BRIDGES | TRUST

Market Commentary | 2Q 2019

Below is our Market Commentary as of the quarter ending June 30, 2019.

ASSET CLASS	INDEX	QTD	YTD
U.S. Large Cap Equities	RUSSELL 1000	3.04%	18.84%
U.S. Small Cap Equities	RUSSELL 2000	2.09%	16.97%
Foreign Equities	MSCI ACWI IMI ex USA	2.74%	13.33%
Emerging-Markets Equities	MSCI EM	0.69%	10.69%
U.S. Investment-Grade Bonds	Barclays Aggregate	3.08%	6.11%
Cash Equivalent	3 Month T-Bill	0.62%	1.22%

Source: Bloomberg

From October to December 2018, the S&P 500 fell 600 points as economic excitement gave way to fears of trade war escalation and that the Fed was on the cusp of a policy mistake. Since then, the S&P has recovered its losses and then some, first on hopes of a quick China resolution (still pending) and then on a dovish Fed signal of an 'insurance cut' at its next meeting. The net result being nine months later the market is roughly where it started, having traded strong earnings expectations for a lower cost of funds.

While the market is near all-time highs, there has been a meaningful deceleration in real-time economic indicators. Industrial production and manufacturing data have both stalled and the first quarter's 3.1% GDP is likely to be the highwater mark for the year. While the economic repercussions of trade negotiations take time to materialize and have thus far been manageable, their impact on animal spirits is starting to sting, and in the end, may ultimately be self-fulfilling.

Whether the Administration can negotiate a grand bargain, or the Fed can engineer a soft landing only time will tell. But we must invest in the markets we have, not those we wish for. Our clients hire us to select securities that protect and grow their capital in both expansions and contractions, neither of which can be predicted. (Actually, predicting them is easy, being right, less so). While the decelerating economic data has led many to forecast a recession, we've been hesitant to follow suit. Economic policies are fluid and things can rapidly change. But we do feel safe saying we're closer to the next recession than we have been in the recent past.

Many in our industry have tried to express this view by positioning their portfolio defensively, raising cash or buying stocks in less-economically sensitive industries like utilities, real estate and staples. The dilemma we face is that those assets have been bid up to prices that provide little margin of error, reminding us that the right asset at the wrong price can still result in a bad outcome.
While recessions are a fact of life, they should be viewed as opportunities to acquire strong businesses at attractive prices. Regardless of the economic outlook, we attempt to own securities that are durable, structurally advantaged and can compound value at above average rates. Many 'safe' stocks excel at the first two but fail the third. Said another way, recessions come and go. But great businesses will always find a way to thrive.

While equities have more economic sensitivity than bonds, the risk-reward in bonds remains especially unattractive. The globe has $13 trillion of negative yielding debt (i.e. you pay the government to hold your money). While the U.S. 10-Year Treasury yield sounds anemic at 2.00% it's a relative bargain to much of the world. The Japanese 10-Year currently yields -0.15% and the German 10-Year bund just -0.36%. If you're tempted to lend money at those rates, please call us before you do. Corporate spreads are miniscule, and terms and conditions have lost their bite. We remain defensively positioned and resist the temptation to chase yield.

Since the Fed began raising rates in 2016, there's been a debate as to whether the U.S. could hit escape velocity or if it would be pulled down by a world mired in negative rates. Right now, the latter argument seems more likely, especially if the economy were to slow. Bonds continue to play an important capital preservation role in our clients' portfolios and provide valuable optionality in downturns. But one shouldn't hope for strong returns from here.

Analysts' estimates are for the S&P to grow earnings just 2.8% this year. We wouldn't expect an interest rate cut to dramatically change this projection. Consensus estimates for 2020 EPS is $186. The S&P has traded at 15X average forward earnings over the past ten years, yielding an S&P 500 of $2,790. Up almost 19% year-to-date, we believe the S&P fully captures an expectation for strong earnings growth in 2020.

Should this strong earnings growth next year not materialize, we wouldn't be surprised if volatility were to increase, especially as trade angst between the two largest economies clouds visibility. But we view volatility as opportunity and some of our best returns have come when the outlook was bleakest. In the short term, we expect trade and interest rates to dominate the headlines. In the long term, we'll keep looking for attractive businesses at fair prices.

The Bridges Trust Investment Committee