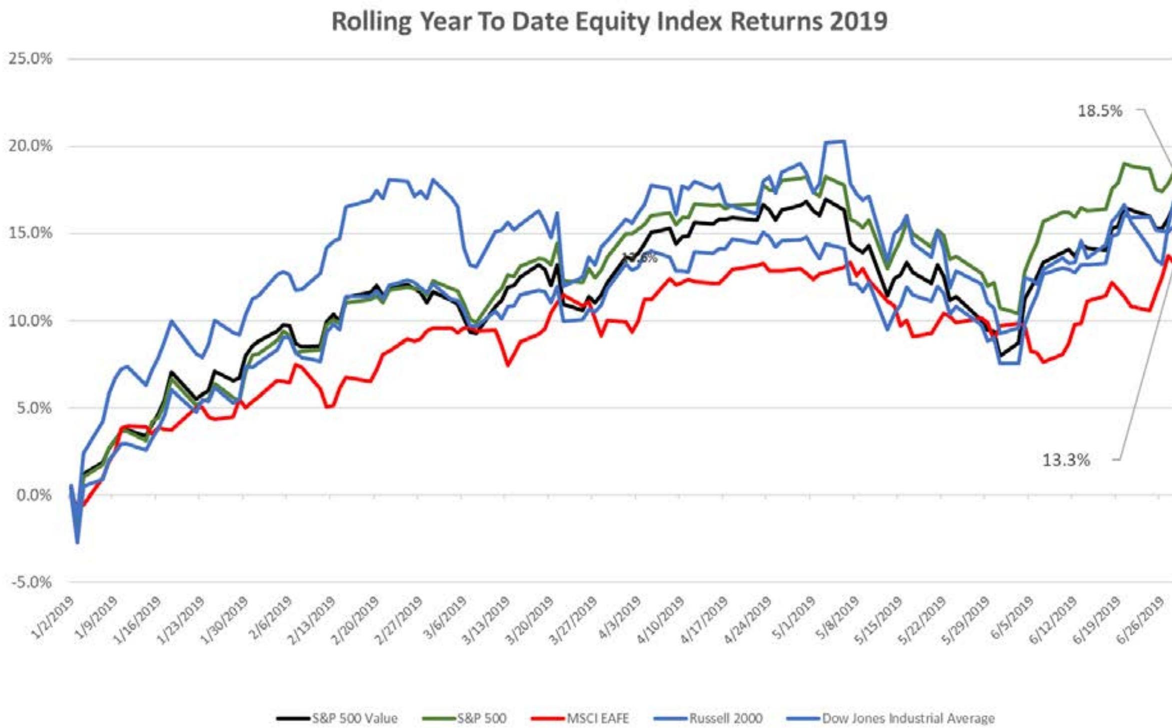
Mid-Year 2019 Commentary

Dear Turtle Creek Client,

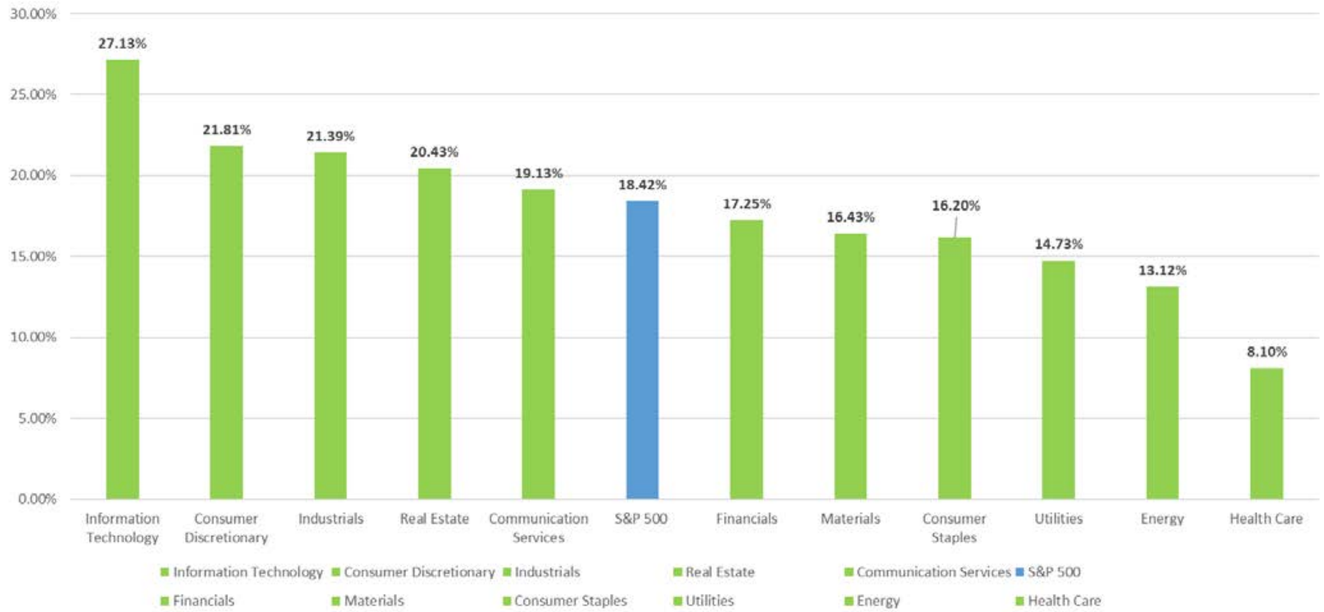
Both fixed income and stock markets continued their synchronized advance through the second quarter. As we have noted in previous letters, these markets are traditionally uncorrelated, meaning they react in opposite fashion to the same set of circumstances. At the moment they are sending conflicting messages. The ongoing global decline in bond yields provides a dour forecast reflecting a slowing U.S. economy, trade frictions, a lack of inflation, and international markets mired in recession. Stocks on the other hand continue to appreciate despite slowing corporate profits, signaling that current economic volatility is temporary and better economic times are ahead. We have attempted to reconcile these conflicting messages in previous communications but realize at some point one market could be right at the expense of another.



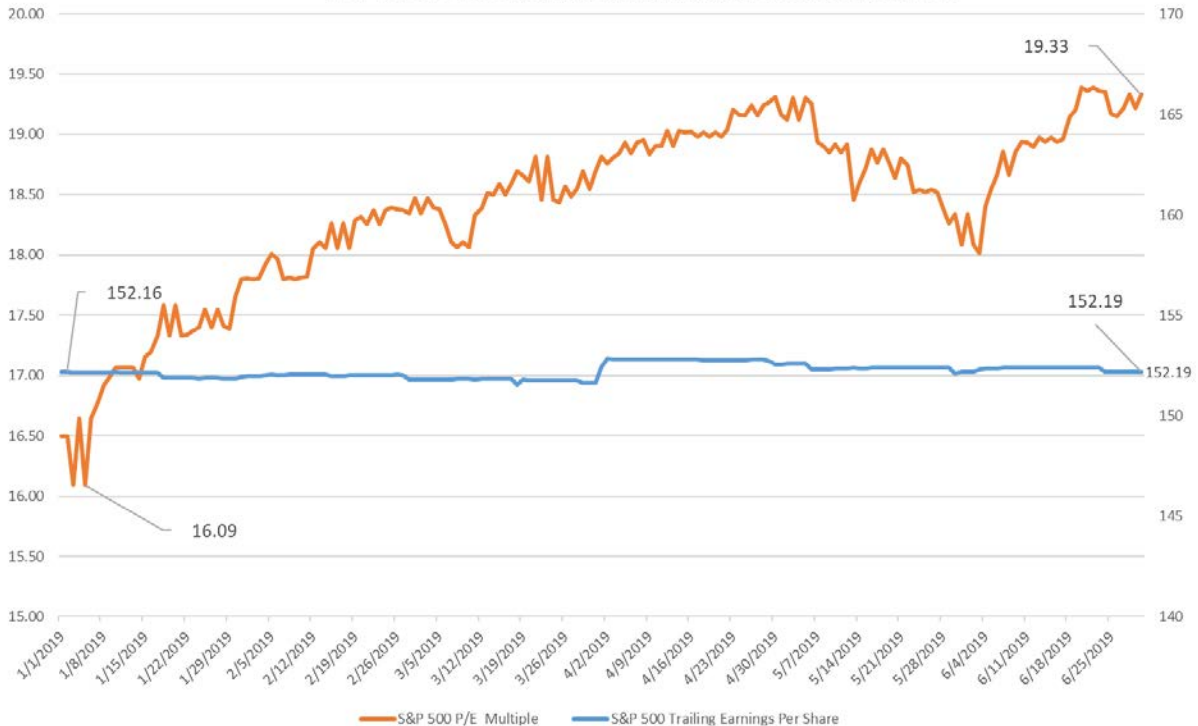
Source: Bloomberg

<u>Factors in Stock Market Performance</u>

U.S. stocks delivered a balanced performance through mid-year with defensive investments largely keeping pace with growth-oriented sectors. Consumer Discretionary, Information Technology, and Industrial companies continued to lead overall market performance but were joined by traditionally defensive investments in the Real Estate and Communications sectors. Consumer Staple and Utilities firms also largely kept pace with the market. The noticeable laggard has been the Health Care sector. Regulatory scrutiny of drug-pricing and health insurance as well as litigation against key pharmaceutical companies has translated to only modest gains during the year.



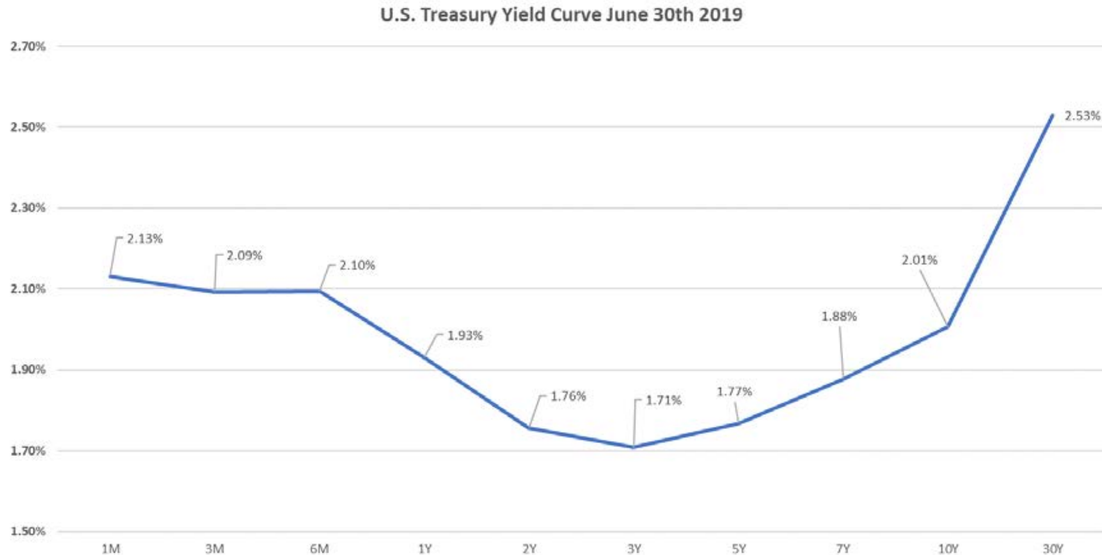
The stock market is currently advancing on the hope of economic recovery rather than fundamental progress. S&P 500 corporate earnings have flat-lined during the year as the Trump Administration's trade-war inflates commodity input costs and interrupts key cross-border business relationships. The transitory benefits of recent-corporate tax cuts have also faded. Wall Street analysts expect a second-half earnings recovery and further growth into 2020, a trend that would justify the market's recent advances. The arrival of this good corporate news is critical, however, to sustaining the stock market's recent gains.



Source: Bloomberg

Fixed Income Markets

Bond yields in most parts of the world extended their declines during the second quarter despite solid but slowing economic data for the U.S. economy. Key sections of the Treasury yield curve remain slightly inverted, a status that we have previously highlighted as a forecast of potential recession.



Source: Bloomberg

Inversions have historically been reliable but not perfect predictors of economic decline and there is a danger of declaring "this time is different." That being said, market analysts have noted the unusual backdrop for this inversion as compared to prior recessions. Key differences include:

- Central Banks Stimulus – Rates remain by most historical measures very accommodative of economic growth. Prior recessions were preceded by significant Federal Reserve hiking cycles that halted economic growth.

- The Historically Sub-Par Pace of the Current Expansion – While the length of the current expansion is approaching the longest ever, the size of the recovery is modest compared to other growth cycles. GDP growth has averaged 2.3% during this expansion while averaging 3-5% during prior growth booms.

- Dormant Inflation – Inflation, once the great scourge of the economy, remains below historical trend and Central Bank targets. Interest rates over the long run are greatly influenced by inflation trends, so the recent halt in inflation could partly explain low yields.

- A Lack of Cyclical Excess – History shows that great booms are followed by deep busts. Corporate efficiency is running at historic peaks at the moment, however, and usually cyclical industries such as airlines, rails, housing, and retail have all shown restrained capital expenditures through the recent cycle.

- International Yields –U.S. Treasury yields seem paltry shine compared to other leading economies such as Japan and Germany who currently offer of zero or even negative yields on sovereign bonds. Money has shifted to U.S. Treasuries in huge sums as a result. This excess demand from abroad is thought to have pushed up bond prices and pushed down yields.

These conditions point to a slowdown that, if it arrives, should be mild as compared to the greater economic collapse of the 1980s or 2008. Other factors do put into question the precise meaning of the current state of the yield curve.

Trade Tensions Persist

A key element of this year's market recovery has been the perception that the White House was slowing or even backing away from tit-for-tat tariffs and trade hostilities with economic partners. This status changed quickly in May as President Trump renewed tariff hikes against China and threatened similar action against Mexico and the European Union.

The impact of the trade war has recently transitioned from theoretical to quantifiable. Corporate leaders have begun to dial back hiring and capital expenditures, the necessary ingredients for future growth and a healthy economy. The Federal Reserves June statement on the economy stated that tariffs "*appear to have lowered imports and exports in the United States and elsewhere, while uncertainty surrounding trade policy could be leading firms to delay investment decisions and reduce capital expenditures.*" U.S. companies that earn more than half of earnings from outside the U.S. posted a nearly 10% decline in year-over-year earnings during the latest quarter. Primarily domestic companies posted positive earnings during the same period. As the cost of the trade war grows, a productive resolution to the recent dispute is becoming an ever more critical element to sustaining economic growth and stock market expansion.

Portfolio Positioning

All assets are winning at the moment, a trend that history says will not persist. They are doing so without fundamental progress in the corporate profits or resolution to key markets risks. Given this backdrop, it is most prudent to remain within the asset allocation goals for your portfolio. Stock allocations are likely above target due to this year's market rally. Reducing these holdings to keep in line with your strategic allocation is sensible. Increasing the quality of stock holdings is another prudent step. Larger corporations with durable cash flows and quality balance sheets have historically fared better during market downturns.

Fixed income investments retain their value as a source of portfolio stability, but longer-term yields have sunk to levels that make it difficult to grow your portfolio while preserving capital and meeting planned withdrawals. Stocks currently offer superior dividends yields as compared to bonds with the added value of capital appreciation over the medium and longer-term. Equities should remain the locomotive for portfolio expansion in the years ahead.

International stock markets provide the most interesting longer-term risk/reward. Clients have rightly noted that both developed and emerging international markets produced significantly inferior returns compared U.S. markets the last ten years. This poor stretch is historical anomaly. In the thirty-five years prior to the 2008 market crash, international markets beat U.S. returns nearly half the time and did so in an uncorrelated fashion, helping portfolios provide superior risk adjusted returns. As large emerging markets continue to modernize and experience rising standards of living, they should reward investors and currently sell at much more attractive valuations as compared to U.S. companies.

Over the longer-term, business cycles will run their course but the potential for economic growth and the corresponding compounding of your wealth remains strong. Please call or write should you have questions on these topics or any other topic. As always, we appreciate the trust and faith you place in our firm.

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