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Investment Environment

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Markets: Deal or No Deal

Domestic equities improved upon their robust first quarter gains, with large cap (S&P 500) and small cap stocks (Russell 2000) registering their strongest first half advances since 1997 and 2003, respectively. The road to the market's success within the last three months was rocky, as it vacillated based largely on the prospects for a trade deal between the U.S. and China. Equities were up modestly in April as a deal seemed imminent, only to sharply reverse course and decline in May as discussions were abruptly terminated and threatening rhetoric between government officials escalated. Fortunately, cooler heads prevailed as the June G20 meeting approached, with the U.S. and China reaching a truce and restarting negotiations to the delight of equity investors. Monetary policy continued to have a significant influence on market action, as the Federal Reserve pivoted to a more accommodative stance and investors quickly embedded lower interest rates into their forward assumptions. Throughout this period, corporate earnings managed to surpass expectations, but growth rates decelerated and future estimates were reduced to reflect the heightened uncertainty of trade policy and economic growth.

Equity Markets (% Total Return)							
	Second Quarter 2019				Year to Date 2019		
	Growth	Index	Value		Growth	Index	Value
Russell 1000	4.64	4.25	3.84	Russell 1000	21.49	18.84	16.24
Russell Mid Cap	5.40	4.13	3.19	Russell Mid Cap	26.08	21.35	18.02
Russell 2500	4.14	2.96	1.89	Russell 2500	23.92	19.25	15.26
Russell 2000	2.75	2.10	1.38	Russell 2000	20.36	16.98	13.47
Russell Microcap	0.43	0.92	1.41	Russell Microcap	16.50	14.15	12.00
S&P 500		4.30		S&P 500		18.54	
International*		3.97		International*		14.49	
Emerging Markets**		0.74		Emerging Markets**		10.76	
Gold Price Change %		9.07		Gold Price Change %		9.90	

* MSCI EAFE in U.S. $ ** MSCI EMF in U.S. $ Source: FactSet (Indices)/Bloomberg (Gold Price Change%)

Global Economy: Tariff-ied Economies

The Global Purchasing Managers' Index (PMI) has steadily declined over the last year, in part due to the impact and proposed threats from trade tariffs on the U.S. and China economies, but also from the unintended consequences on key trading partners of the two combatants. Canada, Germany, Japan and the U.K. are among the prominent countries that have languished as the U.S and China "tariffy" each other's economy. The negative impact on China's economy has been more pronounced than the modest PMI decline would suggest, as May's industrial production was the lowest in seventeen years and retail sales increased at the slowest pace since 2003. The Chinese government has feverishly implemented stimulative measures such as increased social financing, specialized capital raising for infrastructure projects, rate cuts to facilitate bank lending, and currency devaluation, as it attempts to offset the contractionary effects of U.S. imposed tariffs. These initiatives have not yet achieved the desired results, and, at best, have propped up the economy from even sharper declines.

The U.S. economy has also started to buckle under the weight of existing and proposed tariffs. Domestic PMI has moderated from the mid 50's in the Fall to the low 50's in the latest reading (bordering on the 50 level that delineates growth and contraction). The uncertainty of negotiated outcomes has impaired CEO confidence, manufacturing levels, and the expectations component of consumer confidence, causing a slowdown in capital spending, durable good outlays and big ticket purchases of homes and vehicles. In response, more than 600 U.S. companies composed a letter urging the President to swiftly resolve the trade dispute because of the damage being inflicted on businesses and consumers. Even employment, which has been the stalwart of the country's longest tenured economic expansion, experienced a pothole with the May payroll data (where we saw the lowest result since March 2010). The aforementioned truce between the U.S and China at the G20 meetings was crucial, as the latest round of suggested tariffs was expected to have a more meaningful impact on consumers (particularly lower end demographics) and a more dampening effect on gross domestic product of 0.40% compared to earlier rounds according to Cornerstone Macro.[1] In addition, increasing concerns about the added inflationary effects were beginning to weigh more heavily on investor minds and tweak up recession risk probabilities despite the Federal Reserve's pivot to a more accommodative posture.

Monetary Policy: The Big Easy

The Federal Reserve has done a remarkable about-face over the last six months, offering insurance against a more dramatic slowdown, by pivoting from a stubbornly restrictive policy at year-end 2018 to one that appears more pro-actively accommodative. Commentary such as "closely monitor the implications of incoming information" and "act as appropriate to sustain the expansion" has replaced "patiently monitoring" in the Fed's vernacular. This change in stance curtailed increasing recessionary concerns and helped fuel enough investor optimism to facilitate the strong first half returns. The Fed has expressed increased concerns about the broader threats from lackluster global economies and trade uncertainty on the U.S. expansion, while also discussing temporary headwinds such as Boeing's production moderation due to 737 MAX safety issues and the recent, sharply lower, energy prices. Since March 2019, market-based probabilities for near-term interest rate cuts have sky-rocketed from about 0% to essentially 100%, with greater than a 50% potential for more than two interest rate reductions. Such accommodation is often beneficial to equity markets, inspiring investors to embrace risk while seeking added exposure to firms better leveraged to domestic economic improvement. Historically, small cap stocks (Russell 2000) generally outpace large cap equities (Russell 1000) in the first three and twelve months subsequent to the initial interest rate cut, with average first year returns of 10.9% (versus 7.4%) according to Jefferies' analysis.[2] Equity markets during non-recessionary periods (such as those that exist today) experience an even more robust initial boost from the first interest rate reductions, with gains of 24% in the first twelve months (compared to 11% in recessionary phases) per Canaccord Genuity.[3]

Other Global Central Banks appear to be reading the same tea leaves regarding the impact of economic and trade uncertainty, as several have already eased interest rates or signaled a shift to a more accommodative monetary policy. Prominent institutions like the People's Bank of China, Reserve Bank of India (lowest interest rates in 9 years), and Reserve Bank of Australia (first rate cut in 3 years) have eased recently, while Japan, Russia and the European Central Bank, among others, have signaled a future intent. With over two-thirds of global economies having a Manufacturing PMI below 50 and the Global Manufacturing PMI declining steadily to below 50 in June (from 53 a year ago), the sense of urgency for synchronized accommodation seems obvious but will take some time to take effect on economic growth.

Earnings: Tapping the Brakes

Since peaking in the third quarter of 2018 in the mid-twenties, earnings growth (represented by the S&P 500) has deteriorated to the point where first quarter results registered the first decline since the second quarter of 2016. Moreover, the second and third quarters of 2019 are forecasted to register annual earnings declines, creating an extended period of weakness not experienced for some time. Profit margins have been squeezed by labor and raw material cost pressures, and many companies have highlighted trade friction as a profitability headwind on their quarterly conference calls. As evidence, a FactSet analysis[4] showed that companies generating more than fifty percent of sales abroad (more susceptible to tariffs) had earnings declines of nearly 13% compared to gains of 6% for firms with less than fifty percent of international sales. Future outlooks have also been more cautious, with the percentage of companies issuing better than expected guidance hitting multi-year lows and the negative-to-positive guidance ratio achieving its highest level in three years. As a result, 2019 growth forecasts have moderated from about 9-10% three quarters ago to around 2% currently, even considering the typical 3-5% quarterly positive earnings surprises reported in the interim. Typically, stretches of earnings malaise and deceleration such as this benefit companies that are the focus of CCI's ***Positive Momentum & Positive Surprise*** discipline (absent any pronounced macro-related pressures), as scarcity valuation premiums are afforded to companies with secular growth models that are less affected by external pressures and continue to deliver consistently solid growth.

Politics: Polar Vortex

Since the Trump Administration took office, equity markets and the domestic economy have generally experienced success, spearheaded by tax policy that accelerated corporate earnings, stimulated capital spending and bolstered consumer expenditures. However, a polar vortex seems to have descended on the nation's capital and extended across the country, creating chilling behavior between political parties and threatening to create a continental divide between groups with stubbornly opposing viewpoints on key political issues such as immigration, healthcare, taxes, trade, education, etc. Compromise seems to have become a forgotten tactic, as differing factions seem more impassioned to vocalize their opinions rather than working toward some middle ground solution. Equity investors generally welcome congressional inaction (as the status quo helps mute uncertainty), but the increased pace of Presidential executive orders has proven to be an offset. A RenMac Macro Research assessment of year-to-date S&P 500 attribution illustrates that Washington D.C. politics has been less than a 100 basis point cumulative headwind to performance, whereas trade tensions (created via executive orders) have adversely impacted returns by about 400 basis points.[5] Investors will closely monitor the coming year leading to the 2020 Presidential election to position portfolios accordingly for whomever resides in the White House come January 2021. Markets and companies within specific industries may be whipsawed in the interim by the noise from individual policy actions, Congressional hearings/investigations, political rhetoric, candidate debates, primaries, social media posts, etc., but sustained market moves should continue to be predicated on corporate earnings, economic growth, inflation and monetary policy.

[1] Cornerstone Macro, "Weekly Economic Update," May 10, 2019, page 2.
[2] Jefferies, "SMID Cap Strategy – Q2 '19 Recap & Outlook," July 3, 2019, page 9.
[3] Canaccord Genuity, "Macro Strategy," June 19, 2019, page 1.
[4] Factset, "Earnings Insight," May 10, 2019, page 2.
[5] RenMac Macro Research, "2H 2019 Outlook," July 2, 2019, page 21.

Outlook: Another Date with TINA

There Is No Alternative (TINA) is a moniker used to highlight the compelling total return potential of stocks in comparison to bonds when yields are at extremely low levels. TINA is synonymous with the liquidity driven rally after the U.S. Financial Crisis, when the zero interest rate policy championed by Federal Reserve Chairs Bernanke and Yellen facilitated risk-taking into higher yielding assets such as equities. The TINA tailwind gained traction until monetary policy tightened and interest rates ascended to levels attractive enough to make yields on bond instruments more compelling again. The reappearance of TINA as a potential market catalyst is tied to the recent domestic interest rate declines in sympathy with reduced inflation expectations, the Fed's pivot to a likely easing cycle, and the inflection in negative yielding global debt which now approaches $13 trillion compared to $6 trillion in the Fall. Any sustained period of depressed interest rates could begin to shift investor money flows from bonds to stocks, as investors seek the best total return opportunities.

Typically, secular growth companies provide leadership during periods of uncertainty, as investors afford them scarcity valuation premiums for their more predictable future prospects. Such an environment is likely to persist as investors continue to struggle with the simultaneous assessment of economic slowdown, corporate earnings deceleration, fluctuating trade negotiations, and monetary policy variability. Inversion of some portions of the interest rate yield curve, geopolitical tensions (e.g., Iran nuclear ambitions), and political friction are other storm clouds weighing on investor minds. Within this macro turbulence, investors have prioritized corporate fundamentals in their decision-making, a key contributor to the revived success of active portfolio management, as more than fifty percent of growth managers have exceeded their benchmarks year-to-date across the market cap spectrum (including more than 70% within small cap). We continue to monitor the investment landscape for any changes in leadership that might arise from a reversal of these headwinds and warrant tactical portfolio changes, but we anticipate that sustainable growth companies which are the focus of CCI's ***Positive Momentum & Positive Surprise*** investment discipline could provide better risk-reward opportunities in the near-term.