EQUITY MARKET UPDATE

As of 06/30/19 | Volume 8, Issue 6 | FFTAM.com

Stocks experienced their best June since 1955 as central banks around the world, including the Federal Reserve, promised easier monetary conditions. These promises were in response to weakening economic data worldwide. Much of the soft data continues to revolve around trade uncertainties between the United States and China. At month-end, President Trump and President Xi agreed to resume trade talks, averting for now an escalation in the trade war. Mr. Trump vowed to hold off on new tariffs against $325 billion in Chinese imports, and he agreed to lift some restrictions on the Chinese tech company Huawei. In exchange, China will buy additional amounts of agricultural and energy products. More importantly, there was no indication from either side of progress on the key sticking points which caused the potential deal to fall apart in early May.

New All-Time High for the S&P 500 as Stocks Surge

The S&P 500 returned to record high territory in June after posting a monthly return of 7.05%. The index experienced its best first half to a year since 1997 gaining 18.54%. All economic sectors are positive thus far in 2019, with the biggest gains coming from technology, consumer discretionary, industrials, and REITs.

The Dow Jones Industrial Average experienced similar results advancing 7.31% in June. Large gains in Apple, Home Depot, Goldman Sachs, and Caterpillar powered the index upward. Year-to-date, the Dow is up 15.40%.

The NASDAQ had another strong month climbing 7.51%. It remains the leader in 2019 with a total return of 21.34%. Gains in software services, internet portals, and social media have powered the tech heavy index.

Mid and small-sized companies had a strong June with the S&P 400 Mid-Cap and S&P 600 Small-Cap Indexes gaining 7.64% and 7.45%, respectively. This was somewhat surprising given the continued drop in interest rates and the large exposure each index has to banks. We have written for months that falling interest rates, along with an inverted yield curve, serve as a double whammy for community bank stocks as net interest margins shrink and the potential for loan losses rise. Year-to-date, mid-cap and small-cap stocks are up 17.96% and 13.67%, respectively.

Foreign Stocks Gain as Economic Data Weakens, but Central Banks Promise Stimulus

Economic data in foreign markets continued to weaken in June. European and Chinese Manufacturing PMIs were both less than 50, signaling contraction. Trade tensions caused declines in export orders and production. In China, industrial production grew 5% on a year-over-year basis, its lowest annual growth rate since 2002. Fixed asset investment was also weaker than expected.

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400 Pine Street Suite 300 Abilene, TX 79601 325-627-7100	1000 Forest Park Blvd Suite 200 Fort Worth, TX 76110 682-703-6404	2201 W. South Loop Stephenville, TX 76401 254-918-6262	222 S. Koenigheim St San Angelo, TX 76903 325-659-5987	201 Elm Street Sweetwater, TX 79556 325-235-6644	3555 Billy Hext Rd Odessa, TX 79765 432-367-8912	3515 Dowlen Road Beaumont, TX 77706 409-600-6460	24080 Hwy 59 N Kingwood, TX 77339 281-318-4625

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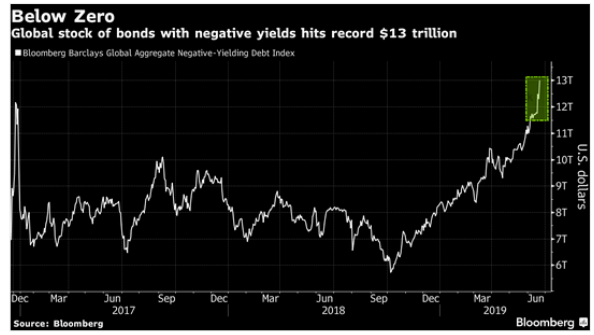
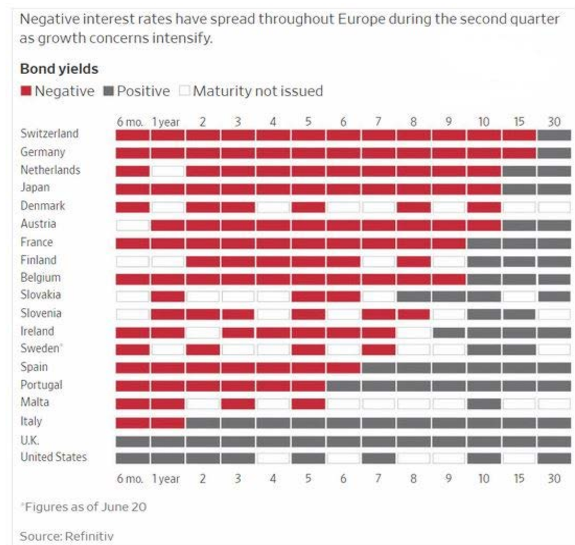


The British are still in the process of electing a new Prime Minister after Theresa May resigned after failing to reach a Brexit agreement that could be passed by Parliament. Finally, to make matters worse, oil prices rose after two tankers in the Gulf of Oman, near the Strait of Hormuz, were attacked by Iran.



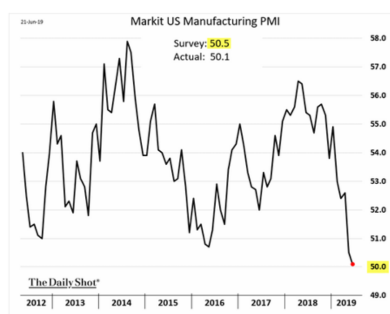
In response to the weakening data and geopolitical uncertainties, ECB President Mario Draghi announced that interest rate hikes were not likely until June 2020 at the earliest. He also hinted at further rate cuts since inflation has failed to reach the central bank's 2% target. Not to be outdone, Bank of Japan Deputy Governor Masazumi Wakatabe also promised "pre-emptive action" if the economy should weaken further. Finally, the Reserve Bank of Australia cut their rates to a record low 1.25%.

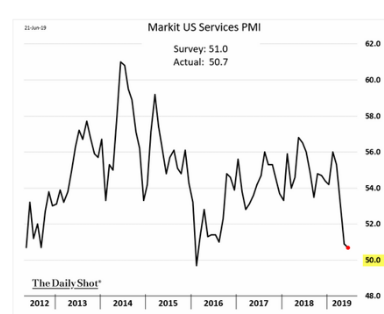
With so much talk of additional monetary stimulus, international bond yields collapsed. Record low yields can be found throughout Europe with the 10-year German Bund yielding a negative 0.36%. Globally, negative yields now encapsulate a record $13 trillion in bonds, with Japan comprising 60% of that total.

International stocks responded favorably to the negative yields with the MSCI EAFE and MSCI Emerging Market Indexes jumping 5.97% and 6.27%, respectively. Year-to-date, MSCI EAFE has gained 14.53%, while MSCI Emerging Markets has returned only 10.69% due to effects from a stronger US Dollar.

Bond Yields Plunge on Softer Economic Data and Dovish Fed

June was the first time that economic data in the United States collectively showed weakness from the trade skirmishes. Both the Manufacturing and Services PMI declined to levels not seen since early 2016. Business investment in machinery and structures came to a grinding halt as companies were unwilling to deploy capital into an uncertain global trade environment, and CPI continued to show that inflation was subdued for now. Consumer data weakened somewhat, but it remains very strong due to the strong labor market.

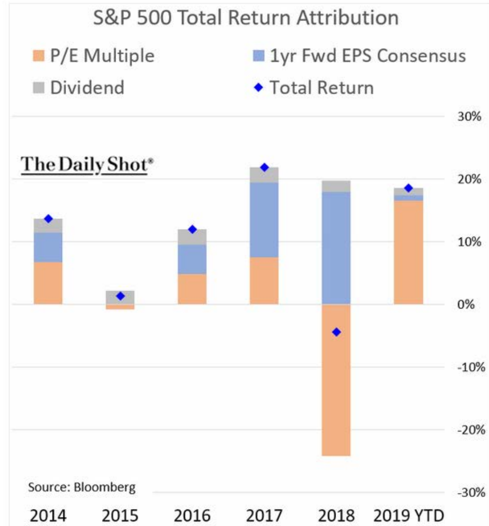




With economic growth weakening and central banks around the world promising more stimulus, the door opened for the Federal Reserve to lay the groundwork for future rate cuts. At its June 19th meeting, the FOMC voted to maintain its target rate range at 2.25% to 2.50%, but it signaled that rate cuts could be coming as soon as July. The dot plots released after the meeting were also very dovish with seven FOMC members expecting two 25 basis point reductions this year. The Fed's statement also dropped the word "patient" and now includes language that the committee will "act as appropriate to sustain the expansion."

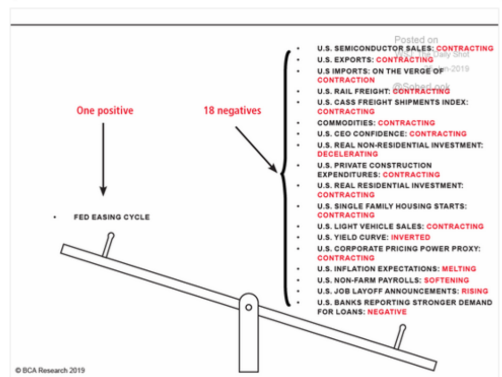
Rally Raises the Forward PE Ratio on the Eve of 2nd Quarter Results

The sharp rally in June boosted the forward PE ratio on the S&P 500 by over a point. Currently, the S&P 500 trades at 16.92x forecasted earnings for the next twelve months. This is an increase from the 14.90x forecasted earnings seen at year-end, and it is above the 10-year and 30-year average of 14.97x and 15.75x, respectively. Almost all the rally this year has come from the PE multiple expanding.



Second quarter earnings season is about to kick-off, and the consensus estimate is for earnings to decline 2.6% on a year-over-year basis. If this should come to fruition, it would mark the start of an official earnings recession since first quarter results were also down 0.3%. According to FactSet, if we experience an earnings recession, it should be short-lived as third and fourth quarter earnings estimates are solidly in growth territory on a year-over-year basis. However, given that the G-20 meeting between Mr. Trump and Mr. Xi did not end the trade stand-off, much attention will be paid to each company's forward guidance.

This sets the stage for additional market volatility given the large gains seen in stocks in the first half of the year. The theme so far in 2019 has been slower economic growth coupled with lower interest rates creating a "goldilocks" environment for stocks. We wrote about this in April, along with the dangers it presents. The plunge in global bond yields over the last six months has created a boon for stable, defensive companies like utilities, consumer staples, and REITs. These sectors have helped the market reach record highs despite fund flows showing investors reducing their equity allocations. According to data from Merrill Lynch, these three sectors now trade at some of their highest PE multiples in history. This poses the question of whether the recent stock market rally is too reliant on rate cuts from central banks.



What We Are Doing—Our Outlook and Strategy

The US economy is on firmer footing compared to other countries around the world; however, we are beginning to see weakness in manufacturing and inflation. The state of the consumer remains strong as the labor market continues to add jobs. Most data points in our proprietary economic checklist indicate the US economy is in the late stages of the economic cycle. With growth slowing and the yield curve inverted, it is hard to imagine stock PE multiples expanding much further than current levels. We expect the stock market to experience higher bouts of volatility with any additional gains coming from continued earnings growth and improving geopolitical conditions.

We were quiet on the trading front in June. Most of our trades in 2019 took place during the first quarter when we used the stock market rally to trim earnings risk from our portfolios. We were rewarded as volatility increased throughout the spring. If quarterly earnings show that companies are struggling in the current environment, it is likely we will conduct another round of risk reduction trades among our stock holdings with energy stocks serving as our primary sell candidates given our overweight position.