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FINANCIAL STRATEGIES

# Q3 2019 Market Commentary

*Economic and Market overview:*

- *June was a historic month for stocks!*
- *U.S. economy is slowing but growing.*
- *Corporate profit growth is expected to contract for the first 3 quarters of 2019[1].*
- *The Federal Reserve is widely expected to lower interest rates twice this year.*
- *Recession risk is widely discussed but likely avoided in the near term.*
- *This month marks the longest U.S. economic expansion on record[2].*

*Portfolio Positioning:*

- *Favoring US equities over International equities.*
- *Own "higher quality" equities with more stable earnings and historically less volatility.*
- *Extending bond maturities to add yield and return potential.*
- *Closely aligning portfolio risk according to each client's tolerance for risk.*
- *Rebalancing bonds and equities possible should stocks correct meaningfully.*

## Why is bad news good news?

US economic growth is expected to slow, profit growth for companies in the S&P 500 is expected to contract for the first 3 quarters of 2019, and the trade dispute with China is still unresolved. Ironically, the stock market responded with strong gains not achieved in decades! The S&P 500 had its best June performance since 1955 (+6.9%) and the Dow Jones Industrial Average had its best June performance since 1938 (+7.2%)1. In July, the S&P 500 crossed the 3,000 level setting a new all-time high. The bond market has also enjoyed investment gains this year.

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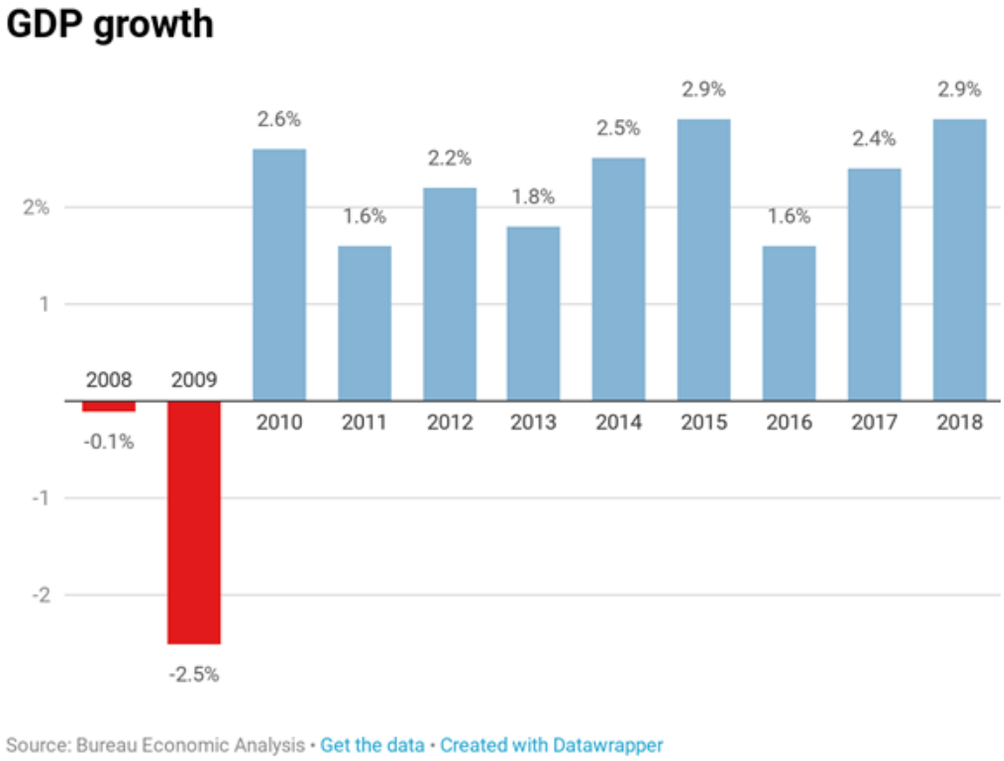
Markets typically enjoy good news, so why do they cheer bad news? The simple answer is the Federal Reserve Board (FRB). The FRB controls short term interest rates and stated publicly their willingness to lower rates as necessary which is positive for both stocks and bonds. For stocks, lower interest rates reduce borrowing costs for businesses and that helps profitability. Lower rates also positively affect how companies are valued by stock analysts. Bond prices increase because existing bonds paying a higher yield are worth more than newly issued bonds paying a lower yield (bond prices and yields move inversely). Despite short term corporate profit and geopolitical headwinds, the indication of lower interest rates was ample good news to keep investors buying stocks.

The current economic expansion that began in June 2009, has now become the longest on record as of this month[1]. However, the 10-year annualized growth rate of 2.3% has been the slowest of major recoveries[1,4]. The Federal Reserve is expecting around 2.0% economic growth this year. Investors have expressed their concern that growth will slow from the 2.9% achieved in 2018, but it is within a reasonable range of the 10 year average of this expansion. The slower recovery has kept the economy from "over-heating" and therefore, extending beyond a normal cycle of 4-6 years.




## What's next?

The next move higher or lower in the stock market will likely be driven by corporate earnings and/or a change in interest rate policy implemented by the Federal Reserve. Stock market volatility may remain elevated as investors digest corporate earnings and determine what prices are appropriate for stocks. Another consideration is that stock valuations are elevated so earnings need to catch up to stock prices or stock prices need to fall to bring valuations back in line with historical averages. These valuations can remain elevated but at this level return expectations over time are just under 5%[5]. If earnings are broadly more disappointing than expectations and if the Fed does not lower rates as expected during the year, it will be a disappointment and we would not be surprised to see the markets make a move down. There are several "indicators" that tell us that a recession will occur, but none accurately predict *when* they will occur. We are cautiously watching and while recession risks have risen, there is no clear sign that a recession is imminent. It is important to keep in mind that the stock market historically corrects well in advance of a recession which is why we are more mindful of your portfolio allocation than we are on market timing.

## Where is your money?

We are striving to maintain an allocation to stocks, bonds and cash consistent with our client's tolerance for risk. In most portfolios, the more volatile holdings have been reduced or eliminated (taxes and planning permitting). Equity holdings are more weighted toward companies that grow their dividends, have more predictable earnings and less overall volatility. The yield in our bond holdings has increased which will provide more income. Credit quality is also higher allowing for the potential to produce gains in our bonds should the equity market correct. If we see a meaningful correction in the market, we are prepared to rebalance to ensure that we have the appropriate allocation to stocks to take advantage of a rebound. If your financial situation has changed meaningfully or if you would like further clarification on how this information pertains to your individual situation, please call or email your financial advisor.

Chris Proctor

*Chief Investment Officer*

*Sources:*

*1 FactSet; 2 Schwab; 3 CNBC/Reuers; 4 JPMorgan (6/30/19); 5 Ned Davis*