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INVESTMENT MANAGEMENT

Second Quarter 2019 Commentary

The first half of 2019 saw robust gains across most asset classes. Global stock markets got a jump start on the year thanks to progress in U.S.-China trade negotiations and a newly "patient" Federal Reserve, but an abrupt breakdown in the trade talks spurred a sharp market sell-off in May. Stock markets subsequently recovered in June, rebounding on expectations of Federal Reserve rate cuts later in the year and (tentative) signs of re-engagement on the U.S.-China trade front. The S&P 500 hit a new high near the end of June. Large-cap U.S. stocks shot up 7.0% for the month; their best June since 1955. They were up 4.3% for the second quarter, and a strong 18.0% for the first six months of the year; their best first half since 1997.

International developed stocks gained 6.0% in June, 3.7% for the second quarter, and 14.2% for the year to date. In April, the "Brexit can" was kicked down the road at least until October 31, but the risk of a disruptive "no-deal" exit remains. Emerging market stocks also rebounded in June, gaining 5.6%. Although emerging market stocks were only up 1.3% for the second quarter, their first-half gains still stand at a robust 11.9%.

Moving on to the fixed-income markets, the 10-year Treasury yield continued to plunge from its multi-year high of 3.2% posted last October dipping below 2% following the Federal Reserve's June meeting. This was a near three-year low, and among its lowest levels ever. While U.S. bond yields are very low, at least they are still positive. Across much of Europe and Japan, many government and corporate bonds have negative yields; meaning investors who buy and hold these bonds to maturity are guaranteed to lose money on their investment. The total dollar amount of this negatively yielding debt recently shot above $13 trillion, a record high.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	4.3%	10.9%	11.0%
US Mid Cap Stocks	4.4%	7.8%	8.9%
US Small Cap Stocks	2.9%	2.3%	7.7%
International Developed Stocks	3.7%	0.9%	2.7%
Emerging Market Stocks	1.3%	4.4%	3.2%
US Bonds	3.1%	7.9%	2.9%
Global Bonds	3.4%	4.1%	-0.1%
US REITs	1.0%	9.7%	6.4%

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD
US Mid Cap Stocks: CRSP US Mid Cap TR USD
US Small Cap Stocks: CRSP US Small Cap TR USD
Emerging Market Stocks: FTSE Emerging TR USD
International Developed Stocks: FTSE Developed Ex US TR USD
US Bonds: Barclays US Aggregate Bond TR USD
Global Bonds: Barclays Global Aggregate Ex USD TR USD
US REITs: MSCI US REIT NR USD

At the June Federal Open Market Committee meeting, Federal Reserve Chair Jerome

Powell suggested "the case for somewhat more accommodative policy has strengthened", citing heightened uncertainty around the outlook for global growth, trade policy, and below-target inflation. For now, the Fed Funds Rate remains unchanged at 2.25% to 2.5%, but investors are currently forecasting a near 100% probability that the Federal Reserve cuts rates by at least 0.25% this year, a 92% odds of at least two quarter-point rate cuts by year-end, and a 60% odds of three or more rate cuts. U.S. and global fixed income markets are clearly sending worrying signals about the prospects for future global economic growth.

As of July, this will be the longest economic expansion in U.S. history, beginning its 11th year. However, it's also been the most sluggish recovery in the past 70 years. Real GDP growth has averaged just 2.3% per year during this expansion, compared to a median growth rate of 4.4% per year for the prior 11 post-WWII expansions.

There is no economic law that says a recession must occur on a set schedule or duration. While the average post-WWII U.S. expansion cycle lasted around five years, the three most recent expansion cycles (excluding the current one) lasted an average of eight years. Similarly, U.S. equity bear markets have occurred less frequently in recent decades, although they have been more severe in magnitude. As the U.S. economy has evolved from manufacturing- based to more service-, technology-, and consumer-based, the nature of the economic cycle has likely evolved. For better or worse, so have central bank and political attempts to proactively "manage" the economy and sustain expansions. To state the obvious, attempts to lower interest rates are generally a stimulant for financial markets and asset prices, all else equal. A lower interest rate implies higher asset valuations (e.g., higher price to earnings multiples for stocks). But all else is rarely equal. And the implications of lower rates and monetary stimulus are not so obvious when you go beyond simple, first-level thinking to consider the broader economic context for these low rates (i.e., concerns about slowing growth and very low inflation).

This dynamic evolution in the drivers of the economy on the one hand and policy intervention on the other means uncertainty remains a constant when it comes to investing. Those of us who own stocks (in particular) need to be prepared to ride through inevitable down periods. Bearing the risk of shorter term stock price movements is the price we pay to earn the higher expected returns over the longer term.

All of us at Leavell Investment Management appreciate your trust and confidence.

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