Second Quarter 2019 Commentary

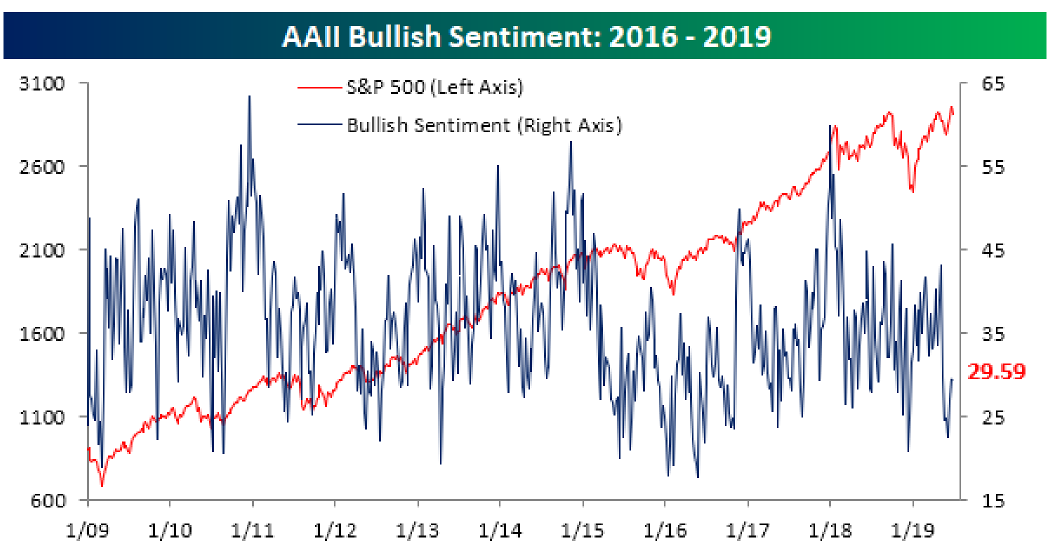
July 12, 2019

Markets

Global equity markets generally ended the second quarter of 2019 in positive territory despite a period filled with geopolitical uncertainty, ongoing international trade tensions, and key central bank decisions (or lack thereof). Market volatility and concerns about slowing global growth were not enough to stop equity market indices from reaching or nearing all-times highs.

The MSCI All Country World Total Return Index finished the quarter up 2.63%, while the S&P 500 and Russell 2000 Indices returned 3.11% and 1.02%, respectively. Developed international equity markets, as measured by the MSCI EAFE Total Return Index, were up 2.81% for the quarter, while Emerging Market equity bounced back from a rough May to a loss of just 0.39%.

Bespoke Investment Group keenly pointed out that as markets were moving towards all-time highs, bullish sentiment levels were "relatively muted in spite of this price action." Interestingly enough, in the most recent American Association of Individual Investors (AAII) sentiment survey dated June 26, 2019, of the investors surveyed, 29.6% described themselves as "Bullish", 38.4% described themselves as "Neutral", and 32.1% described themselves as "Bearish". Each of these categories saw little change over the previous survey, which is somewhat peculiar as demonstrated in Bespoke's comparison between the S&P 500 price chart and bullish sentiment below:



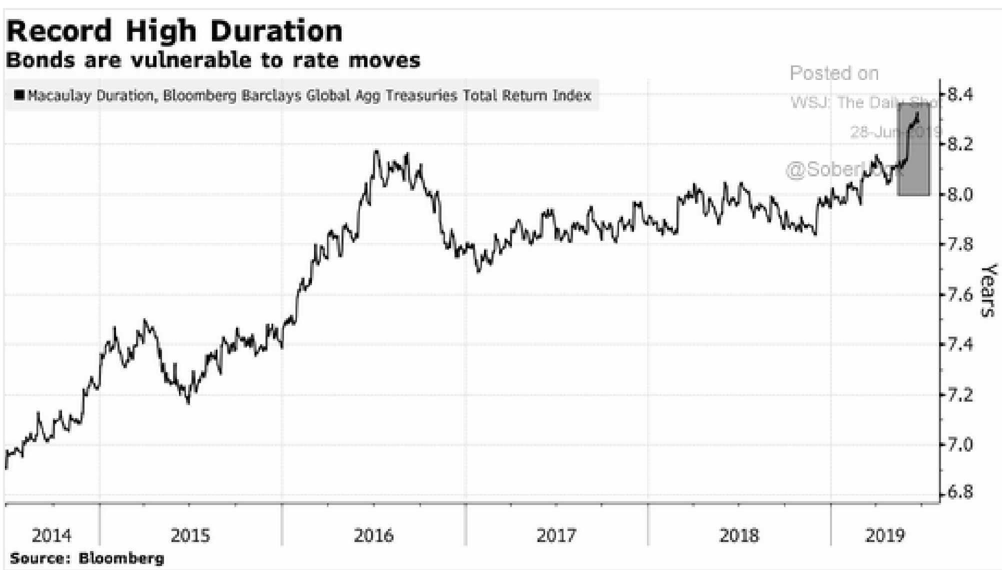
According to the group, "Bullish, bearish, and neutral sentiment all simultaneously moving less than 0.1% is something that rarely has happened in the history of the survey… While it is a small sample size, [future] performance has generally leaned positive going forward, although we wouldn't put much weight into it."

Fixed income markets also ended the quarter on a very solid note, with the Bloomberg Barclays Global Aggregate Bond Total Return Index earning 3.62% and the Bloomberg Barclays U.S. Aggregate Bond Total Return Index gaining 3.47%. We do not, however, believe these returns are sustainable, and the rally in U.S. Treasuries sets the table for a possible future retracement.

6/30/2019	Economic and Market Review									
Overall	Indicator Name	Value	1 Mo. Ago			3 Mo. Ago		1 Yr. Ago		
▲	S&P 500 Total Return	5,908	5,592	▲	5.66%	▲	4.30%	5,351	▲	10.42%
▲	Russell 2000 Total Return	7,864	7,444	▲	5.64%	▲	2.10%	8,133	▼	-3.31%
▲	MSCI EAFE Total Return	8,070	7,651	▲	5.48%	▲	3.97%	7,942	▲	1.60%
▲	MSCI Emerging Markets Total Return	2,396	2,246	▲	6.68%	▲	0.74%	2,358	▲	1.61%
▼	10 Year Treasury Rate	2.00%	2.22%	▼	-9.91%	▼	-20.32%	2.85%	▼	-29.82%
▲	Barclays US Aggregate Total Return	2,172	2,136	▲	1.68%	▲	3.08%	2,013	▲	7.87%
▲	Euro to US Dollar Exchange Rate	1.14	1.11	▲	2.21%	▲	1.44%	1.17	▼	-2.38%
▲	Gold Price in US Dollars	1,409	1,281	▲	10.00%	▲	8.77%	1,250	▲	12.68%
▼	VIX	15.08	17.30	▼	-12.83%	▲	14.94%	16.09	▼	-6.28%

Source: yCharts

What's more, some were quick—and quite correct in our estimation—to point out that there is an extreme level of duration or interest rate risk present in fixed income markets. As noted by *Bloomberg*, the Macaulay Duration or the weighted average maturity of cash flows of a bond, which is one of several measures used to calculate the interest rate risk of fixed income instruments, of the Bloomberg Barclays Global Aggregate Bond Index is at a record high—nearly 8.4 years. According to State Street Global Advisors, the yield-to-maturity on the index is a paltry 1.59%.



The effective duration of the index, which factors in certain features of bonds like call or put provisions, is 6.98 years according to State Street—in other words, no matter how the data is viewed, investors are not compensated properly for adding duration. (As a side note, this is why we continue to keep the duration profile of our fixed income portfolios in a range of 1-3 years).

U.S. Economy

Turning to the U.S. economy, the third and final estimate of first quarter GDP growth came in at 3.1%, unchanged from the second estimate and 0.1% lower than the initial print, according to the U.S. Bureau of Economy Analysis (BEA). According to the BEA, the update included upward revisions to nonresidential fixed investment, exports, state and local government spending, and residential fixed investment which were offset by downwards adjustments to consumption and inventory investment.

According to a *Wall Street Journal* survey of over 60 economists, second quarter GDP growth is expected to come in at 1.6%, while 2.2% growth is projected for full-year 2019.

A strong albeit shallow GDP print was not enough to halt the U.S. Federal Reserve's increasingly dovish stance, which recently adjusted its forecasts in its June policy meeting. Despite keeping policy rates unchanged, the Fed modestly downgraded its expectations of economic conditions—in the face of a strong labor market and rising growth in household spending, the Fed noted softening business investment and weakening inflation. Fed Chair Jerome Powell in his post-meeting press conference

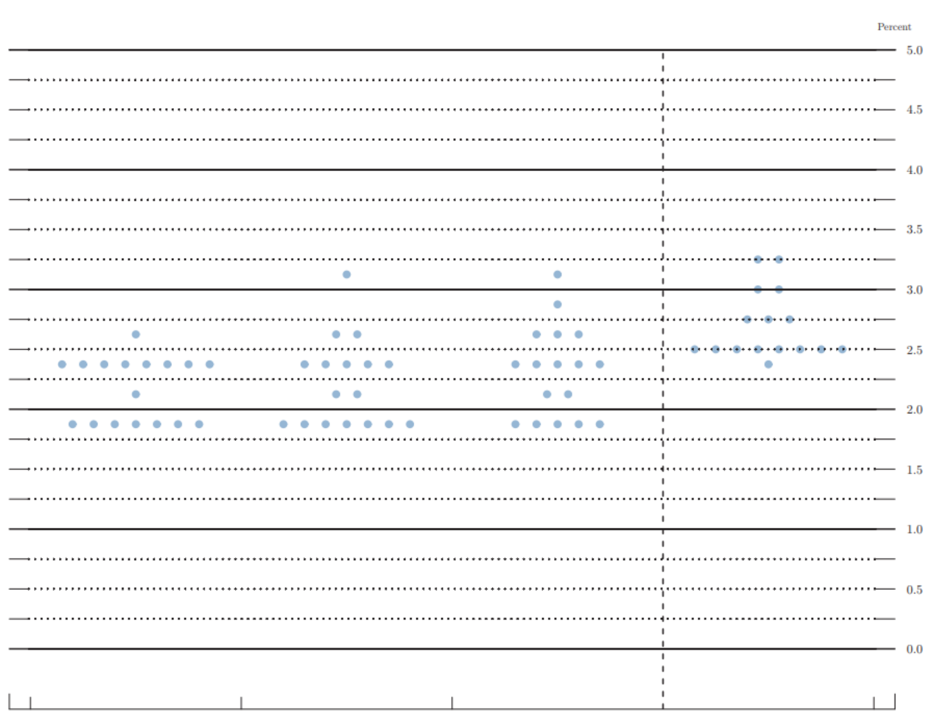
6/30/2019	Economic and Market Review						
		Last Reported	1 Mo. Ago		3 Mo. Ago	1 Yr. Ago	
Overall	Indicator Name	Date	1 Mo. Ago	% Change	% Change	1 Yr. Ago	% Change
▼	US Core Inflation Rate	5/31/2019	2.06%	▼ -3.67%	▼ -4.57%	2.24%	▼ -11.09%
▲	ADP Change in Nonfarm Payrolls	6/30/2019	41	▲ 148.38%	▼ -35.24%	221	▼ -53.76%
▬	US Unemployment Rate	5/31/2019	3.60%	▬ 0.00%	▼ -5.26%	3.80%	▼ -5.26%
▼	US Producer Price Index: Savings Institutions	5/31/2019	94	▼ -0.43%	▲ 1.41%	95	▼ -1.37%
▼	US ISM PMI	6/30/2019	52	▼ -0.77%	▼ -6.51%	60	▼ -14.12%
▼	US Housing Starts	5/31/2019	1,281	▼ -0.94%	▲ 10.44%	1,332	▼ -4.73%
▼	US 30 Year Mortgage Rate	6/27/2019	3.99%	▼ -6.52%	▼ -8.13%	4.55%	▼ -18.02%
▲	US Consumer Price Index	5/31/2019	255.0	▲ 0.08%	▲ 0.81%	250.6	▲ 1.80%

Source: yCharts

highlighted the strengthening case for accommodative monetary policy, leading markets to price in a 100% chance of a July rate cut, according to the CME FedWatch tracker.

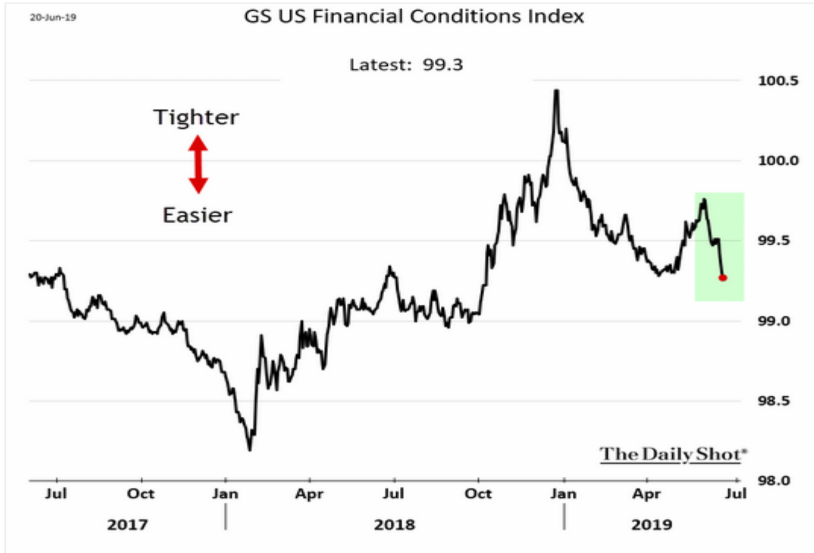
The Fed's dot plot also showed a widening gap between the 17 voting officials. The median interest rate projection for 2019 was unchanged at 2.25-2.50% percent; however, seven officials expect 50bps of cuts this year, one anticipates one 25bps cut, eight expect no cuts, and one member expects a 25bps hike. In other words, the Fed is split nearly down the middle on which way rates should go—undoubtedly the July meeting will be extremely important as officials and analysts begin to parse second quarter data.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Source: Federal Reserve

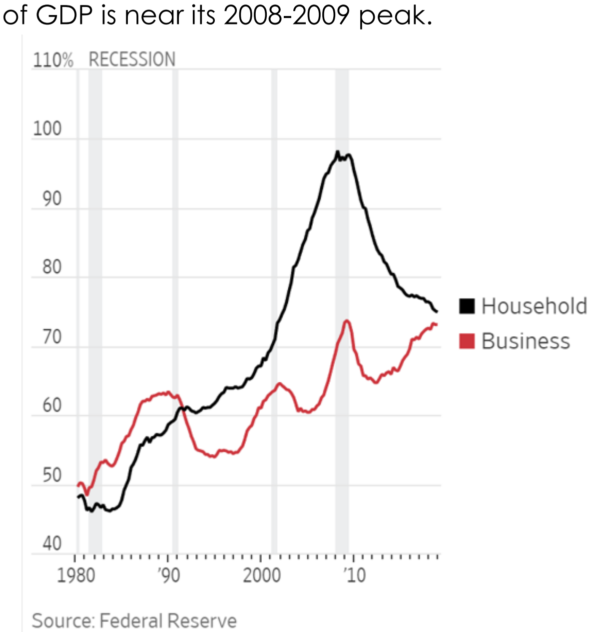
The Fed's dovish tone has already had an impact on financial conditions as a whole, as the Goldman Sachs U.S. Financial Conditions Index eased significantly over the quarter.



The 10 year U.S. Treasury yield began the period at 2.49% before sinking to a multi-year low of 1.97% on June 19th—not-so-coincidentally the day of the Fed's press release and Fed Chair Powell's press conference.

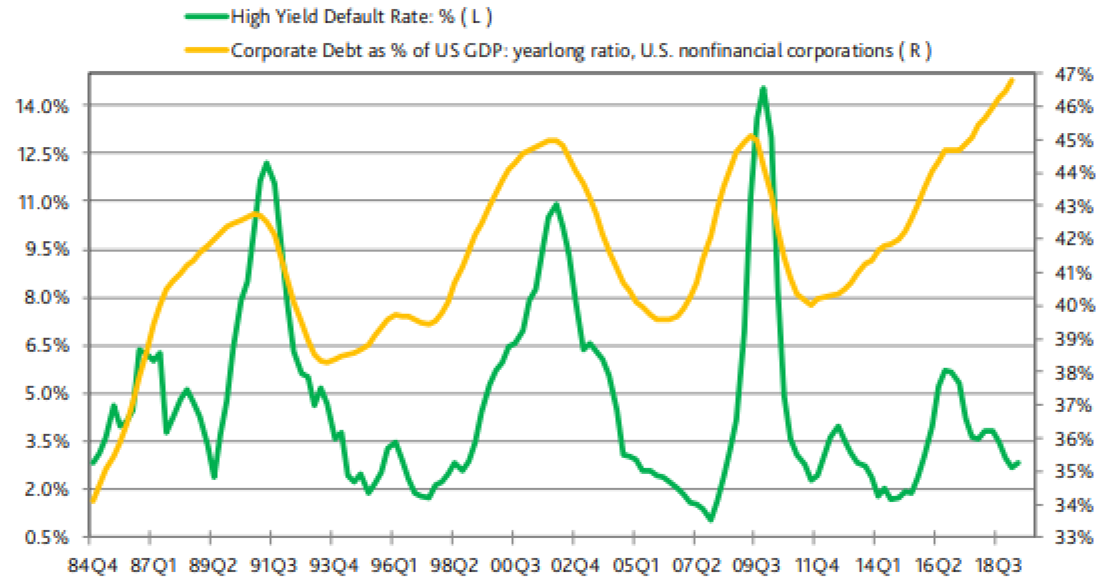
The Fed's moderated sentiment on the U.S. economy was also echoed by the U.S. consumer, as the Conference Board's index of consumer confidence fell to 121.5 in June, its lowest level in 21 months. According to the Conference Board, consumers cited trade tensions as one of the primary catalysts for waning confidence. Lynn Franco, Senior Director of Economic Indicators at the Conference Board, highlighted how "escalation in trade and tariff tensions earlier this month appears to have shaken consumers' confidence… although the Index remains at a high level, continued uncertainty could result in further volatility in the Index."

Despite falling consumer sentiment, U.S. households appear to still be in solid shape. According to data released by the Federal Reserve, household debt as a percentage of GDP is at multi-year lows last seen in the pre-Crisis era. Unfortunately, the reverse is true for U.S. businesses, according to the Fed—business debt as a percentage of GDP is near its 2008-2009 peak.



Notwithstanding increasing amounts of corporate debt, according to Moody's Analytics, the high yield default rate is still well below its long-term medium of 3.8%.

Figure 2: Default Rate Remains Well Below Long-Term Median of 3.8%
Despite Yet New Record High Ratio of Corporate Debt to GDP
sources: Moody's Investors Service, Federal Reserve, BEA, Moody's Analytics



In the world of corporate earnings, FactSet reports that second quarter S&P 500 earnings are expected to decline at a rate of 2.6%, while revenues are expected to grow 3.8%. If these earning projections materialize, it will be the first time since Q1 and Q2 2016 that S&P 500 companies will have reported back-to-back earnings declines. For the full calendar year 2019, analysts are projecting just 2.7% earnings growth and revenue growth of 4.4%. In terms of valuations, as the S&P 500 continues to careen upwards, the forward P/E ratio is 16.6, above both its 5 year and 10 year averages of 16.5 and 14.8, respectively.

International

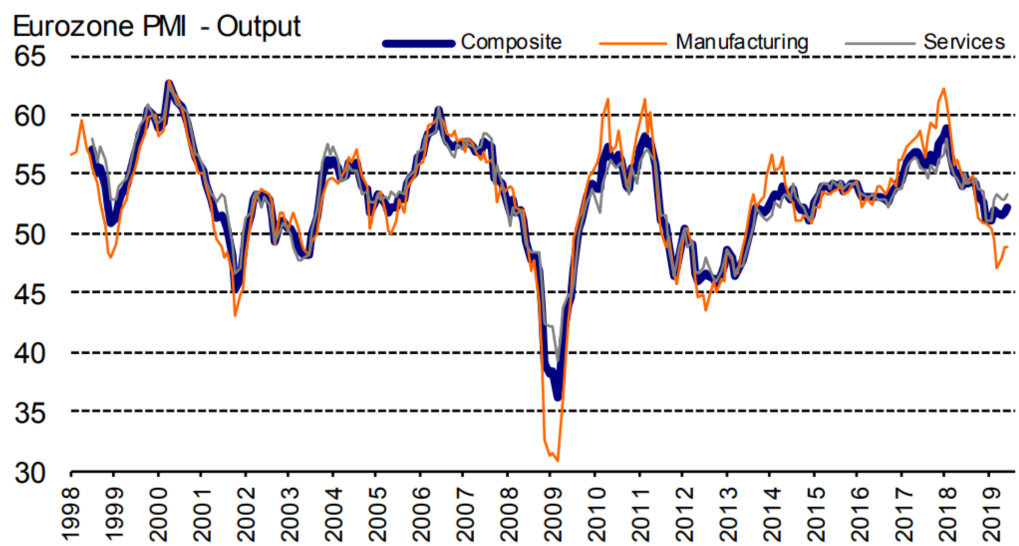
On the international front, the theme of uninspiring, slowing growth persisted across the board. Trade conflicts, financial strains, and unexpectedly sharp slowdowns in stronger, developed countries led the World Bank to cut its world economy growth forecast to 2.6% this year, the slowest calendar-year growth since 2016.

After reporting a 3.7% drop in April exports along with a 1.9% contraction in industrial output, Germany's central bank cut its 2019 GDP forecast in half to just 0.6%. Bank officials commented in their update, "For economic growth and, to a lesser extent, for the rate of inflation, it is the downside risks that predominate as things stand today."

As the Eurozone's largest economy continued to struggle, the European Central Bank (ECB) took a markedly dovish tone, despite it being one of five central banks that already maintains a negative benchmark rate. As reported by *Bloomberg* in mid-June, ECB President Mario Draghi "cited rate reductions as an option" in the face of a dimming outlook for both growth and inflation. His comments sent the euro lower and also led to markets pricing in a 10 basis-point rate cut by December—which would bring the ECB's policy rate to -0.50% from -0.40%. Claus Vistesen, chief euro-zone economist at

Pantheon Macroeconomics, confidently stated that Draghi would "finish his tenure with a cut", adding that "the door is now open and I don't see how they cannot walk through it." Draghi also received some ammunition for a possible rate cut in the preliminary June inflation report published by Eurostat—June inflation is expected to be a meager 1.2% annualized, the lowest print seen thus far this year.

The IHS Markit Flash Eurozone Composite PMI, which tracks both the services and manufacturing sectors, yielded mix results. On the one hand, the index reached a seven-month-high of 52.1 in June, 0.4 points higher than May's 51.8 reading. However, despite the positive uptick, Chris Williamson, Chief Business Economist at IHS Markit, noted in his commentary, "Concerns about weaker economic growth at home and in export markets, rising geopolitical risks and trade wars continue to dominate the picture and dampen business spending, investment and sentiment."

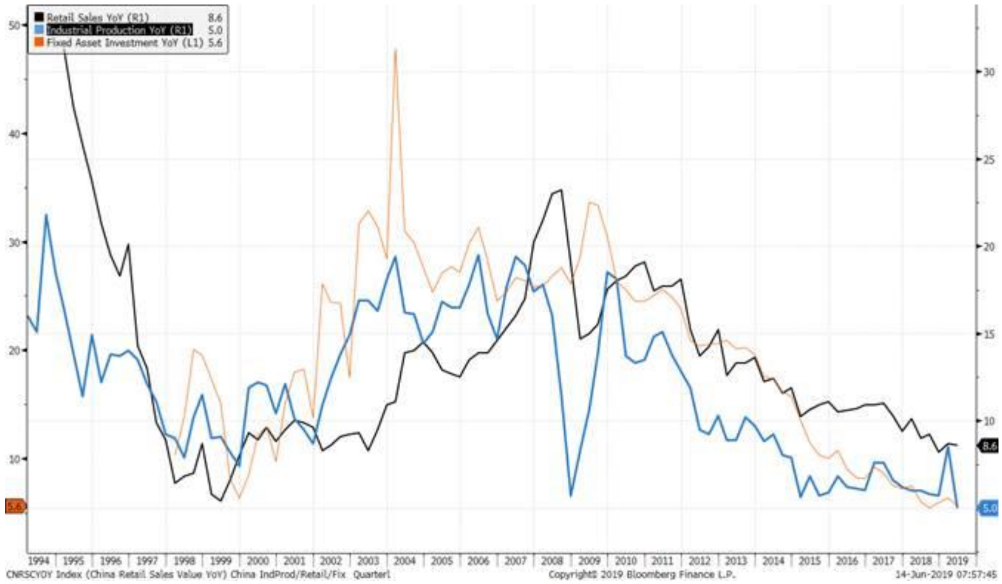


Source: IHS Markit

Japan's Flash Manufacturing PMI dropped slightly to 49.3 in June from 49.8 in May, highlighting worsening conditions for Asia's second largest economy for the second month in a row. Tim Moore, Associate Director at IHS Markit, noted "Japanese manufacturers continued to suffer from the slowdown in global trade volumes and weaker overseas demand conditions in June… Survey respondents linked the fall in exports to softer demand from customers in China, alongside a drag on sales from global trade frictions and weakness in the automotive sector."

The hard data from the quarter also lent credence to the notion that the Japanese economy will continue to press on with uninspiring growth. June exports contracted for the 6th consecutive month (down 7.8%), although an early June update on first quarter GDP showed annualized real growth of 2.2% due to an upswing in capital expenditures. However, the revised figures also pointed towards weakening consumption going forward. According to the *Japan Times*, "analysts continue to emphasize the risk of a downturn due to sluggish personal consumption."

Finally, China continues to face uncertainty on both the trade and domestic growth fronts. While the Chinese economy continues to see positive growth in key areas like retail sales (8.6% YoY), industrial production (5.0% YoY), and fixed asset investment (5.6% YoY), growth is occurring at an ever-slowing rate—a far cry from the booming economy seen in pre-Crisis era. It remains to be seen whether the government's stimulus efforts will have a material, lasting effect. The International Monetary Fund believes China is heading for a growth rate of 6.2%, its lowest annual rate since 1990.



Source: ZeroHedge, Bloomberg

Markets and global trade participants received some much needed good news from the very recent G20 Summit in Osaka, Japan, as President Trump and President Xi Jinping agreed to resume trade talks. In order to bring China back to the table, President Trump agreed to delay tariffs on $300 billion of Chinese imports, while President Xi made a promise that China would purchase more U.S. farm goods. However, according to the *Wall Street Journal*, the key bargaining chip was a U.S. concession on Chinese telecom giant Huawei Technologies. The fine details are being hammered out by the U.S. Commerce Department, but will essentially allow the company to buy high-tech equipment from the U.S. as long as the parts don't affect U.S. national security. One administration official says the licensing will contain "particular scrutiny of the threat that Huawei poses to our broadband networks, which are crucial to national security."

Some expressed concern about the outcome of the summit, including Hannah Anderson, global market strategist with JPMorgan Asset Management, who remarked that markets have "seen this movie before… China and the U.S. talk, leaks from policymakers on both sides encourage speculation we are close to a deal, things fall apart, the U.S. presses forward with higher tariffs and markets express their displeasure with corrections and higher volatility." Along a similar vein, U.S. Senator Marco Rubio commented from his official Twitter account, "If President Trump has agreed to reverse recent sanctions against Huawei he has made a catastrophic mistake. It will destroy the credibility of his administrations warnings about the threat posed by the company, no one will ever again take them seriously." Undoubtedly, in the midst of slowing growth, U.S.-China trade policy will play a key role in keeping this near-record expansion alive.

STAR™ Spectrum – Economic Outlook for 2019

The second quarter of 2019 confirmed in our minds that investors are indeed entering a period of "Great Moderation". Despite strong first quarter growth in the U.S., the prospects are dimming—at home and abroad—with the effects of fiscal and monetary stimuli beginning to show signs of age. This has understandably led central banks around the globe to take a decidedly more dovish tone, for better or for worse. Nevertheless, we also see some bright spots amidst the fading backdrop—the U.S. consumer remains on strong footing and U.S. household debt as a percentage of GDP continues to fall, while lower interest rates could lend a needed boost to the housing market. Partnervest's

Investment Committee remains vigilant as we continue to monitor economic data points and trends in order to make investment decisions for the STAR Spectrum portfolios.

STAR™ Spectrum – 2Q19 Tactical Shifts

Both the final quarter of 2018 and the first quarter of 2019 saw several tactical changes to the STAR Spectrum portfolios. During late March 2019, the portfolios were de-risked by reducing both U.S. and Non-U.S. Equity allocations. Those funds were allocated into either cash or enhanced cash. Since that tactical shift, we feel confident about our current holdings and have not completed any new tactical shifts during the second quarter 2019. We continue to monitor the market conditions for opportunities to reinvest the cash and enhanced cash holdings. We appreciated your continued commitment to the STAR Spectrum strategies.

Sincerely,

Partnervest
STAR™ Spectrum Investment Team

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