SlateStone WEALTH

Balancing Your Life Goals with Financial Results

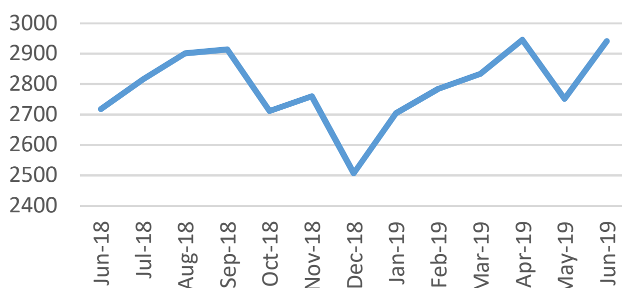
Investment Review & Outlook

July 2019

Review

The economy and S&P 500 earnings came in better than expected in the first quarter. We will have to wait for several weeks to get our first definitive answers on the health of the economy for the second quarter. Interest rates are low, employment growth is healthy and therefore the US consumer has the ability to continue to drive the economy forward. Current expectations are that the rate of growth in the US economy peaked at 3.2% in the first quarter. As we look forward look to the second quarter and beyond, GDP growth should tail-off towards 2% later this year and into 2020 as the diminishing impact of last year's tax cuts and reduced inventory build related to trade tensions slows growth. Nevertheless, there is nothing wrong with 2% growth. That is the growth rate achieved over most of this record-long expansion. So we revert to a slower, sustainable rate after the impact of the tax cuts fade.

The S&P 500 moved higher in April, then dropped by almost 7% in May and then rallied to a new all-time high in late June / early July. This kind of volatility is something we should expect to continue. The June rally was a function of near universal belief that the Federal Reserve will cut interest rates by at least ¼% at the end of July, coupled with an agreement to re-start the trade negotiations. The short-term interest rate cut is already priced into longer-term rates, while the trade negotiations are likely to drag on for a long time.



One interesting observation is that it is hard to find any aggressively bullish market predictions in the financial press, despite the fact that the US equity market is hovering near an all-time high. This suggests, in a contrary way, that we are not at a major market top even though we might have to grind back and forth around current levels for a while.

Global Markets

We have had a big move in share prices so far in 2019. On a total return basis (price change + dividends), the S&P 500 is up 18.5% this year. The world's developed markets (including the US) are up 17% so far. After such a strong run this year, it is easy to forget that the S&P 500 dropped 14% in the fourth quarter last year. This year's rally brings us just marginally above where we were last Fall. Market timing sounds like a good idea, but it will cost you in terms of long term return.

Very low risk Treasuries that mature in one-to-three years generated a return of 2.5% over the first half of 2019. Slightly longer three-to-five year Treasuries generated 4.1%. A longer time to maturity results in greater price volatility for a given move in interest rates and results in more risk in a fixed income investment.

Equity Market Performance
To 28-Jun-2019, in US Dollars

	2nd Quarter 2019	12 Months 6/30/19
MSCI World Index	4.0%	6.3%
Europe	4.5%	1.9%
France	6.5%	3.0%
Germany	7.1%	-3.8%
Switzerland	8.4%	19.8%
United Kingdom	0.9%	-2.1%
Japan	1.0%	-4.2%
Pacific, ex Japan	5.2%	8.1%
EAFE	3.7%	1.1%
USA	4.1%	9.6%
Emerging Markets	0.6%	1.2%

Source: Morgan Stanley Capital International,
Total return, dividends less withholding tax reinvested

Data sources: Standardandpoors.com, Bloomberg, MSCI.com *Continued on page 2*

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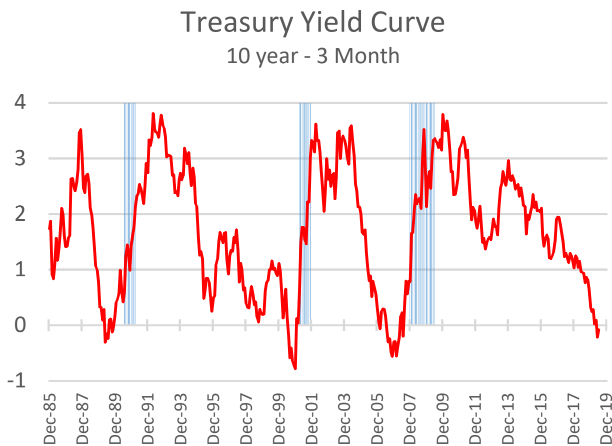
Outlook

There is no shortage of things to worry about, global trade impediments including: US / China, US / EU and Japan / South Korea as well as other geopolitical hazards. Then we add on the risk of another debt ceiling confrontation in the Fall. But the thing that concerns us the most is the threat of US recession that comes with the "inverted yield" curve. Normally, the yield curve (a graph of US Treasury interest rates plotted against the length of time to maturity) inverts when the Federal Reserve is pushing over-night interest rates higher. When. 3-month Treasury Bills offer a higher yield than 10-year Treasury Notes the yield curve is "inverted" as represented by the line falling below zero on the chart below.



Note: Blue columns represent recession periods

An "inverted curve" has been a reliable indicator of looming recession. However, the arrival of recession, on average, takes about a year from the onset of a curve inversion. Assuming the widely held expectation that the Fed will cut short-term rates at the end of July comes true, that should push the line back above zero. But, the line typically has been back above zero prior to the arrival of past recessions. At this point, there is no need for a panicky response but additional caution is reasonable..

The best case scenario is that we are headed into a global economic slowdown. If a recession is just over the horizon the current consensus estimates may be overly optimistic.

Real GDP Growth - YoY %				**Market P/E**
	2018	2019	2020	2-July-19
US / S&P 500	2.9	2.5	1.8	17.1
Eurozone / Stoxx 600	1.9	1.2	1.3	18.1
UK / FTSE 100	1.4	1.3	1.5	17.9
China / CSI 300	6.6	6.2	6.0	14.7
Japan / Nikkei 225	0.8	0.7	0.4	16.2

Source: Bloomberg, July 2, 2019

Earnings expectations for the S&P 500 have drifted modestly lower since our last report. That is fairly typical as they tend to be overly optimistic early in the year. Despite all of our concerns and the expectation of increased share price volatility, we have maintained our price target of 3000 (a new high) for the S&P 500 at year-end 2019. Looking out to mid-year 2020 we can argue for a 3200 price target. These targets are contingent on hitting Standard & Poor's consensus earnings expectations about which we do have some doubts. On the other hand falling interest rates, could reasonably result in higher P/E ratios than we are currently using.

Standard & Poor's 500				
	Annual Earnings	%Change Y-o-Y	Price/ Earnings	Year-end Price
Dec-12	86.51	-0.5%	16.5	1426.19
Dec-13	100.20	15.8%	18.5	1848.36
Dec-14	102.31	2.1%	20.1	2058.90
Dec-15	86.53	-15.4%	23.6	2043.94
Dec-16	94.55	9.3%	23.7	2238.83
Dec-17	109.88	16.2%	24.3	2673.61
Dec-18	132.39	20.5%	18.9	2506.85
Dec-19e	150.00	13.3%	20.0	3000
Jun-20e	157.90	15.4%	20.3	3200

Source: Standardandpoors.com June 28, 2019

Health Care stocks significantly underperformed the broad equity market so far this year. We blame a difficult political environment in the US for the sector's struggles. The demographics of an aging global population support the idea that health care continues to offer above average growth characteristics at a reasonable price. The potential for new drug development, particularly in the biotechnology segment, is huge. However, the US election cycle may limit the share price upside in the short-run.

On the fixed-income side, we use bonds in balanced portfolios to mitigate the risk inherent in equity investing and to provide liquidity for unanticipated expenses. We will continue to be very conservative in our bond investments. But when the yield curve begins to "steepen" there may be an opportunity to increase income levels through extending our average maturity.

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