This Month in the Markets

July 2019

EQUITY COMMENTARY

Fewer Options

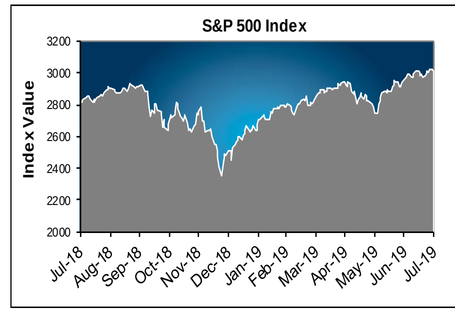
Equity markets put in a mixed performance in July. The MSCI World Net Total Return Index was essentially flat in the month with the U.S. market posting a 1.4% rise while the MSCI EAFE Net Total Return index slid 1.3%. The MSCI Emerging Markets Net Total Return Index fell 1.2%.

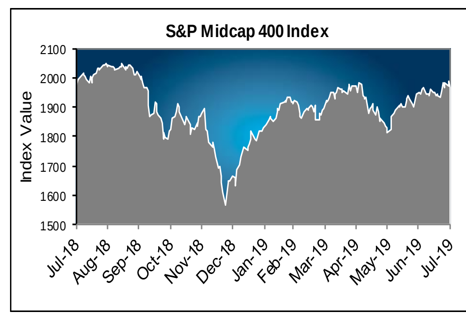
The technology sector recouped some of the prior months losses with a gain of 2.9% as global trade concerns moderated (although they escalated at the beginning of August). The MSCI World Energy Net Total return index was the weakest sector on macroeconomic growth concerns and the slide in Brent crude prices.

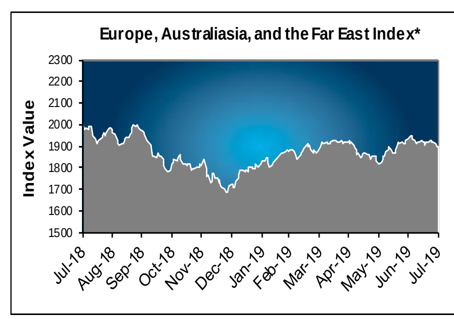
Earnings season is coming in rather well for the S&P 500. According to Bloomberg, of the 392 companies that have reported in the S&P 500, the average earnings surprise is 5.5%. Earnings overall, however, continue to get marked lower on a forward basis. The Feds decision to lower rates is not likely to offer much in the form of a growth catalyst at this point. We believe that monetary policy and its direct effects on the economy are now at a point where little is likely to be gained to aid and assist aggregate demand. Fiscal policy will be needed by governments globally to spur some form of additional consumption. The other negative associated with lower rates and bond yields is the ironic effect it may be having on consumption. As yields fall savers need to save more to generate the same amount of income. Those who rely on fixed income to generate income, for example retirement earnings, may reduce consumption to increase savings. The irony is that lower rates that arguably should increase borrowing and leverage in general may not spark the animal spirits needed to boost consumption. Only time will tell but we may have reached the end game where lower and lower rates do little to nothing in terms of supporting general economic consumption. This could result in a further headwind to growth. The global economic slowdown and geopolitical concerns would incline many managers to favor more defensive sectors, such as staples and utilities. The problem is these sectors offer little to no value. Valuations are now stretched with multiples expanding to levels indicative of high growth companies, yet earnings are growing low single digits at best. This has made sector rotation difficult and far less effective than in prior periods. Therefore, we continue to focus on secular themes that can survive and thrive in any future dislocations as their success is not necessarily predicated on the general economic climate. Options are fewer these days but there still is some opportunity.

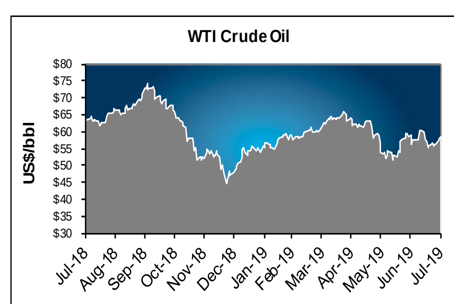
Alphabet (Google) was the biggest gainer in the month in the Anchor equity portfolio, rising about 12%. The company posted solid earnings with reaccelerating revenue growth. Cloud computing is becoming a larger driver. It also announced a $25 billion buyback. The biggest detractor in the month was Total which stumbled about 7% as geopolitical risks led to a slide in crude prices.

In July we replaced the Lazard position with Morgan Stanley. Lazard shares rallied 24% from the end of May on the prospects for better deal activity in the second half of the year but we were concerned by the consistent outflows in the asset management division. Lazard has more exposure to European and emerging markets than other global investment firms and therefore it will be significantly impacted by the trade wars. We believe that Morgan Stanley is a compelling value as a leading investment bank with leading positions in investment banking (M&A and equity underwriting), equity trading, and wealth management. The firm's large wealth management business and strong client relationships lowers the business risk of the franchise. While the shares are impacted by short-term market volatility, they appear significantly under-valued. We believe that Morgan Stanley can achieve a 11.4x PE on the 2019 $4.90 consensus EPS estimate (15% below its historical 10-year P/E). This target implies 37% 12-month total return inclusive of the 3.3% indicated dividend yield.









*MSCI EAFE Index

FIXED INCOME COMMENTARY

Fed Fumble

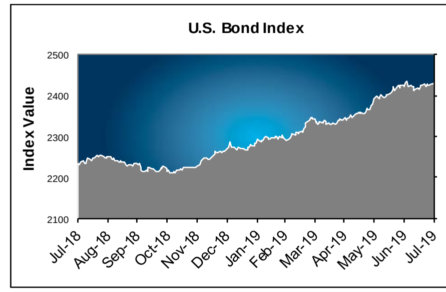
While July marked the longest economic expansion in U.S. history, the IMF cut its annual global growth forecast to 3.2%, the lowest since the Global Financial Crisis. Significant U.S./Sino trade tensions have echoed through to global trade and impacted business confidence. For example, manufacturing purchasing managers indexes (PMI) have been falling since mid-2018 and are in contractionary territory in many cases. While the U.S. has been less impacted by the slump in global trade, the U.S. manufacturing PMI has also fallen in 2019 and now sits bang on the border of the expansion and contraction signal. In late July the Fed cut the fed funds rate 0.25% largely based on forward looking business indicators, despite a generally strong U.S. consumer aided by low unemployment (3.8%), and rising wages, most notably among the entry level cohort.

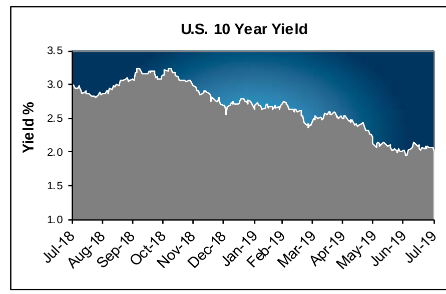
Interest rates across the developed markets have fallen in 2019. At the time of writing there is USD-equivalent ~$14 trillion of negative yielding debt. This isn't just comprised of sovereign bonds; about a quarter of the European investment grade debt has a negative yield to maturity. This has led to a reach for yield among yield starved investors, which has resulted in tighter credit spreads as corporate credit has been well bid. Money has also flowed into emerging markets debt. Indeed, the yield to maturity of the Bloomberg Barclays Global EM Local Currency Govt Index reached a record low in July. The Government of Italy (BBB-rated) issued EUR3 billion of 50-year bonds with yield to maturity of 2.877%. Incredibly, the issue was 5.5x oversubscribed! To further demonstrate these puzzling conditions, in mid-July Bank of America reported that there were 14 euro-denominated high yield debt issues that traded at negative yields. As a reminder, high yield companies are those that are considered on the riskier end of the corporate credit spectrum…

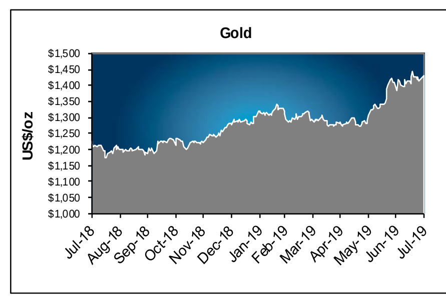
These are astonishing statistics and compelling evidence that the European Central Bank's negative interest rate policy has totally distorted the risk/reward trade-off and is crushing savers… and European bank's profitability. For example, Deutsche Bank, the poster boy of troubled European banks, announced restructuring plans where it will lay off 18,000 employees (approximately 20% of its workforce) and will shrink the investment banking side of the bank by exiting its equities sales and trading business. Also, in July UniCredit announced it will lay-off 10,000 employees, about 10% of its work force. Meanwhile, U.S. banks reported tens of billions of dollars in profits in Q2.

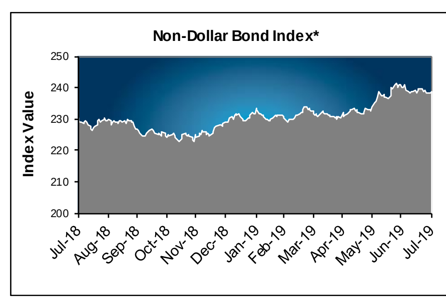
Elsewhere, Turkey's president fired the head of the Turkish central bank complaining that interest rates were too high despite an inflation rate of 15.7%. Demonstrations have continued daily in Hong Kong, while Iran/U.S. tensions in the Strait of Hormuz have escalated as a result of the shooting down of U.S. drones by Iran. Lastly, Boris Johnson became Prime Minister of the UK. He has filled top government positions with pro-Brexiteers who have publicly said that they would be willing to leave the EU without a deal. As a result, the GBP has weakened versus the USD and, at the time of writing, trades at its lowest level since March 2017.

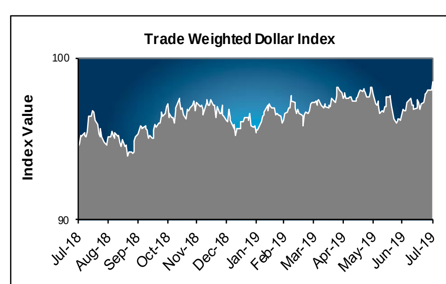
Looking forward, it difficult to forecast where the race to the bottom for interest rate will end while the economic statistics are weakening and trade wars rattle markets. With that said, we all know that nothing last forever, especially in the financial markets. We remain focused on maintaining quality in our bond portfolio and limiting duration risk.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

Disclaimer