BTC CAPITAL MANAGEMENT™

Investment Insight

Second Quarter | 2019

Economic and Market Overview

Contributed by | Jon Augustine, CFA, Chief Investment Officer

How ’Bout Them Markets!

As the second quarter progressed from April into May, it would have been completely understandable if equity investors anticipated a weak follow-through from the very strong returns generated in the prior three months. With a 12.2% return from global equities in the first quarter, a downshift would not have been unexpected. But saving the day were suggestions that trade tensions between the United States and China were potentially easing.

Additional help came from monetary policy officials and the fixed income markets, which, through a decline in bond yields, helped stocks surge higher in June with U.S. equities hitting all-time highs. With its return of 7.1%, not only did the S&P 500 have its best June since 1955, it also had its best first-half performance since 1997, registering 18.5% for the six-month period.

And with the aforementioned assist from monetary officials, the fixed income markets generated a very respectable return of 3.1% for the quarter as well as a healthy 6.1% year-to-date return. The performance of the fixed income markets may not have been as impressive as the equity markets, but the magnitude of its return was not anticipated and is reflected in the 10-year U.S. Treasury yield decline, which fell from 2.7% at the beginning of the year to a level of 2.0% at the end of the second quarter.

International equities have also participated in the strong year-to-date returns as the developed markets, measured by the MSCI EAFE Index, have returned 14.5% for the first half and emerging markets also registered a double-digit return at 10.8%.

How ’Bout That Economy!

Not to be outdone by the record-setting equity markets, the U.S. economy is also entering a never before seen phase of growth. As the third quarter begins in July, it will mark 121 consecutive months of expansion, surpassing the previous record of 120 months achieved during the period of March 1991 through March 2001.

This recovery has been characterized by modest growth, but to its credit the growth has been consistent as the economy has seen unemployment decline from levels that approached double digits during the financial crisis to the current level of 3.6%. Also, it has been accompanied by very modest levels of inflation.

While numerous pieces of recently released economic data suggest the outlook of slower growth is warranted, we are not anticipating an imminent recession. Several factors lead us to this view. In terms of the U.S. consumer, the most recent reading of the Bloomberg Consumer Comfort Index hit its highest level in 18 years. Key components of this reading included gains in household finances and buying climate components that point to the prospect of steady consumer spending.

In contrast, the University of Michigan Index of Consumer Sentiment declined in its most recent reading. While it did decline, it is still close to the peak it hit last year and the shortfall was attributed to households within the top third of the consumers surveyed. This suggested the lower reading may have been due primarily to concerns of how a prospective increase in trade tensions could negatively impact consumers’ equity portfolios.

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Looking Forward

U.S. GDP growth is expected to slow in the second quarter. A survey of economists conducted by Bloomberg reveals a consensus forecast of 1.8% and the most recent GDPNow outlook from the Federal Reserve Bank of Atlanta stands at 1.5%. Driving the lower growth forecast for the second quarter is a stark reduction in the private investment component of GDP, the first quarter’s strongest contributor. This decline will be offset somewhat by an increase in personal spending, but is still anticipated to be a significant drag on the overall result.

Also, it was widely anticipated the recently released ISM Manufacturing Index could fall below the growth/contraction demarcation line of 50. The actual reading came in at a better than expected level of 51.7, which is indicative of ongoing growth. Of course, an increase in trade tensions could lead to additional economic weakness. As previously stated, we continue to feel a recession is not on the near-term horizon.

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Staying the Course

While the financial markets have delivered strong returns in the first half of the year, we continue to maintain our current asset allocation positioning. This composition includes an overweight to domestic equities, neutral weighting to international equities and an underweight to fixed income. As previously stated this allocation strategy has been very rewarding given the strength of the equity markets, particularly U.S. equity markets. We readily acknowledge volatility measures may move their equilibrium into a higher range in the second half of 2019. With the strong year-to-date performance delivered by the equity markets, investors will be sensitive to the potential for disappointment. For example, second quarter earnings reports will be scrutinized closely, not only for the prospect of earnings shortfalls but also the outlooks provided by company management that accompany the releases.

Despite the anticipation of a potential increase in volatility, our long-term focus leads us to look through the short term and place more emphasis on what we see further on the horizon.

In addition, we review our outlook for the financial markets on an ongoing basis and recognize the potential for a negative impact to the markets from an increase in trade and/or geopolitical tensions. If the inputs into our economic and market outlook indicate the need for a shift in our allocation positioning, we will make the appropriate adjustments.

As we typically do at the conclusion of these musings, we encourage investors to review their investment objectives to ensure the asset allocation currently being used truly reflects the goals, income needs and risk tolerance they want represented in their portfolio.

Fixed Income Commentary

Contributed by | Justin Carley, CFA, Managing Director

Beware the Consensus

A year ago bond yields were moving up materially and reached multi-year highs. Economists were racing to put up the highest number on their yield forecast for 2019 while financial advisors were fielding constant questions about potential losses from their clients' fixed income portfolios. Once again the consensus was wrong in the financial markets. Not only did the Bloomberg Barclays Aggregate Bond Index post a positive gain amid the fear, but in fact completed the best rolling 12-month stretch since 2012. If we cherry-pick the top in yields, the eight-month gain of 8.7% is the second-largest since 2001. Just as in 2016, when yields bottomed, we are starting to see an uptick in firms lowering their 10-year yield forecast below the current rate in a race to the bottom.

The large gains are attributable to an unusual circumstance where corporate bond spreads were tightening even as Treasury yields were falling. Usually spreads widen when Treasury yields make a sharp lower move given a large percentage of buyers that are yield focused. The recent rally in corporate bonds could set up a "pain" trade as most active managers are underweight in the space, especially BBB-rated bonds, given the narrative of excessive debt levels and downside economic scenarios. We continue to overweight BBB-rated bonds partly due to a favorable convexity, i.e., they gain more on the upside than they lose on the downside. We have been overweight BBB-rated bonds for several quarters.

Corporate spreads have exhibited significant volatility in the past year, and we have been fortunate enough to generally be on the right side of these actions. Following a tactical underweight in May that saw corporate bonds underperform Treasuries more than 1.25%, we upgraded the space to neutral with an overweight bias in early June. We continue to limit exposure to longer-dated corporates, which has been a tailwind to performance and helps alleviate some of the risk from the overweight to BBB-rated bonds. It does appear we are at a crucial threshold regarding corporate bonds. Either downside economic scenarios start to unfold or the large percentage of investors that have de-risked will be forced to buy back in at higher prices as forward-looking economic indicators improve. We will objectively follow our models and expect to outperform should either scenario unfold, although this could be associated with slightly higher than normal turnover levels.

Easing Bias

The Federal Open Market Committee (FOMC) essentially adopted an easing bias at their June meeting. Seven of the 17 members who put out fed funds forecasts expect a cut of 50 basis points before the end of the year. Federal Reserve (Fed) Chair Jerome Powell started off the press conference by making it clear the Fed will do everything possible to extend the economic cycle. The Fed is now clearly saying they will support the market, a complete U-turn

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from the rhetoric in December. Despite these comments from Chair Powell, it still appears many members remain reluctant to cut rates unless the data worsens. This defeats the point of a pre-emptive cut. It makes it more likely when cuts do arrive, it will be too late to ward off the self-reinforcing economic downturn.

We very recently shifted our outlook on duration from overweight to a new underweight. This is driven by the excessive move in yields prone to a retracement along with some pickup in early growth indicators. Despite this, we expect the headline data to get worse before it gets better. We are closely monitoring the leading indicators for evidence they are rolling over. This would greatly improve the likelihood the Fed is behind the curve and warrant a return to an overweight duration.

Equity Commentary

Contributed by | Mark Mandziara, Senior Managing Director

The Second Quarter in Review

Equity investors rode a rollercoaster during the second quarter. As the quarter began, global equity valuations extended their rise initiated during the first quarter. April ended and, as Jon notes in the “Economic and Market Overview” section, sentiment turned negative in May. Uncertainty relating to monetary policy, ongoing trade conflicts, concerns about sustained economic growth coupled with a slowdown in corporate profitability all weighed on equities, both in the United States and globally.

Jump forward to June and what a difference a month made as domestic large cap equities exhibited their best June since 1955. Surprisingly, not much changed in June to bolster valuations.

> ***Domestic large cap equities exhibited their best June since 1955.***

While first quarter gross domestic product rose a solid 3.1%, sustained economic growth in the United States and elsewhere continues to be questioned. And corporate profitability, which exhibited weakness during the first quarter, remains a concern.

That said, global equities rose 4% during the second quarter. U.S. large cap equities led equity performance rising 4.3% while small caps increased 2.3%. Foreign developed companies advanced 3.7% and emerging markets eked out a marginal gain of 0.6% for the quarter. On a style orientation basis, growth outperformed value.

Forward Considerations

Corporate profitability has been an area of contention. Specifically the scenario that forward equity valuations will be sustained by continued growth in corporate earnings within the framework of a slowing (but growing) domestic economy, coupled with ongoing angst regarding the lack of resolution pertaining to trade agreements.

According to FactSet, for all of 2019 analysts estimate earnings for U.S. large cap companies will grow 2.6% year over year (YOY). This is materially below the growth of 21.7% YOY exhibited during 2018. A similar pattern is exhibited for U.S. small cap and foreign developed companies.

In contrast, analysts remain upbeat for calendar years 2020 and 2021, with earnings projected to grow YOY by 11.4% and 11.5%, respectively. This pattern holds for developed markets outside the United States. For 2019, analysts estimate earnings growth of 2.9% YOY, with estimated growth increasing in 2020 to 7.9% YOY.

Valuations

Equity valuations have trended up throughout 2019, both domestically and outside the United States. Broad equity indexes within the United States have achieved new highs recently. One may question if this trend is expected to continue.

A recognized valuation measure is the price-to-earnings ratio (P/E) for the trailing 12 months. For the MSCI USA Index, its current P/E of 20.9x exceeds an average P/E of 19.4x over the last 10 years, which may give one pause.

However, when considering the next 12 month (or forward) P/E for this index, a different picture arises. Based on current prices and estimated earnings, the forward P/E for this index is 17.2x. One may see opportunity for higher equity valuations going forward should valuations revert to the mean (or average) and the projected growth in earnings is realized.

Outlook

Given our assessment presented above regarding both forward earnings and valuation, we believe equites continue to present opportunity relative to historical valuations and also other asset classes. We expect U.S. equities will outperform foreign equities and remain biased to domestic large caps over small caps.

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