VERITAS
INVESTMENT & WEALTH ADVISORY

Second Quarter Market Review and Comment
July 2019

Updated Market Performance

Returns	2nd Quarter 2019	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**4.30%**	**10.42%**	**14.19%**	**10.71%**	**14.70%**
DJIA	**3.21%**	**12.20%**	**16.80%**	**12.29%**	**15.03%**

Performance: April began right where March left off notching a return of 4.05%. May did not bring flowers this year reversing course and taking away -6.35%. However, June got us back on track with a return of 7.05%. The net result from the volatile quarter was 4.30%. Leading to a great first half start to 2019 with a return of 18.54% including dividends, the best start since 1997's 19.49%.

After a celebrated 1st quarter with the S&P 500 up 13.65% the 2nd quarter of 2019 brought some volatility with it, the S&P 500 (SP500) posted a 4.30% return in the 2nd quarter that just ended on June 28, 2019. The Dow Jones Industrial Average (DJIA) trailed the SP500, posting 3.21% over the same period. For the previous twelve months the SP500 has returned 10.42%, underperforming the DJIA which returned 12.20% over the same period. The annualized three-year returns are better than near term returns, with the SP500 posting 14.19%, while the DJIA is running at 16.80%. Over the last five years the annualized returns are running above historical norms (around 10%), with the SP500 returning 10.71% and the DJIA posting 12.29%. The ten-year annualized numbers are also running above long-term averages (around 10.00%); the S&P500 posted 14.70% vs the DJIA which turned in 15.03%.

Breaking down the returns for the Q2 2019, we note that there were five outperforming sectors and six underperformers. **The best sectors were Financials (7.43%), Materials (5.72%) and Information Technology (5.65%)**. **The losers during the quarter were Energy (-3.71%), Health Care (0.94%) and Real Estate (1.58%).** The clear winners the last twelve months were Utilities (15.09%), Consumer Staples (12.90%) and Real Estate (12.88%). Bringing up the rear were Energy (-16.07%), Materials (0.96%) and Financials (4.03%).

The DJIA continued its rise in the 2nd quarter as the Fed continued its dovish stance, the street started to believe in lower interest rates, and an eventual trade deal with China. Trade tensions continue to be visible, but there has been renewed hope of a trade deal that is evident of the recent returns in the equity market. Trade tensions and slowing economic growth are still top of mind. Global trade and global economic growth are important since more than half of the 30 Dow components get 50% or more of their revenue from outside the U.S., according to FactSet. The SP500 by comparison derives 38% of revenue from outside the U.S.

Economy: Economic growth for the 2nd and 3rd quarter are expected to remain below average.

The third estimate of 1st quarter Gross Domestic Product (GDP) is 3.1% according to the report released at the end of June by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 1st quarter accelerated by ~0.9% compared to the 4th quarter 2018 when GDP was running at a

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rate of 2.2%. Overall, the economic recovery has continued so far in 2019 following growth of 2.9% in 2018 and 2.2% in 2017. The long slow recovery which has been in place since mid-2009 should continue for the foreseeable future although we continue to see deceleration and begin to see vulnerabilities. Currently the New York Fed Staff Nowcast (Forecast of U.S. GDP Growth) has forecasted Q2 GDP growth at 1.48% and Q3 GDP growth at 1.7%. By comparison, China says their GDP grew at 6.4% in the 1st quarter of 2019. China's 2018 GDP was 6.6% compared to 6.8% in 2017. The weakest annual growth rate in 28 years, due to the continued trade pressure from the US as well as slowing demand at home and abroad. Declines were not as bad as feared by economists due to a continued increase in policy driven stimulus. Growth rates for the European Union (EU) and the Euro Area were 1.5% and 1.2% respectively in the 1st quarter 2019. For 2018, GDP rose 1.9% for the EU and 1.8% for the Euro Area. This is down from the 2.4% growth both achieved in 2017 giving further evidence to the slowing of global growth.

Unemployment continues to stay historically low. According to the Bureau of Labor Statistics, June unemployment held steady at 3.7%. Unemployment for 2018 came in at 3.9%, the last time the unemployment rate maintained an average of 4.0% or lower was in the late 1960s. Job growth occurred from healthcare, in professional and business services, and in transportation and warehousing. The labor force participation rate was 62.9% for June, was little changed for the month and unchanged over the last 12 months.

Inflation is still below historical averages. After averaging ~1.64% in the 1st quarter, inflation as measured by the Consumer Price Index (CPI) increased to an average of 1.81% in the 2nd quarter. The average rate of inflation for 2018 was 1.9% and continues to be subdued by historical standards (2.60% over last 30 years). June came in at 1.65%, a modest decrease from May's reading of 1.79%. Most of the decrease is attributable to a decrease in energy prices.

Consumption is an important driver of the economy as it represented 67.6% of 1st quarter 2019 nominal GDP. The U.S. Census Bureau announced in July that retail sales for June 2019 were up 0.4% compared to May but were up 3.4% above June of 2018. Non-store Retailers were up 13.4% from June 2018, while health and personal care stores were up 5.5% from last year.

Manufacturing economy had growth in manufacturing for the 34th consecutive month. Economic activity in the **manufacturing sector** grew for the thirty fourth consecutive month in June, with the Purchasing Managers Index (PMI®) registering 51.7, a decrease of 0.4 from May's reading of 52.1. This is the lowest reading since October 2016. The PMI® continued a period of expansion softening that began in September 2018. Softening this month was primarily due to demand and inputs – new orders, supplier deliveries and inventories. Four of the six big industries expanded, but at lower rates. The **overall economy** grew for the 122nd consecutive month, according to the nation's supply executives in the latest **Manufacturing ISM®** *Report on Business®*. Based on historically relationships between PMI and GDP, a PMI of 51.7 corresponds to a 2.6% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices continue to rise, but price increase have continued to slow since the peak in 2017. According to the S&P Case-Shiller Home Price Indices home prices rose in April with the S&P CoreLogic Case-Shiller National Home Price Index rising 3.5% over the last 12 months. Las Vegas, Phoenix and Tampa had the largest year over year increases of 7.1%, 6.0% and 5.6% respectively. The favorable economy has continued to support recent gains in housing. In 2019, mortgage rates reversed course and got back down below 4% for a 30-year fixed mortgage after nearly reaching 5% in late 2018. The national supply of housing is trending upward and suggesting weaker demand.

Markets: After ending the year with a December rate increase, then a pause in interest rate increases, and now a 100% chance of a .25% interest rate cut. What are we to expect going forward after already achieving 18.54% in the first half of the year?

- **Earnings growth for the SP500 is expected to decline -2.6% for the 2nd quarter 2019. If actual growth comes in as estimated, it will be the first time the index has reported two straight quarters of year over year declines in earnings since Q1 2016 and Q2 2016.** According to FACTSET, of the SP500 companies that have reported earnings as of 3 July (Approximately 21), 86% reported earnings above the mean estimate and 71% have reported sales above the mean estimate. **Earnings guidance has been skewed to the downside with 88 companies issuing negative EPS (Earnings per Share) guidance and 26 issuing positive EPS guidance**. Estimated earnings for the second quarter fell by -2.6% from the end of Q1 2019 through the end of Q2 2019. This percentage decline was below the 5-year average -3.3%, the 10-year average -3.1%, and the 15-year average -4.2% for a quarter. Looking at future quarters, analysts see a decline in earnings growth in the 3rd quarter 2019 and low mid to single-digit earnings growth in the 4th Quarter 2019.

- **Stocks are rich after receiving an expansion of P/E's in the 2nd quarter from a drop-in interest rates. There is not much room for more P/E expansion, so we need earnings growth to increase to relieve the current extended valuations.** The current 12-month forward Price Earnings (PE) multiple on stocks is 16.7. The long term (20 Year Average) PE for stocks is 15.7, so we don't see a lot of room for valuations to move higher without growth or lower interest rates. There is no room for PE expansion now, so to get continued appreciation we will need an increase in earnings and widening profit margins.
- **Global trade tensions continue to persist.** Trade tensions are still present. This continues to leave a cloud of uncertainty on the market. With trade concerns in the news often and continually being put off, the likelihood of real measurable impacts on U.S. businesses from domestic trade tariffs and retaliatory measures continue to be present.

- **Falling interest rates.** The Federal Reserve decided to maintain the target range for the federal funds rate of between 2.25% and 2.50% during its June meeting. The decision to maintain was predicated by uncertainties about the economic outlook. Recent indicators have pointed to recent growth of household spending that has picked up from earlier this year and a softening of business fixed investment. Fed officials expect that considering the uncertainties along with muted inflation pressures, the fed will closely monitor the implications of new information for the economic outlook and will act as appropriate to sustain the expansion with a strong labor market and inflation near its symmetric 2% objective. In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. The market is currently pricing in at least .50% of rate cuts in 2019.

Forecast: Great start to the first half of the year leads to cautious and dwindling forward expectations.

Slowing growth, low unemployment, and low inflation. *Slowing global growth in the 2nd quarter has led to lower earnings and talks of a potential earnings recession if slow growth persists*. Economic growth will continue to moderate although it looks like it will pick back up towards the back end of the year. Unemployment has reached lows not seen since the 1960s and continues to run below historically averages. Inflation continues to run below average, but with continued economic stimulus and a dovish Fed do not be surprised if we see inflation pick up.

Earnings Growth & Maintained/Increasing Profit Margins. We need earnings growth to avoid an earnings recession. After all the negative earnings revisions and negative earnings guidance for Q2 2019 the bar has been lowered, so the focus and attention will be on forward guidance. Profit margins will continue to be pressured by rising wage and labor costs.

What risks are out there that might disrupt the recovery?

- **Negative earnings guidance and negative earnings surprises**. There have already been negative earnings revisions from SP 500 companies for their current earnings reports due to tariffs and slowing global growth impacting earnings. If forward guidance is disappointing, stocks will be pressured to the downside. There is not currently a compelling reason to sell based on valuations being too rich. The probability of this scenario is medium but could increase if we see a meaningful increase in negative earnings guidance.

- **The Fed not giving the market the rate cuts it has priced in**. Given the continued low inflation and low unemployment, we think the risk of rate increases by the Fed is low. After the Fed made 4.25% increases in 2018, they decided to pause rate increases in January and will most likely cut rates in July. The recent Fed pivot has been a pleasant surprise and a positive for equity prices, but the market is currently being very optimistic about the amount of rate cuts we will receive. If we do not receive the stimulus the market has priced in, don't be surprised if we have a temporary pull back in valuations.

- **Inverted Yield Curve.** We still have an inverted yield curve, but hopefully a dovish Fed that is easing short term rates will lead to a steeping of the yield curve reversing the inversion for now. A yield curve inversion is usually followed by an economic slowdown and recession. The average time from an inversion of the yield curve until a recession is ~14 months according to J.P. Morgan Asset Management.

- **Global trade tensions.** We are continuing to see trade tensions which will continue to hold back business and consumer spending, leading to slower economic growth. We hope to see some type of resolution with some of the trade tensions later this year or early next year as we draw closer to the 2020 presidential election.

We think the biggest threat to the stock market is the uncertainty presented by slowing economic growth as well as rising corporate debt levels. This uncertainty will persist until there is clarity over what the final resolution will be on the trade front. It will also depend on the amount of economic stimulus injected globally to spur growth. Rates on the long end of the yield curve have retreated recently, as prospects for global growth have deteriorated causing yields to fall and the Fed to telegraph easing monetary conditions. After the first half rally to start the year it will not take much negative market sentiment and fear to get the market to head to the downside. We think the SP500 will end the 3rd quarter between 2,750 and 2,850. At this juncture, we venture a guess that stocks will end up somewhere between 18%-20% for the year.

For the next six to nine months, the Federal Funds rate should remain near its current range of 2.00%-2.25%. **The 10-year Treasury which is currently priced at ~2.03% may rise toward 2.25% before the end of the 3rd quarter.** By year end we should see the rate between 2.25%-2.50%, assuming that inflation increases and global growth expands.

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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