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Second Quarter 2019 Letter

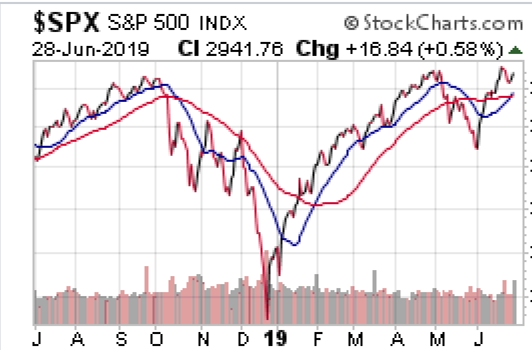

Fig. 1 – S&P 500

Fig. 2 – U.S. 10-Year Treasury Yield

Stocks continued to advance in the second quarter of 2019, recovering most of last year's losses. The large cap S&P 500 index (**Figure 1**) posted a total return of +4.3% and is now up +18.5% year-to-date. The Russell 2000 Small Cap index lagged slightly but also rose, adding +2.1%. International market returns were mixed, generally trailing the U.S., after suffering heavy losses in 2018. Emerging markets (**Figure** 3) fell -0.7% as Asian stocks suffered from ongoing trade war rhetoric and tariffs. Developed countries outside the U.S., including Europe and Japan, fared better, rising +3.7%. Foreign stock returns, especially in Europe and Latin America, were helped by a falling U.S. dollar.

After four consecutive quarters of double-digit increases, S&P 500 earnings fell -0.4% in the first quarter. This was the first decline since 2016, and a significant drop from the previous quarter's +13.1%. Analysts had expected a decline of -4.0% at the beginning of earnings season. Revenue held up better, growing +5.3% vs. last quarter's +5.8% gain. The energy sector (-26.6%) was the primary contributor to the decline in earnings, as was the case in 2016. Energy companies suffered as the price of oil fell steeply. It is worth noting that a decline in oil prices is often a boost for other sectors of the economy: Consumer Discretionary earnings rose +5.2%, as individual spending continued apace. According to research service Factset, 76% of S&P 500 companies topped earnings expectations. This outperformance in April and May's quarterly reports helped stocks keep and build on the first quarter's gains. Analysts now forecast +3.2% aggregate growth for the year vs. the +4.1% expected at the end of March. ????

First quarter gross domestic product grew +3.1%, bolstered by increases in fixed investment and consumer spending. However, many economic readings continued to weaken in the second quarter. Purchasing manager surveys in both the manufacturing and service sectors indicated slower growth, although both avoided contractionary readings. The manufacturing sector appeared to suffer from tariffs as well as restrictions on sales to Chinese networking giant Huawei. Housing data improved modestly through the quarter, as buyers took advantage of lower mortgage rates. Both existing home sales and housing starts recovered from their steep slump in the second half of 2018. Consumer sentiment, which suffered with the fall in stocks in the fourth quarter of 2018, also improved substantially, and retail sales increased accordingly. Employment has remained strong overall, although new job growth was much less than expected in May.

Second quarter news provided investors with many of the same sources of concern as last quarter. There was back and forth with China over tariffs and other trade issues. Iran continued to make threats, and two oil tankers were sabotaged in the Straits of Hormuz, briefly sending oil prices higher. In May, stocks fell as President Trump threatened Mexico with

Index returns taken from Morningstar.com

new tariffs to force changes to border security. As has generally been the case in this expansion, bad news was not enough to derail stocks for any length of time. The economic recovery is now ten years old, a U.S. record.

Intermediate and long interest rates fell during the quarter (**Figure 2**), pushing bond prices higher. Investors paid up for the safety of U.S. Treasuries and other conservative bonds as concerns about the slowing global economy dominated fixed income markets. The yield curve once again inverted, as yields on long-term bonds fell below short-term yields, a further sign of investor concern. However, much of the buying pressure came from overseas bond investors, who see U.S. interest rates as a significant step-up from available bonds in Europe and Japan. With interest rates below 2%, investors have little incentive to chase bonds. After strong returns in the first half of the year, bonds are likely to tread water in the next six months.

Developed country stock indexes (Europe, Japan, Canada) moved higher in the second quarter (**Figure 3**), helped by central bank easing initiated earlier in the year. European data has been mixed, but the economy has continued to grow slowly. Emerging markets were generally flat to down in the quarter. Asian issues generally suffered as trade talks with China stalled. However, Latin American stocks generally rose, as those countries escaped trade war fallout. By many valuation measures foreign stocks seem inexpensive relative to their U.S. counterparts. While this speaks to maintaining some allocation overseas, U.S. stocks seem likely to continue their leadership as our economy grows steadily.

Fig. 3 – iShares EAFE

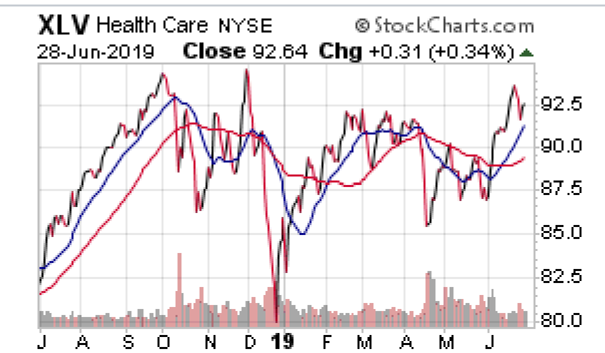

Fig. 4 – Health Care Select Sector Fund

After a strong first half, many stock investors may expect a weaker finish to 2019. We caution against a rush to the exits. The economy seems likely to continue its growth, aided by strong employment and solid consumer confidence. In addition, the Federal Reserve has communicated an end to the recent string of interest rate increases and has indicated a willingness to consider cuts if needed. In this environment, health care stocks, which have underperformed this year on fears of major policy changes (**Figure 4**), appear to offer good growth potential, along with reliable cash flow and dividends.

We hope that you are enjoying summer and encourage you to contact us anytime with questions.

Sincerely,

Kenneth M. Bernard

Kenneth M. Bernard, CFA