LINSCOMB WILLIAMS

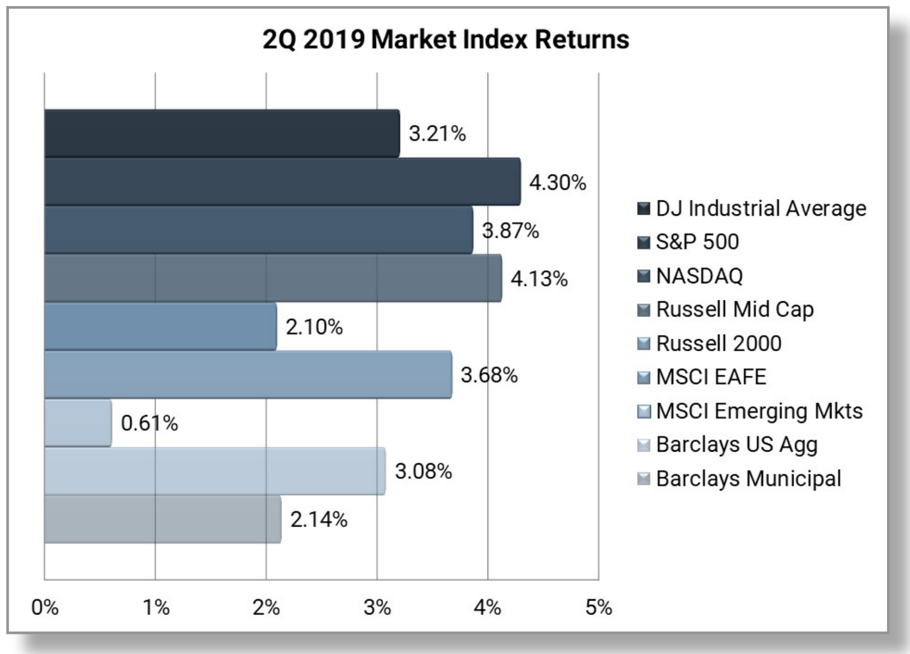
WEALTH MANAGEMENT SINCE 1971

QUARTERLY MARKET COMMENTARY: *Second Quarter 2019*

the ECONOMY

As June comes to a close and we enter the dog days of summer, here in the U.S. we've been blessed with a trio of events worthy of celebration. First, of course, is the July 4th holiday representing America's 243rd birthday. And if you didn't get your fill of fireworks then, the U.S. women's national soccer team secured its second straight World Cup title just a few days later, defeating the Netherlands 2-0. Back-to-back championships have only occurred once before. Bravo. More importantly for investors, though, is that the economic expansion recently reached its own milestone, hitting its 10th anniversary last month, a stretch never before accomplished. Looking back over the past decade, we think economist, Dr. Ed Yardeni, put it best when he recently described it as "The Rodney Dangerfield of Economic Expansions". That is – it just hasn't gotten no respect. The same can be said for the bull market in stocks. There have been numerous obstacles, of course, and more than a fair share of doomsayers along the way, but none worthy enough to put an end to either the economic expansion or rise in asset prices.

Recently, the U.S. economy has moderated somewhat from its heady pace in 2018, but seems to be settling closer to its longer-term trend growth rather than coming to a halt. In the 1st quarter, growth came in at just over 3 percent, and various estimates peg the second quarter between 1 – 2 percent. Despite the ebbs and flows of financials markets and the ongoing back-and-forth between the U.S. and China on trade policy, the domestic labor market looks rock solid. The unemployment rate sits near historical lows at its current level of 3.7 percent, thanks to an average of 172,000 jobs created per month so far in 2019. Most economists suggest



that 75,000 – 100,000 is enough to absorb population growth. And there are plenty of job openings as well -- nearly 7.5 million, based on Bureau of Labor Statistics information. Interestingly, since early 2018 there have actually been more job openings than there have been unemployed people, of which there are roughly 5.8 million presently. In other words, the labor market is tight. In general, this has led to better bargaining power for workers and is reflected in higher wage growth. Different measures put it between 3.1 percent and 3.7 percent over the past year, fairly robust given inflation is just under 2 percent. Consumer spending was less impressive than we expected in the 1st quarter given the aforementioned data, but appears to have bounced back strongly in the 2nd. The rebound in asset prices may have assuaged consumer's fears of imminent economic trouble.

While the consumer is in good shape, business investment has been modest at best. Higher commodity prices incentivized further spending, especially in the oil patch, but persistent trade and geopolitical uncertainty has put a damper on corporate capital expenditure plans. We have noticed a slight uptick in residential investment, though, after five straight quarters of decline. Housing market spending is not terribly big relative to non-residential business investment, but a combination of lower mortgage rates and steady demand should help it and related industries contribute to growth.

GDP in the 28 member European Union (EU) rose 1.5 percent over the past year. Nothing extraordinary, to be sure, but mildly encouraging given some of the headwinds to the region's manufacturing centers and inconstant political environment. The bloc's largest member, Germany, is heavily dependent on exports, which account for nearly half of its output. A broad decelerating of global trade thus has an outsized effect on the country's economy. The German manufacturing PMI survey, a gauge of business sentiment, is currently at a 45 reading, the lowest since 2012. Any measure under 50 signals a contraction in activity. Yet, the region's broader economy hasn't shown too many ill-effects. In fact, at 6.3 percent, the unemployment rate is at its best level in well over a decade. In the U.K., Theresa May has resigned as Prime Minister and the Brexit deadline has been pushed back yet again until the end of October. Nonetheless, the British economy has been holding up rather well. This exit saga has been going on for so long without much progress one way or the other, that a sort of rational, benign indifference may have taken hold. Broad EU parliamentary elections were held in May, and while so-called "populist" parties did gain more support, it is unlikely to usher in any material changes to operations in Brussels.

Little new to report out of Japan, as the country still stands out as a bastion of governmental stability compared to much of the developed world. Prime Minister Shinzo Abe is enjoying record high approval ratings nearly 6 years into his term. A perhaps underreported and underappreciated story has been the steady improvement in Japanese corporate governance. As evidence, we'd point to the doubling of stock buybacks over the past year. While this use of capital has been politically contentious in the States, for Japanese companies it is surely a better use of corporate cash than hoarding it on the balance sheet earning 0 percent interest.

For emerging markets, the relationship between the U.S. and China remains the big story. Early in May, trade negotiations with China had advanced to a point where many were expecting a deal in the near future. Those talks were rather abruptly called off, with Treasury Secretary Steve Mnuchin saying that no further discussions were planned. President Trump then escalated the situation further by threatening tariffs on an additional $300 billion in Chinese imports and placing limitations on U.S. firms selling to Chinese telecom giant, Huawei. As has been typical of the dialogue between the two, a zig one way was shortly followed by a zag the other. During the G20 meeting late in June, the two sides were apparently back on speaking terms, resulting in a cessation of the new planned tariffs and an easing of restrictions on Huawei. Overall, emerging market financial assets and currencies managed to deliver positive performance in the 2nd quarter, though not without a dose of volatility.

CENTRAL BANKS

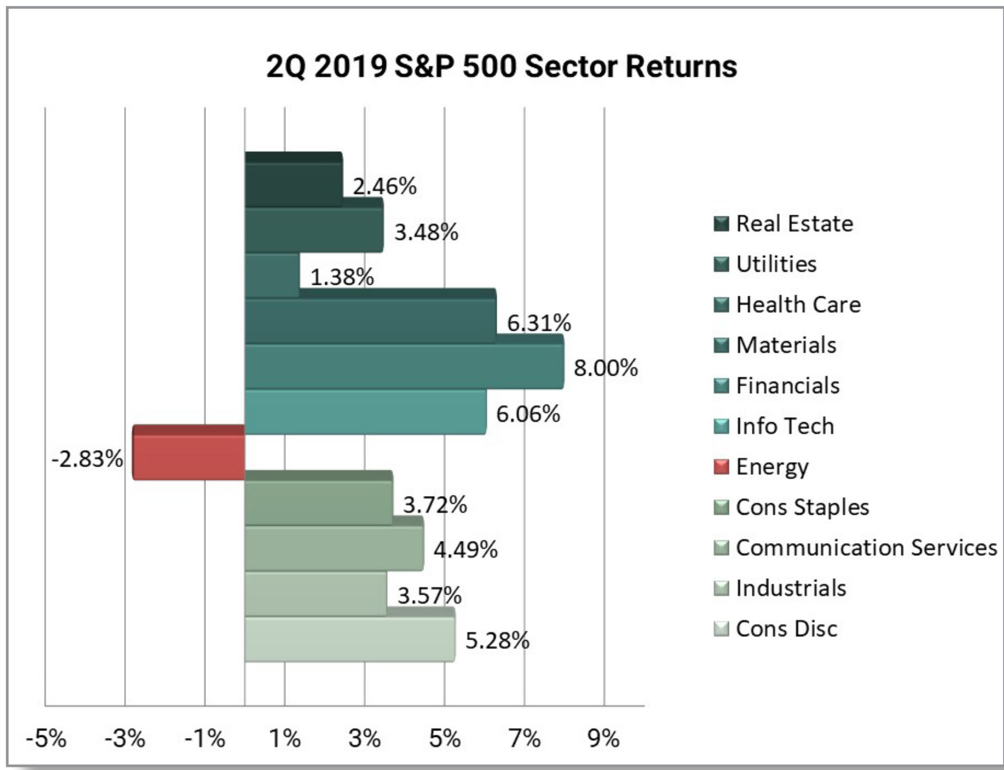
Last quarter, we mentioned a pronounced pivot in the way the Federal Reserve (Fed) was thinking about monetary policy. Well, three months hence and it has managed to pivot even further. A year ago, Fed officials were almost unanimously forecasting a terminal federal funds rate of around 3 percent, and projecting one or two interest rate increases in 2019. As it stands now, though, market odds are near 100 percent for a rate *cut* at the July meeting. Concern about a growth slowdown, induced by trade frictions or otherwise, has the Fed considering what could be termed an "insurance cut". Chairman Jerome Powell stated that the Fed "will act as appropriate to sustain the expansion" which sounds a lot like some monetary policy code language for lower interest rates.

This bias towards lower rates is a global phenomenon indeed. The European Central Bank (ECB) is now not forecasting any changes to policy until mid-2020. Similarly, the Reserve Bank of Australia actually cut its short-term rate at its last meeting. There is no indication that Australia is in a recession, but rather the easing of monetary policy appeared to be an effort to preempt any weakness stemming from an uncertain global trade policy regime.

FIXED INCOME

Interest rates fell globally in the 2nd quarter in response to dovish shifts from major central banks and a ratcheting down of growth expectations. In the U.S., the 10-year Treasury yield ended the quarter at 2 percent, down from 2.49 percent. A similar German bond was yielding *negative* 0.32 percent by the time June came to a close. After the broad decline in interest rates, there is roughly $13 trillion in debt with yields below 0%. Nothing quite like lending out money with the expectation of receiving less of it back.

The good news for those holding bonds already is that as yields decline prices rise, delivering investors in all bond categories solid performance for the 2nd quarter. The



Bloomberg Barclays U.S. Aggregate Index – composed of investment grade corporate and government securities – returned 3.08 percent. A notable standout were corporate bonds, which gained 4.27 percent thanks to significant tightening of interest rate spreads between credit securities and government ones. We'd be remiss not to note that the level of corporate debt outstanding is historically high, yet it doesn't seem to be a concern for many investors currently. Companies in general are enjoying record-high profits and margins and don't seem to be having any problems servicing this debt for the time being. The default rate remains low even for bonds rated below investment grade. Municipal bonds also enjoyed a solid quarter, up 2.14 percent. Outside the U.S., emerging market currencies did strengthen mildly versus the dollar, helping bonds of those countries to a 4.25% return.

EQUITY

How quickly things can change. From the sour mood that gripped investors as the S&P 500 flirted with a bear market in December of last year to the sweet feeling of a new all-time high in June. Stocks have a funny, if often exasperating, habit of doing things like that.

Despite an interim 7 percent pullback in May as trade talks with China faltered, large cap U.S. stocks still gained 4.30 percent in the 2nd quarter to follow up their surge in the 1st quarter. Even though interest rates were lower, which often pressures bank and insurance company earnings, the financial sector was the top performer, rising 8 percent. Energy companies were the only ones in the red, falling 2.83 percent. International equities were positive as well, though less so compared to their U.S. counterparts. Developed markets gained 3.68 percent and emerging markets rose 0.61 percent.

Though investors are of course happy with the performance so far, it befits us to take a step back and see what is driving it. The majority of the upswing has been a result of rising valuations. The price-to-earnings ratio on the S&P 500 is now at 19.3, up from 16.5 to start the year, all the while earnings slightly contracted in the 1st quarter and are expected to do the same in the 2nd quarter. But in regards to the 2nd quarter expectations, specifically, analysts often underestimate earnings as reporting season approaches, so if the corporate "beat rate" comes in close to its historical average, it is likely the profits will show modest growth.

OUTLOOK

The current expansion will go down in the history books for its longevity, but it has also been weaker than average, with the cumulative increase in GDP near the middle of the pack. While this slower rate of growth has been a source of frustration for some, the silver lining may be that it has been the relatively steady, unspectacular progression that has allowed it to endure as far as it has. We generally haven't seen the type of excesses built up prior to the last two recessions – tech stocks, housing debt – this time around. Maybe the secret to long life really is everything in moderation?

Going forward, we feel the U.S. and global economic expansion is poised to continue. Domestically, a robust labor market should support consumer spending, which is a large percentage of GDP. Unemployment is already historically low, leaving less room for improvement, but steady job gains at the rate we've seen in the first half of this year could push it lower still. Given the employment dynamics, we would expect wage gains exceeding inflation to further buoy household finances. The downside to higher worker compensation is often the haircut to corporate profit margins, but that hasn't been the case yet. In a welcome development, productivity numbers have been steadily improving since the middle of 2016. In fact, real output per hour rose 2.4 percent over the past year, the best reading since the U.S. was just emerging from recession in 2010. Productivity is notoriously difficult to predict, but if this trend continues, it could lead to a virtuous cycle of improving wages while giving businesses the flexibility to maintain and improve bottom line earnings.

Growth in mature international economies is unlikely to accelerate much, but we don't see a material slowing either. The current trend seems about right. Australia has eased monetary policy recently, and the ECB remains committed to its accommodative stance. There also may be scope for new fiscal stimulus in countries like Germany and France, which could provide a boost on the margin. In emerging markets, China is the swing factor. Growth in the 6 – 6.5 percent range seems like the appropriate base case for now. One advantage China does have compared to much of the rest of the world is that its government and policymakers likely have the most flexibility in responding to shorter-term economic weakness via monetary, fiscal, or other stimulus measures.

One of the main risks we're watching, that has been mentioned numerous times already, is the state of flux international trade policy finds itself. There is now more evidence that this uncertainty has taken its toll on the global economy, whether it be in the meager growth in total trade volume, weakness in manufacturing surveys around the world, or the declines, though modest, in CEO and CFO confidence here in the U.S. Businesses still operate and invest and do all the things that businesses need to do, of course, but the current environment can lead to indecision and doubt on the margin. Lingering, unsettled political proceedings like Brexit have a similar effect. As far as financial market signals go, we'll keep an eye on equity valuations and their response to upcoming earnings reports. The yield curve inversion, historically a signal of upcoming economic weakness, has yet to resolve, but will look different should the Fed meet market expectations and reduce interest rates in July.

Those risks in mind, our outlook is still a constructive one. Leading economic indicators are positive on balance, pointing to an ongoing expansion in the near term. High-yield and corporate bond markets, which often start to weaken in advance of negative economic events, are flashing the "all clear" sign for the time being. The message from the stock market is positive, recently hitting an all-time high with improving momentum and breadth.

We're off to a fast start this year, which naturally leads investors to want to sell assets and "take chips off the table." But it is important to stick to a disciplined process and not overreact to shorter-term market movements. And historically, when years start off above-average, they tend to finish that way as well. To be sure, financial and economic conditions are always changing, and we stand ready to adapt portfolios as needed in response and in accordance with our clients' unique situations.

info@linscomb-williams.com

1400 Post Oak Blvd., Ste. 1000 Houston, TX 77056
P 713 840 1000 **F** 713 840 7802
www.linscomb-williams.com