MARKET OVERVIEW

Second Quarter 2019

OPAL WEALTH ADVISORS

Outlook

2019 is the first year since 1995 where long term Treasuries and the S&P 500 are both up over 10% for the first half of the year—enjoy. Renewed policy accommodation leaves us with a constructive view as we enter the third quarter. The historic bull market and record economic expansion seem intact. Policy makers have acknowledged the tangible slowdown in economic growth (U.S. and abroad) and declining inflation expectations. Meanwhile, ever present macro risks (trade disputes, Middle East tensions, populism, nationalism) remain tenderly at bay.

In the U.S., we have modest private sector debt growth, restrained levels of cyclical spending, and benign inflation with no glaring imbalances. Modest economic green shoots in Europe, lower non-U.S. equity market valuations, and potentially more favorable currency fluctuations are beginning to argue in favor of global equity rebalancing.

We believe there is a high likelihood of recession prior to 2022 and with elevated valuations across equity and fixed income markets, this presents a particularly challenging backdrop longer term. Overall, in the near/intermediate term, as long as financial conditions remain loose, we remain relatively constructive.

Cautious Observations

- Market rate expectations versus Fed policy rate expectations.
- Continuation of anemic U.S. and non-U.S. economic growth trajectory.
- Percolating inflation data points across wage and input costs.
- Debt ceiling negotiations.
- Middle East tensions, ongoing trade disputes, Brexit negotiations, and the continued rise of global populist/nationalist movements.

Constructive Observations

- Global policy/rate accommodation and supportive liquidity (M2 growth).
- Increasing likelihood of additional Chinese stimulus measures.
- Robust confidence, increasing consumer spending, supportive housing market, seeming absence of economic flow imbalances.

Underweight	Neutral	Overweight
Fixed Income		Equity Cash & Equivalents

Equity tilt—Begin movement toward policy neutral U.S. to non-U.S.
Fixed income tilt—Short duration and credit bias
Alternatives tilt—Emphasize low correlation and income generation

Economic Overview

Growth

The second quarter absorbed the deflationary shock of trade war and a perception of tight monetary policy leaving depressed 2Q growth forecasts at 1.5%-2.0% (Q2'18 was peak growth of 4.2%). U.S. activity has followed a well-established non-U.S. trend of slowing growth. Slowing ISM manufacturing data fell from readings over 60 last summer to 51.7 in June. The service economy remained fundamentally sound with an ISM reading at 55.1. Global PMI readings of 51.2, 49.4, 51.9; EZ readings of 52.2, 47.6, 53.6; and Japan readings of 50.8, 49.3, 51.9 echo trend in the U.S. Early signs of improved consumer spending in the U.S., economic improvements in Europe, and coordinated global accommodation have increased odds of a growth rebound in second half 2019.

Employment, Consumer, Housing

Headline and U-6 unemployment of 3.7% and 7.2%

respectively sit near multi-decade lows. Wage growth of 3.1% is seen as relatively subdued but is higher over shorter observation windows and the Atlanta Fed Wage Growth tracker is at 3.9% for June. May PCE consumer spending (0.4%) came in above expectations and April was revised notably higher (0.6%). A respectable June retail sales result (0.4%) is raising hopes for consumer spending as well. Atlanta Fed is modeling 3.9% growth in real consumer spending for Q2 after only 2.8% in Q1. Consumer sentiment (98.4) and consumer confidence (121.5) remained elevated. Household debt has fallen from 134% of disposable income (2007) to 99% today and debt-servicing costs of 9.9% of after-tax income is at a multi-generational low. Lastly, low vacancy rates, depressed levels of homebuilding, and cheap mortgage rates combine to bode well for housing market prospects. Housing starts and permits are trending higher than 2018 and homebuilder sentiment (65) are at their highest levels since October 2018.

Inflation

Inflation metrics (PCE, CPI, ISM prices paid) have remained benign, unlikely to stoke any urgency at the Fed. Core PCE of 1.6% and core CPI of 2.1% remain well within the Fed target of 2%. Wage inflation and materials input costs are being cited routinely in corporate earnings calls which bear monitoring (cost push inflation) while growth/demand driven inflation risks seem remote given the global growth environment.

Central Banks and U.S. Dollar

The 'on hold' message in the first quarter evolved into an imminent rate cut narrative during the second quarter. The FOMC held rates steady at 2.25%-2.50% at the June meeting but indicated downside risks had "risen materially." Nine of seventeen members said they anticipate lower rates in 2020 than today. Markets currently expect 3.5 rate cuts in the next twelve months despite the Fed firmly telegraphing only a July 25bps cut with another 25bps likely in September. The Fed is part of a renewed global easing cycle. In early January, 52% of global central banks were lifting interest rates, now only the Norges Bank remains in that camp. The ECB extended its 0% refi rate guidance through 2020, maintained its -0.40% deposit rate, announced generous TLTRO III terms, and signaled further rate cuts are under consideration. The U.S. dollar (DXY) weakened 1.2% in the second quarter with a backdrop of twin deficits and Fed easing alongside a forthcoming end of QT and the repatriation holiday. The Fed balance sheet is approximately $3.8t, down over $652b from the beginning of the unwind in October 2017.

Equity Markets

U.S. Equity

The S&P 500 put positive bookend months around a difficult May to finish up 4.3% for the quarter, bringing it to 18.5% year to date. Supportive policy, solid breadth, subdued market sentiment, and small business confidence provided a robust backdrop for U.S. equities to rally. Materials, discretionary, and technology drove returns while healthcare (politics), and energy (global growth) lagged. Corporate earnings are challenged with difficult year over year comps and margin pressure is becoming evident with contraction likely for a second consecutive quarter. Subdued analyst estimates and downward guidance are moving the bar toward higher beat rates and upside surprises per usual. Blended Q2 earnings and revenue growth are projected at -1.9% and 3.8% as of this writing with stabilization and a return to positive year over year earnings by the fourth quarter.

International and Emerging Markets Equity

Developed international (3.7%) and emerging markets (0.6%) both posted gains for the quarter pushing year to date gains for non-U.S. equities to 14%. Global central banks (ECB, BoJ, BoE, PBoC) have pivoted along with the Fed toward accommodation driving global bond yields lower and bolstering risk assets. Most geographies outperformed the U.S. apart from China (trade), Japan (global growth), and the U.K. (Brexit). Emerging Europe (11.7%), Pacific ex-Japan (5.2%), Europe ex-U.K. (5.8%), and Latin America (4.4%) all outperformed the U.S. A strengthening of foreign currencies versus the U.S. dollar also factored into outcomes in the second quarter. Large caps outperformed small caps and growth outperformed value across developed markets much like the U.S. Growth concerns, trade conflicts, Brexit, and the seeming ever present populist tide remain stress points while supportive central banks, troughing fundamentals, and policy responses provide the bullish case.

Fixed Income Markets

Treasuries and stocks rallied together again during the second quarter as yields continued their descent across the curve. Anemic global growth and reinvigorated policy accommodation pushed 10yr UST yields from 2.5% to 2.0% and the 3m/10yr slope back into negative territory from mid-May through quarter end (although 2s10s and 2s30s remained positively sloped). Curve slope moved back into positive territory by mid-July but currently sits near 0. High yield spreads finished (407) approximately where they started (400) but gapped to 470 during the May volatility only to recover in June. Municipal bonds benefited from falling rates as well, posting a 2.1% return, bringing the year to date return to 5.1%. Taxable municipal bonds ranked second only to long-term treasuries, posting a robust 4.5% return for the quarter. Technical dynamics of limited supply and robust demand continued to benefit the sector.

Real Assets

Commodity markets took a breather (-1.2%) in the second quarter, on the back of a strong Q1 recovery in all risk assets. Commodities sold off in sympathy with May's market volatility but did not managed April or June bookends comparable to the equity markets. Energy (-4.6%) and industrial metals (-7.2%) echoed global growth concerns while agricultural commodities and precious metals posted gains driven by corn, wheat, and gold.

Opal Wealth Advisors / 2 Jericho Plaza / Suite 208 / Jericho, NY 11753 / t. 516.388.7980 / f. 516.388.7968 / **opalwealthadvisors.com**