Investors Trust

Investment and Trust Services

2nd Quarter 2019 Market Commentary

				Total Return	
Index	6/30/2019	3/31/2019	12/31/2018	2019 YTD	Q2 2019
Dow Jones	26,599.96	25,928.68	23,327.46	15.4%	3.2%
S&P 500	2,941.76	2,834.40	2,506.85	18.5%	4.3%
Nasdaq	8,006.24	7,729.32	6,635.28	21.3%	3.9%
S&P 400 Midcap	1,945.51	1,896.27	1,663.04	18.0%	3.1%
Russell 2000	1,566.57	1,539.74	1,348.56	17.0%	2.1%
Yield on 10-Year Bond	2.01%	2.41%	2.69%		

Source: FactSet

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Investment Overview

Despite a mid-quarter swoon on trade-related fears, the US equity markets posted solid returns in the second quarter, with the S&P 500 once again hitting all-time highs. As a result, **the major indices of the US equity markets through the first half of 2019 are up over 15%, with some showing total returns in excess of 20%.** If we could bottle up these returns for the full year, we would take them. That is not to suggest that we are more concerned than usual about the markets, but rather an acknowledgment that double-digit returns in any given year is typically something that should be celebrated. And, at the risk of sounding boastful, **we are very pleased that our call in our *2019 Market Outlook* for a notable rebound in the equity markets has indeed largely played out.**

So where do we go from here? We believe that returns for the balance of 2019 are going to be more difficult to come by for US equity markets. Why? Because estimates for US corporate earnings growth have continued to decline, with consensus on Wall Street that earnings growth for 2019 should now approximate 3.6%. That is down from 8.7% at the end of 2018 and 4.6% at the end of the first quarter. We have long preached that equity markets are ultimately driven by corporate earnings growth, so we will likely need to see a pick-up in earnings growth in order for the markets to post continued strong returns for the second half of 2019. Encouragingly, the underlying health of the US economy remains quite good, so there are several possibilities that could cause earnings growth to further increase. These include (a) a trade agreement between the US and China, something that appears more elusive than it did a quarter ago, though we continue to believe it is in both countries' best interest to do; (b) lower interest rates that could encourage investment, and the Fed has already begun to signal that rate cuts could be forthcoming as soon as its next meeting in late July; and (c) productivity improvements associated with prior capital expenditures, which Wall Street analysts have a difficult time quantifying

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and are therefore not likely reflected properly in their estimates.

For the past several quarters, we have been highlighting to varying degrees our work on the benefits of asset allocation, noting that increased diversification through exposure to other investment areas of the market has the potential to enhance the risk and return characteristics of our client portfolios. Additionally, **many asset classes which have not kept pace with US large-cap stocks over the past several years may experience more favorable returns in the coming years.** As a result, we have begun to introduce investments in additional asset classes in most client portfolios. For instance, we have provided some client exposure to Master Limited Partnerships (MLP's) via a mutual fund, which currently provides a dividend yield in excess of 9%, trades at valuations well below historical averages, and is showing improving fundamentals. While not a specific call for 2019, we believe that exposure to additional asset classes should be positive for our clients in the years ahead and could start to show relative benefits in the second half of 2019.

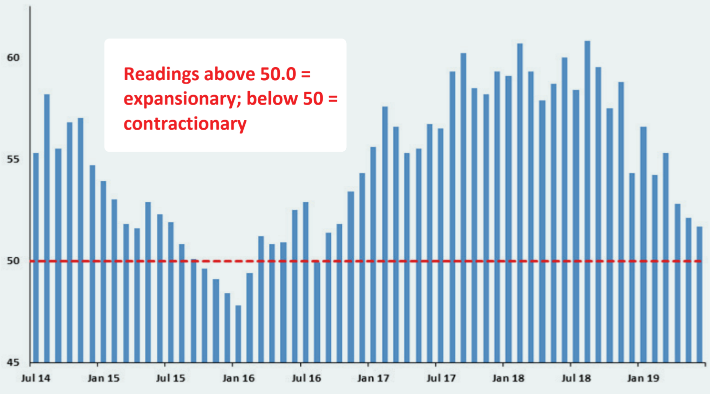
In the fixed income markets, interest rates declined sharply in the second quarter, with the yield on the US 10-Year Treasury dipping below 2.0% during the quarter for the first time since 2016. The drop in rates was largely the result of increasing fears of an economic slowdown due to potential impacts from trade issues between the US and China. **We believe that the fear gripping the bond market is unfounded, as the underlying health of the US economy remains good, with growth in 2019 likely to exceed 2.0%.** No matter, these fears are leading the markets to pressure the Fed to lower interest rates further; while we do not agree that rate cuts are needed, we have reduced our outlook for interest rates again this year. We now believe that rates should end the year around 2.50%.

Economy

The US economy has been quite resilient in the face of several things being thrown at it. For the first quarter 2019, US economic growth came in at 3.1%, markedly higher than expectations and especially impressive in light of several headwinds facing the country (i.e. the US government shutdown, unusually poor weather throughout much of the country, consumer hesitation following the poor fourth quarter stock market, etc.). Current economists' forecasts for economic growth for the second quarter, which should be released preliminarily at the end of July, call for around 2.0% growth. While there remains increasing investor angst over the potential impact of trade issues between the US and China, projections still suggest economic growth for the US in 2019 of around 2.0%. That would be a healthy, albeit not especially robust, number. The fear among investors is whether or not the slowdown in growth is a temporary issue caused by the current trade uncertainty, which at some point will (hopefully) be resolved, or whether there are greater causes for concern.

From our perspective, **we are believers in the underlying health of the US economy** and think a resolution of the current trade issues, whenever that may come, should result in accelerated economic growth. Indeed, numerous metrics that we track (i.e. Payroll gains, the Unemployment Rate, Small Business Confidence, Productivity gains, just to name a few) support our view that the US economy remains in good shape. With that said, there are cracks that are starting to emerge that bear additional monitoring. Specifically, Consumer Confidence, which remains at elevated levels by historical standards, declined in June 2019 to its lowest level since September 2017, largely as a result of the uncertainty associated with trade. Consumers remain confident, helped by the fact that jobs are aplenty and the Unemployment Rate sits at a very low 3.7%, but that confidence has lessened. Further, US manufacturing activity, which historically has been a good predictor of earnings growth, has begun to trend lower, also likely due to the uncertainty tied to trade. A key measure of US manufacturing activity is the ISM Manufacturing Index, and as Chart 1 below shows, this index has been steadily coming down over the past year. It remains in "expansionary" territory, suggesting that the manufacturing economy is still positive, but it has become less positive over the past year. Will this continue such that manufacturing enters a "contractionary" period?

Chart 1:
ISM Manufacturing Index, July 2014 to June 2019



Source: Institute of Supply Management

It is important to emphasize that such cracks in the economy have occurred several times over the past decade during which the US economy has continued to expand. Indeed, as the ISM chart shows, manufacturing activity entered a "contractionary" period in late 2015/ early 2016, yet the economy and markets did just fine. So we do not want to place undue importance on them; rather, we want to share some of the key things that we are watching that may impact our outlook. Should there be positive developments on the trade front, we would fully expect these cracks to be sealed up fairly quickly. If, however, there remain ongoing issues in this regard, it is possible that these cracks widen and others develop.

Equities

US equity markets showed increased volatility in the second quarter, declining at one point roughly 8% before rallying back to finish the quarter near all-time highs. Indeed, the major US equity indices are all up in excess of 15% for the year. As for the quarter itself, trade concerns were the primary culprit impacting the equity markets, as the US and China not only were unable to reach a hoped-for trade agreement, but they became verbally hostile toward one another that led to proposals of additional tariffs. The trade uncertainty has had a negative impact on business confidence, at least in the short-term, as business leaders seek to understand what the trading rules will be so that they can most effectively manage their companies. Lower interest rates combined with a temporary trade truce and an agreement for further trade meetings between the US and China helped ease investor concerns. But Wall Street remains focused on the outcome of US-China talks.

As a result of this uncertainty, estimates for corporate earnings growth for 2019 have declined, with expectations for growth now sitting at roughly 3.6%, well below levels at yearend 2018. Given the strong double-digit returns in the equity markets through the first half of 2019, we believe that returns for the balance of the year may be more challenging to come by without an increase in earnings growth expectations. There are numerous ways that earnings growth could indeed start to pick up in the second half of the year, with a US-China trade agreement likely being the most impactful.

In light of this backdrop, we think it is important to highlight why we have been increasingly discussing the benefits of asset allocation over the past few quarters. While asset allocation provides some risk benefits through improved diversification, it also has the potential to offer additional return benefits. Over the past several years, US large-cap stocks have been an excellent place to be invested, and we continue to believe that US large-cap stocks should be a core component of any equity portfolio. At the same time, we recognize that many well-regarded equity asset classes have underperformed, in some cases significantly, relative to US large-cap stocks. Chart 2 below shows the 1-year, 3-year, and 5-year cumulative total returns for various equity asset classes compared to US large-cap stocks. The length and magnitude of the outperformance of US large-cap stocks is historically abnormal, so we believe that the returns of these other asset classes will start to catch up to US large-cap stocks. That may not occur in 2019 specifically, but we think it should occur in the coming years. As a result, we have begun to provide exposure to these asset classes in many client accounts.

Chart 2:
Total 1-Yr, 3-Yr, and 5-Yr Returns of Equity Asset Classes

Asset Class	1-Year	3-Year	5-Year
US Large-Cap	10.3%	48.7%	65.9%
US Mid-Cap	1.3%	36.1%	46.5%
US Small-Cap	-3.3%	41.0%	39.2%
International Developed	1.3%	28.7%	11.1%
Emerging Markets	1.3%	32.6%	10.2%
Real Estate Investment Trust	12.0%	12.4%	44.7%
Master Limited Partnerships	5.3%	-2.8%	-23.3%

Source: FactSet

We believe these asset classes will start to catch up to U.S. Large-Caps in coming years.

Fixed Income

Similar to the first quarter, interest rate movements played a key role in market activity in the second quarter, as fears of an economic slowdown increased notably following the escalation in trade rhetoric between the US and China. Increasing cries, if not outright temper tantrums, from Wall Street that the Fed must do something in order to prevent a potential slowdown led to a sharp decline in rates in the quarter. Indeed, as Chart 3 below shows, the yield on the US 10-Year Treasury dipped below 2.0% for the first time since 2016 before closing the quarter at 2.01%, down from 2.41% at the end of the first quarter and 2.69% at the end of 2018. The Fed, which had reduced its expectations for rate hikes in the first quarter to 0 from 4, has now suggested that there could be 1-2 rate cuts in 2019. The Street is currently placing a roughly 76% likelihood that the Fed cuts rates 2-3 times by yearend.

Chart 3: US 10-Year Treasury Yield

Source: FactSet

While we appreciate the concerns that some investors have about the impact of the trade issues between the US and China, **we believe that the current drop in rates in light of this fear is overstated.** Indeed, while economic growth has slowed in 2019, it remains on pace to exceed 2.0%. While less than the 2.9% that was posted in 2018, it is hardly a cause for panic among investors. We acknowledge that that things can change relatively quickly, but we question whether it makes sense for the Fed to reduce rates any further in light of the relatively healthy economic backdrop in the US. Our view, which has been wrong thus far in 2019, has been that rates should see upward pressure, not downward pressure. Despite what we think should happen, the reality of the current state of the market suggests something different. As a result, we are reducing our expectations for rates for 2019, now believing that they will finish the year around 2.50%.