The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets — July 2019

From: *Philadelphia* Investment Management Group

OVERVIEW

- *The End of the Financial Cycle Does Not Seem Imminent*
- *U.S. Stocks Have Mostly Enjoyed a Healthy Run on the Back of the Fed's Easy Monetary Policy and the Hope for a Successful China/U.S. Trade Pact*
- *The Fed's Willingness to Cut Interest Rates in Response to Signs of Economic Weakness has Kept Treasury Yields at the Lower Range Over the Past Year*
- *Lower Rates, Which Spur Borrowing and Business Investment, Will Balance the Negative Effects of Slowing Global Growth*

THE ECONOMY

The 1973 oil embargo tripled the price of oil and plunged the U.S. into the worst recession since the 1930s. Things are different now, but still the oil shock provides a useful road map for the present. More expensive imports require costly adjustments to supply chains and business models. The U.S. is as reliant on cheap manufactured products as it was on cheap oil from the mid-East in the 1970s. Globalized production means that the imports nowadays often consist of intermediate goods moving from one supply chain to another and often there are no U.S. substitutes at the ready. The message is clear, and President Trump knows this as well as anyone. The U.S. must stand ready to move quickly to fill the gap in the supply chain of products for many of our manufactured goods.

The importance of the prior paragraph is evident. For the economy to continue on its upward path, there will have to be give and take with our trading partners concerning essential supply needs. Obviously, China and Japan are our biggest suppliers, and we need to tread carefully, as we are doing, to not totally disrupt the business model.

The bottom line to our thinking is that the economy will continue to move slowly ahead, that there will be disappointments in certain areas of our economy and continued improvement in others. The trade confusion will work itself out, giving everyone a little of what they want in order to save face. Obviously, this "back and fill" behavior has the markets, both equity and fixed income, in a more volatile state. As investors, the best we can do is stay the course and not try to figure out the next card to be played. In our view, the economy will muddle through the confusion and keep on a positive track.

FINANCIAL MARKETS

EQUITIES

U.S. equity performance for the second quarter of 2018, while positive, trended lower the further down the capitalization range you traveled. Large caps, as measured by the S&P 500, gained 4.3% against only a 2.1% gain for the Russell 2000 index of small companies. This divergence looked to us to be driven largely by the ongoing effects of declining interest rates. The relative returns for small caps have historically been stronger in rising interest rate periods and weaker in falling rate periods. Reports that the Federal Reserve was considering future rate cuts in response to the economic weakness resulting from the U.S.-China trade war drove stocks higher early in June, and they never gave up the advance.

	Equity Returns*		
Index	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	4.30%	13.65%	18.54%
Dow	3.21%	11.81%	15.40%
NASDAQ	3.58%	16.49%	20.66%
Russell 2000	2.10%	14.58%	16.98%

*Total: price change + reinvested dividends

Declines in both manufacturing and service indexes and a drop in new jobs in June gave signals of a softening economy, while retail sales and existing home sales were both positive. The overall breadth of the rally had most industry groups posting positive average price changes for the month and quarter. Reports coming in at the end of the quarter, and specifically signs of a near-term interest rate reduction, caused manufacturing stocks to report good results, with construction and materials handling and auto manufacturing ranking near the top for average price change. The metal sector had strong gains, while energy stocks continued to underperform for the quarter, with the oil sector and coal among the weakest groups.

Many stocks, particularly in areas just mentioned, have been left behind by investors who were only attracted to a select group of high-multiple growth stocks. Until very recently, it was challenging to find value in those "left behind" names. While some businesses are permanently impaired, many others were unfairly punished in the 2018 fourth-quarter downturn. Today, for the first time in a while, we view the equity universe as fertile ground for attractive, undervalued companies.

			Returns*		
Sector	**Weight**	**2nd Qtr**	**1st Qtr**	**YTD**
• Energy	5.0%	-2.83%	16.43%	13.13%
• Materials	2.8%	6.31%	10.30%	17.26%
• Industrials	9.4%	3.57%	17.20%	21.38%
• Cons. Discretionary	10.2%	5.28%	15.73%	21.84%
• Consumer Staples	7.3%	3.72%	12.01%	16.18%
• Health Care	14.2%	1.38%	6.59%	8.07%
• Financials	13.1%	8.00%	8.56%	17.24%
• Info Technology	21.5%	6.06%	19.86%	27.13%
• Communication Svcs	10.2%	4.49%	13.98%	19.09%
• Utilities	3.3%	3.48%	10.84%	14.70%
• Real Estate	3.1%	2.46%	17.53%	20.42%

06/30/19
*Price + income
Source: S&P Dow Jones

Confirming the effect of further Fed interest rate reductions and positive trade-related news are the returns reported for the S&P 500 sectors, as reflected in the table above. The sector that stands out in front of all others in the past quarter is the Financials sector. While other sectors, for the most part, showed positive returns for the second quarter, only Financials kept pace with its first quarter return. Not only are lower interest rates positive for companies in this sector, but further investment by the private sector in business and related areas is a real plus for this group. Other sectors performed well in the second quarter, maintaining the "across the board" advance in the financial markets.

FIXED INCOME

Fixed income investments continued to trade in a narrow range during the second quarter. The 10-year Treasury, on which investors tend to focus to give an insight into coming events, so to speak, trades in line with the overall notion of where we are going with interest rate cuts by the Fed and what announcements might be coming out of the European and Asian markets. In June, volatility within the market did not rise nearly as much as at the beginning of the quarter.

Base Interest Rates

U.S. Treasury Yields

	Maturity				
Date	3 mo.	2 yr.	5 yr.	10 yr.	30 yr.
Dec 31, 2018	2.35%	2.49%	2.51%	2.68%	3.01%
Mar 31, 2019	2.39%	2.26%	2.23%	2.41%	2.82%
Jun 30, 2019	2.09%	1.76%	1.77%	2.01%	2.53%
Change:					
3/31-6/30/19	-0.30%	-0.50%	-0.46%	-0.40%	-0.29%
12/31-6/30/19	-0.26%	-0.73%	-0.74%	-0.67%	-0.48%

The U.S. high grade bond index gained a solid 1.30% in June, the fifth time it has been over the 1% mark in the last seven months. During the last seven months, the index has accumulated an 8.83% return. Not since early 2001 have we seen such a return. As shown in the table below, all index sectors posted positive returns for the quarter and year to date, with long bonds outperforming intermediate-term bonds for both periods. All sectors have moved in the same direction every month over the last seven months, though there has been a fairly healthy gap between the best and the worst performing sectors.

Fixed Income Returns

Index	**2nd Qtr**	**1st Qtr**	**YTD**
Corporate/Govt.	3.55%	3.26%	6.93%
Int. Corporate/Govt.	2.59%	2.35%	5.00%
Long Corporate/Govt.	6.45%	6.17%	13.01%
U.S. Treasury	3.06%	2.18%	5.31%
- Intermediate	2.32%	1.57%	3.92%
- Long	5.90%	4.59%	10.77%
Corporate	4.35%	5.01%	9.57%
- Intermediate	3.13%	3.80%	7.05%
- Long	7.06%	7.85%	15.46%
- Quality			
- AAA	4.86%	4.98%	10.08%
- AA	3.53%	3.73%	7.39%
- A	4.12%	4.59%	8.90%
- BBB	4.66%	5.58%	10.50%
Municipal	2.34%	2.95%	5.35%
- Intermediate	1.59%	2.09%	3.72%
- Long	2.80%	3.49%	6.39%

Source: BofA Merrill Lynch

The importance of limiting exposure to riskier segments of the fixed income market cannot be over-emphasized. Lower credit-quality bonds, such as high-yield and emerging market bonds, tend to be more sensitive to economic ups and downs compared with Treasuries or investment-grade municipal and corporate bonds. One should also consider a laddered approach to fixed investments with maturities spread out over a period of a few years to provide liquidity and flexibility.

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The key question facing the financial markets in the second half of the year will be whether the economy is just slowing down or heading into a recession. The Fed's willingness to cut rates in response to signs of economic weakness presumably is to avoid a recession. This suggests it is likely there will be a rate cut in July and possibly another in September. We believe a slowdown scenario is the most likely but worry that trade conflicts could be a catalyst for a recession longer term. As stated earlier, we also believe that there will be compromise on the trade issues. However, we want to point out, as we have done, how important these concerns are to the health of our economy.

Philadelphia Investment Management Group
105 Clarke Avenue
Pocomoke City, MD 21851