ASSET STRATEGY CONSULTANTS

MARKET REVIEW

Second Quarter 2019

We are pleased to present *Market Review,* featuring a discussion of the Capital Markets during the Second Quarter 2019 and a summary of historical performance for the major asset style passive indices for the period ending June 30, 2019. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing $9.9 billion under advisement. Headquartered in Baltimore, Asset Strategy Consultants has offices throughout the East Coast.

THE MACROECONOMIC ENVIRONMENT

Must all good things come to an end?

Economists are fond of saying that expansions do not die of old age; they must be killed. As the U.S. enters its 121st month of expansion, the longest on record, and valuations are lofty across most markets, the eventuality and timing of a U.S. recession remains forefront on investors' minds. In its most recent meeting, the Fed announced a relatively new policy objective — to "sustain the expansion"— and U.S. Treasury and stock markets rejoiced in tandem. Stock markets approached record highs, and the 10-year U.S. Treasury yield hit a multi-year low.

Outside of the U.S., global growth continued to decelerate but remained positive, but central banks generally expressed a willingness to engage in further stimulus measures as needed. A persistent lack of inflation, at least according to traditional measures, remains a conundrum and a key challenge for banks around the world. Away from data, trade talks with several countries are fluid; a no-deal Brexit this October is no longer a remote possibility; and tensions with Iran are mounting. All of these issues, added to the distractions associated with the 2020 election in the U.S., pose additional variables for investors to untangle.

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The U.S. economic picture continues to be mixed. A strong labor market and rising personal income have supported consumer spending, which accounts for roughly 70% of GDP. First quarter 2019 real GDP was +3.1% (y-o-y), though this figure is expected to slow. And unemployment hovers at a five-year low at 3.6%, although wage growth, as measured by private sector average hourly earnings, remains sluggish (+3.1% y-o-y in May). Meanwhile, manufacturing continues to be a point of weakness; the most recent (June) Purchasing Managers' Index continued to signal expansion (above 50), but only barely so with a leading of 51.7, which is sharply off its August 2018 peak of 60.8. And as noted above, Inflation remains elusive with the headline Consumer Price Index (CPI) up 1.8% in May (y-o-y) and Core (excluding food and energy) up 2.0%. The Fed's preferred inflation gauge, the Core PCE Deflator, is still falling short of its 2% target and rose only 1.6% over the trailing year.

The Fed left rates on hold at its June meeting, but comments from Chairman Powell were interpreted to be dovish and that cuts would be imminent. As of quarter-end, markets had priced in a 100% probability of a rate cut in July, and the probability of three additional 25 bps cuts in 2019 was greater than 50%. But, there appears to be room for disappointment if economic data releases do not justify these moves.

Overseas, European Central Bank (ECB) President Mario Draghi also emboldened investors with his comments that rates could be cut and/or asset purchase programs restarted if inflation does not reach the bank's target. Following those remarks, the German 10-year government bond yield hit a new record low and continued to trend lower into quarter-end, closing the quarter at -0.33%. (The policy rate remained unchanged at -0.40%.) Inflation in the euro area was +1.2% (y-o-y) in May and the lowest monthly rate since 4/2018. GDP was barely positive in the euro area (+1.2% y-o-y) and while Q1 GDP for Japan (+2.2% annualized) beat expectations, growth is expected to slow for the export-driven country. Inflation continues to be almost non-existent in Japan; +0 .8% y-o-y in May. As in the U.S., manufacturing remained a key source of weakness in Europe and Asia with trade tariffs and tepid global demand being key drivers. ■

EQUITY MARKETS

U.S. equity markets approached record levels as investors were heartened by the potential for imminent Fed rate cuts. The S&P 500 Index rose 4.3%, bringing its ytd return to 18.5%. Financials (+ 8.0%) were the best performers while Energy (-2.8%) was the only sector with a negative return. Small cap stocks (R2000: 2.1%) underperformed large (R1000: 4.2%) and growth continued its trend of outperformance across the capitalization spectrum, albeit only modestly in Q2. In a reversal from Q1, quality factors such as operating margin and return on equity contributed to performance. Value factors (P/B, P/E trailing, and yield) were mixed while growth factors (EPS growth, sales growth) were positive.

Developed markets were also buoyed by optimism for rate cuts. The MSCI ACWI ex-USA Index rose 3.0%, with Canada (+4.9%), Pacific ex-Japan (+5.2%) and Europe ex-U K (+5.8%) leading the way. Japan (+1.0%) and the UK (+0.9%), at the lower end of the group, were able to eke out small positive returns. The Canadian dollar, yen and euro appreciated versus the U.S. dollar while the British pound and Australian dollar lost ground. Emerging markets (M SCI Emg Mkts: +0.6%) underperformed developed but returns across countries varied. Russia (+16.9%) was at the top while China (-4.0%) was among the few countries with negative returns for the quarter. Also worth mentioning are BRIC countries Brazil (+7.2%) and India (+0.5%). The U.S. dollar weakened versus most emerging market currencies as the prospect for rate cuts in the U.S. loomed large. ■

FIXED INCOME MARKETS RESULTS

In the U.S., the Bloomberg Barclays US Aggregate Bond Index rose 3.1% for the quarter, nearly mirroring its Q1 result (+2.9%). U.S. Treasury yields hit multi-year lows in June, and the 10-year closed the quarter at 2.0% (lowest since 11/2016). The curve remained inverted between the 90-day T-bill and the 10-year U.S. Treasury, but the more widely watched spread between the 2- and 10-year widened during the quarter to 25 bps. Investment grade corporate bonds performed best (+4.5%). Agency mortgages underperformed (+2.0%) as lower rates raised concerns around prepayment risk. TIPS (Bloomberg Barclays TIPS: +2.9%) underperformed as inflation expectations fell; the 10-year breakeven spread was only 1.69% as of quarter-end versus 1.88% as of 3/31/2019. The high yield corporate bond market (Bloomberg Barclays High Yield: +2.5%) underperformed investment grade but is up nearly 10% ytd. Leveraged loans (S&P LSTA: +1.7%) held their own in spite of negative press and falling rates. Municipal bonds (Bloomberg Barclays Municipal Bond: +2.1%) underperformed U.S. Treasuries in Q2.

> Hedged into dollars, the Index gained 2.9%. In a reversal from Q1, the dollar lost ground vs. most currencies, with the pound being a notable exception.

Overseas, yields across developed markets generally fell. The Bloomberg Barclays Global Aggregate Index rose 3.3% for the quarter on an unhedged basis. Hedged into dollars, the Index gained 2.9%. In a reversal from Q1, the dollar lost ground vs. most currencies, with the pound being a notable exception. In Germany, the yield on the 10-year government bond hit an all-time low and closed the quarter at -0.33%. Negative yielding debt globally hit a new high of nearly $13 trillion and is now roughly 25% of the Global Aggregate Index. Emerging market debt performed well; the U.S. dollar-denominated JPM EMBI Global Diversified Index gained 4.1%. Local currency emerging market debt, as measured by the JPM GBI-EM Global Diversified Index, rose 5.6%. ■

REAL ASSETS

The Bloomberg Commodity Index fell 1.2% in Q2. Both the Precious Metals (+7.2%) and Agriculture (+4.5%) commodity sectors were positive performers, driven by strong individual returns for Gold (+9%) as well as Corn, Wheat, and Coffee, respectively. Meanwhile, Livestock, Energy and Industrial Metals commodity sectors all posted negative quarterly results. Oil pulled back but was roughly flat for the quarter, ending at $58/barrel (WTI), while Natural Gas within the Bloomberg Energy Sub-index declined a precipitous -16.2%. Elsewhere, MLPs (Alerian MLP Index: +0.1%) were flat and REITs saw modest gains (FTSE Nareit Equity: +1.2%) but lagged listed infrastructure assets (DJ Brookfield Global Infra: +4.3%). ■

CLOSING THOUGHTS

With such a torrid start to the year for broad asset classes following an almost equally disappointing end to 2018, more periodic bouts of volatility seem inevitable. Central bank policies that portend lower rates have fueled gains in bonds and stocks globally, but much optimism in the way of stimulus has been priced into asset prices. Valuations are lofty, the certainty and timing of a U.S. recession are unknown, and numerous geopolitical events continue to loom. Thus, just as we have stated in the past, adherence to an appropriate and well-defined long-term asset allocation policy remains the best course of action to manage the path to successful attainment of long-term investment goals. ■

PRELIMINARY RETURNS FOR VARIOUS PERIODS: 2Q19

		April	May	June	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
EQUITY	1 Russell:3000 Index	3.99	(6.47)	7.02	4.10	18.71	8.98	14.02	10.19	14.67	8.88
	2 Russell:1000 Index	4.04	(6.37)	7.02	4.25	18.84	10.02	14.15	10.45	14.77	8.94
	3 Russell:1000 Growth	4.52	(6.32)	6.87	4.64	21.49	11.56	18.07	13.39	16.28	9.90
	4 Russell:1000 Value	3.55	(6.43)	7.18	3.84	16.24	8.46	10.19	7.46	13.19	7.84
	5 Russell:Midcap Index	3.81	(6.14)	6.87	4.13	21.35	7.83	12.16	8.63	15.16	9.83
	6 Russell:Midcap Growth	4.50	(5.75)	7.02	5.40	26.08	13.94	16.49	11.10	16.02	10.25
	7 Russell:Midcap Value	3.30	(6.42)	6.75	3.19	18.02	3.68	8.95	6.72	14.56	9.33
	8 Russell:2500 Index	3.50	(7.11)	7.09	2.96	19.25	1.77	12.34	7.66	14.44	9.07
	9 Russell:2500 Growth	3.50	(6.64)	7.78	4.14	23.92	6.13	16.14	9.98	15.67	9.95
	10 Russell:2500 Value	3.51	(7.54)	6.47	1.89	15.26	(1.92)	8.98	5.55	13.28	8.10
	11 Russell:2000 Index	3.40	(7.78)	7.07	2.10	16.98	(3.31)	12.30	7.06	13.45	8.15
	12 Russell:2000 Growth	3.05	(7.42)	7.70	2.75	20.36	(0.49)	14.69	8.63	14.41	8.90
	13 Russell:2000 Value	3.78	(8.17)	6.37	1.38	13.47	(6.24)	9.81	5.39	12.40	7.28
	14 S&P:500	4.05	(6.35)	7.05	4.30	18.54	10.42	14.19	10.71	14.70	8.75
	15 S&P:400 Mid Cap	4.02	(7.97)	7.64	3.05	17.97	1.36	10.90	8.02	14.64	9.67
	16 S&P:600 Small Cap	3.87	(8.73)	7.45	1.87	13.69	(4.88)	11.97	8.41	14.99	9.43
	17 MSCI:ACWI ex US	2.64	(5.37)	6.02	2.98	13.60	1.29	9.39	2.16	6.54	5.85
	18 MSCI:EAFE	2.81	(4.80)	5.93	3.68	14.03	1.08	9.11	2.25	6.90	5.35
	19 MSCI:EM	2.11	(7.26)	6.24	0.61	10.59	1.22	10.66	2.49	5.81	8.70
	20 MSCI:ACWI	3.38	(5.93)	6.55	3.61	16.23	5.74	11.62	6.16	10.15	7.03
FIXED INCOME	21 Blmbg:Aggregate	0.03	1.78	1.26	3.08	6.11	7.87	2.31	2.95	3.90	4.27
	22 Blmbg:Gov/Credit	0.05	1.96	1.48	3.53	6.90	8.52	2.41	3.11	4.09	4.33
	23 Blmbg:Credit	0.49	1.47	2.26	4.27	9.35	10.34	3.74	3.92	5.77	5.20
	24 Blmbg:Corporate High Yld	1.42	(1.19)	2.28	2.50	9.94	7.48	7.52	4.70	9.24	7.58
	25 Blmbg:Municipal Bond	0.38	1.38	0.37	2.14	5.09	6.71	2.55	3.64	4.72	4.53
	26 Blmbg:US TIPS	0.33	1.65	0.86	2.86	6.15	4.84	2.08	1.76	3.64	4.07
	27 Blmbg:Glob Agg ex USD	(0.61)	1.04	2.98	3.42	4.99	4.10	0.97	(0.12)	2.10	3.33
	28 S&P:LSTA Levg Loan	1.65	(0.22)	0.24	1.68	5.74	3.97	5.24	3.68	6.16	4.71
	29 ML:US Treasuries 1-3 Yrs	0.20	0.71	0.52	1.44	2.44	3.96	1.29	1.21	1.20	2.15
	30 LIBOR - 3 Month	0.21	0.22	0.19	0.63	1.30	2.61	1.78	1.21	0.78	1.78
	31 3 Month T-Bill	0.19	0.23	0.22	0.64	1.24	2.31	1.38	0.87	0.49	1.38
REAL ASSETS	32 Blmbg:Commodity TR Idx	(0.42)	(3.36)	2.69	(1.19)	5.06	(6.75)	(2.18)	(9.15)	(3.74)	(2.58)
	33 GS Commodity Index	2.85	(8.21)	4.43	(1.42)	13.34	(11.49)	1.55	(13.33)	(5.19)	(4.62)
	34 MSCI:US REIT Index	(0.26)	0.28	1.27	1.29	17.77	11.06	4.14	7.81	15.55	9.02
	35 Alerian:MLP Index	(1.33)	(1.14)	2.64	0.12	16.96	3.09	(0.42)	(7.20)	8.21	8.48
	36 DJB:Glbl Infrastructure	0.71	(0.20)	3.80	4.32	20.73	12.69	7.65	4.41	12.11	10.84
	37 US DOL:CPI All Urban Cons	0.53	0.21	0.02	0.76	1.95	1.65	2.05	1.45	1.73	2.02