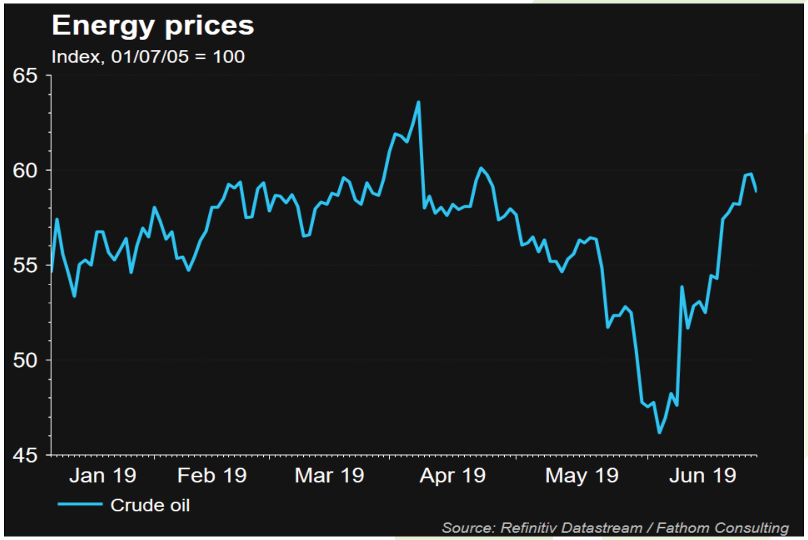
Overseas it was a similar story as interest rates fell in most major economies resulting in a record level of sovereign debt trading at negative interest rates. The Vanguard Total International Bond Index Fund, which tracks the performance of an index that includes international government, agency, and corporate securities, mostly from developed countries but also some emerging markets countries, gained 3.03% for the second quarter.

FIXED INCOME

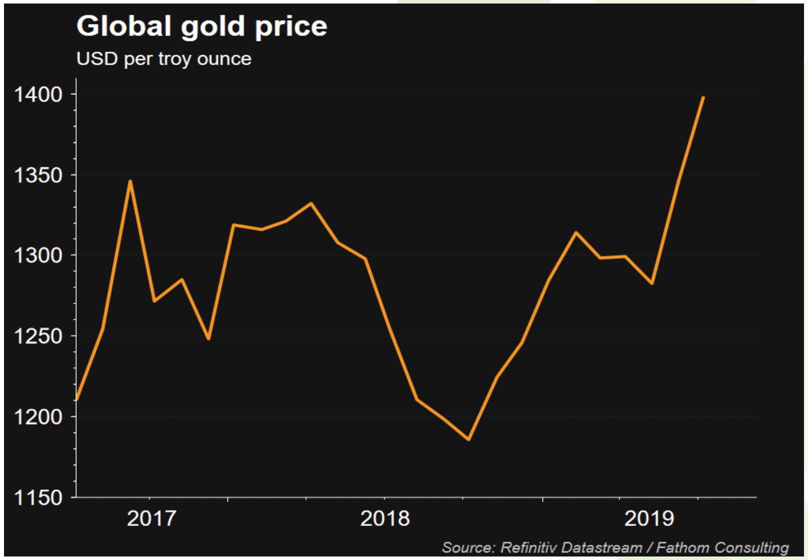
Supply and demand dynamics continued to be supportive of municipal bond performance, which has been a consistent theme in 2019. Modest levels of issuance has resulted in net negative issuance (more bonds were called, refunded or matured than new bonds issued) during four of the six months this year, while demand has remained strong. As a result the Barclays Municipal Bond 10-year Index was up 5.36% for the second quarter. Last year we predicted that rates would remain in their long term historical band until a decisive breakout lasting months. There is again no reason to handicap a breakout, up or down, absent a many-month breakout.

COMMODITIES

Oil prices, after having fallen early in the second quarter, have recently risen as tensions with Iran have overcome concern with surging U.S. oil production and slowing demand for crude as a result of the weakening global expansion. WTI crude ended the second quarter at $58.20 a barrel, up 28.90% since the start of the year.



Gold has rallied sharply in June closing at $1,412.30 an ounce, up over 7% for the quarter, and closing at 6 year highs. Weakness in the U.S. dollar, expectations for lower interest rates among global central banks, as well as geopolitical concerns drove safe haven demand for the precious metal.



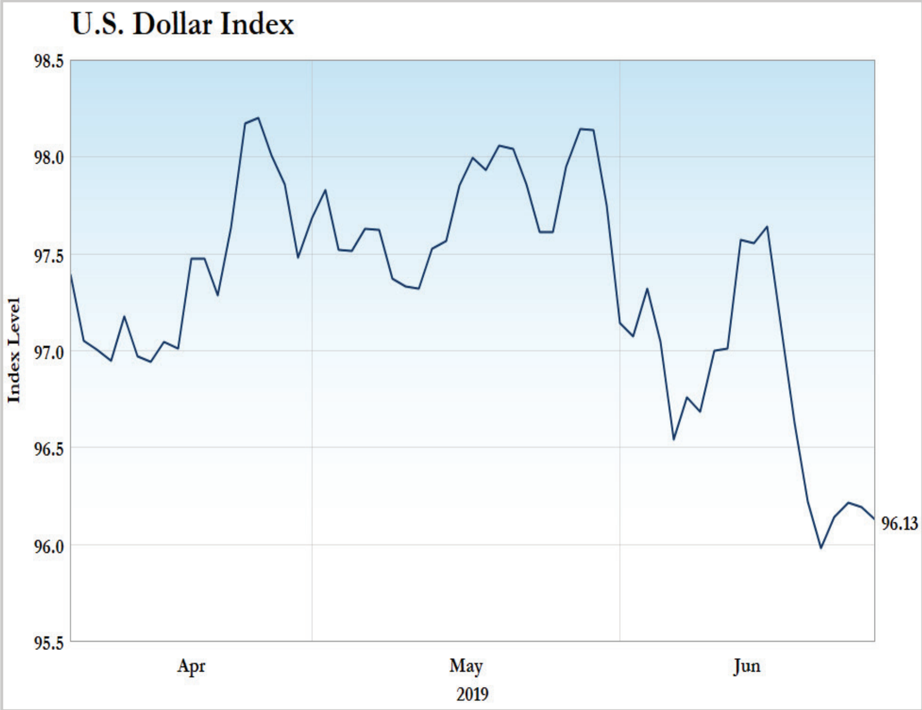
COMMODITIES

Silver is a different story; it's basically flat for the year and the quarter at $15.34 an ounce. The white metal's lagging price performance in recent months has resulted in it trading at its biggest discount to gold in three decades.

In other commodity markets lean hogs and corn have been stellar performers this quarter and year, while orange juice, cotton and cattle have been the worst. Flooding has swamped fields and it is likely that increased prices for animal feed will manifest in higher prices for protein as the year progresses.

CURRENCIES

The U.S. dollar index, after strengthening in the first quarter and early in the second quarter, closing at 96.13. The dollar fell as the prospect for lower U.S. interest rates and slowing domestic growth emerged. The dollar is now down on the year against a basket of major foreign currencies. All else being equal, a weaker dollar is generally favorable for emerging market assets because it makes it easier to service dollar-denominated debt. For other currencies it was a mixed bag in the second quarter. On the plus side the Russian ruble, the Ukrainian Hryvnia and Thai Baht were the best performers. Conversely the Argentine Peso, the Pakistani Rupee and the Turkish Lira were the worst.



Source: Eikon.

LOOKING AHEAD

Not much has changed since the year started excepting the rapid demise of QT and resultant upward movement of financial markets. The U.S. is still engaged in a global trade war with China and some of its other trading partners, Brexit is still unresolved, Japan remains mired in a multi-year slump, we still have poor relations with North Korea, Russia and Iran, and there's no peace in the Middle East. Despite all this, the global economy is still chugging along, albeit at a slower pace and with plenty of help from central bank stimulus. Global financial markets also continue to move moderately higher on investor hope for a trade deal and even lower interest rates.

As to what happens next nobody really knows. There's an old adage in the investment business "the secret to investment success isn't to know the future, but rather to be prepared for any contingency." With the current economic expansion in the U.S. the longest on record, the S&P 500 Index trading at the upper end of its historical valuation range and the 10 year U.S. Treasury note barely yielding 2%, that advice seems pretty prudent today. Accordingly we are being cautious and, while we are confident in the diversified nature of our portfolios, we remain focused on the changing financial market landscape to determine if, and when, appropriate changes are needed or necessary. Our defense first, offense second investment approach should serve us well if things take a turn for the worse. With that said we are staying disciplined and rebalancing portfolios when the opportunities present themselves.

CONCLUSION

As always we thank our clients for their partnership and welcome any comments or questions. For those of you who are not our clients feel free to contact us as well.

Telemus Investment Committee

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