BERMAN CAPITAL ADVISORS

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BCA Q2 2019 Review and Outlook

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Summary Outlook

- Markets continued to rally in Q2, although not at the pace seen in the first quarter. We expect modest gains for equities and credit investments in the second half. We think the rally in longer dated government bonds is likely exhausted for now as expectations of rate cuts and weak economic growth abroad are priced in.
- We see equity valuations as elevated, but importantly we don't see major imbalances in the economy disrupting the financial markets. Our best guess is that recession is a 2021 event.
- Emerging market fundamentals are better than generally appreciated and thus emerging markets are long term attractive. But two factors argue for a prudent approach with smaller over-weights and under-weights relative to a normal portfolio: the aging bull market and the possibility that massive central bank easing still has unforeseen consequences.
- This scenario implies investors should overweight global equities, underweight high quality bonds, and maintain a neutral allocation to cash.
- The most significant risk is still economic weakness, especially in the developed world outside the U.S.

Second Quarter in Review

The markets' reversal from the difficult fourth quarter of last year continued building on the sharp rise seen in Q1 2019. Last year, of the eight major asset classes tracked by Ned Davis Research, none rose more than 5%. In the first half of this year, all eight had! Such a rapid shift is quite unusual. It's also rare for "risky" stocks and "safe" government bonds to be performing together so closely.

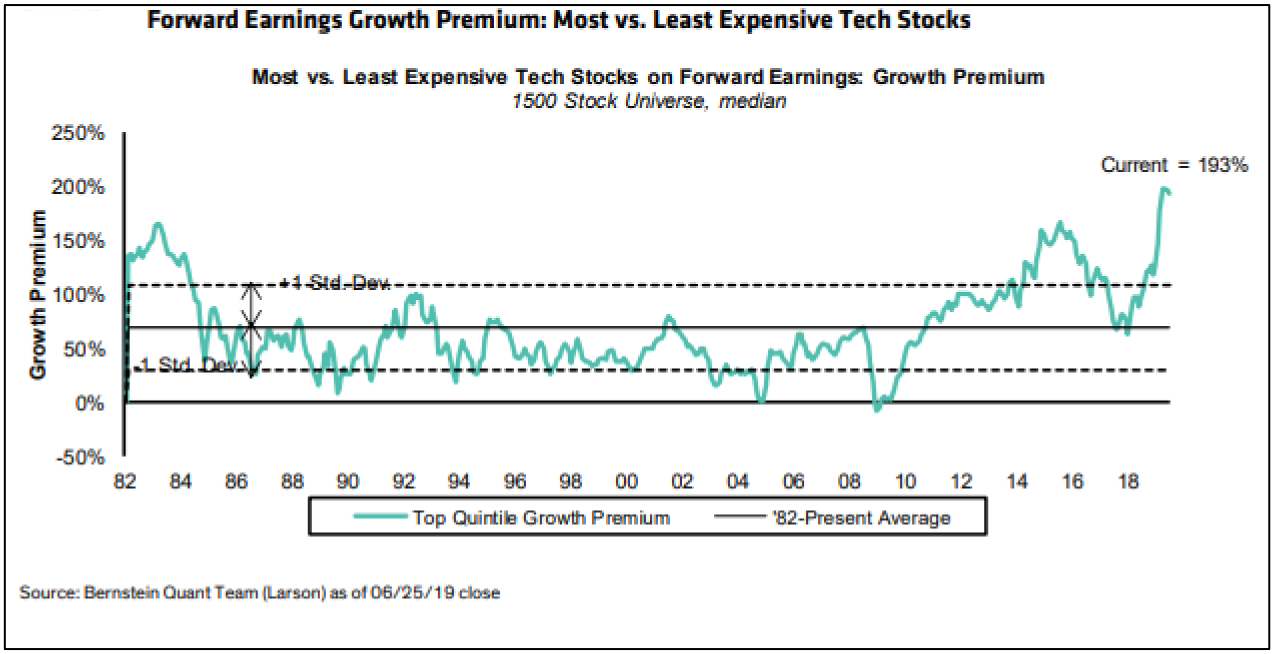
Total Index Return	Q2 2019	YTD 2019
S&P 500	4.3%	18.5%
Russell 1000 Growth	4.6%	21.5%
Russell 1000 Value	3.8%	16.2%
Russell Small Cap	2.1%	17.0%
MSCI EAFE (International)	3.1%	14.5%
MSCI Emerging Markets	0.3%	10.8%
US Aggregate Bond	3.1%	6.1%
High Yield Bonds	2.5%	9.9%

Source: Factset Research; data through 6/30/2019

Note: Int'l market returns reported in U.S. Dollars, not local currency

During the quarter, U.S. large and Mid-cap stocks generally performed best. Small cap stocks still posted positive returns and are close to large caps on a year to date basis. By style, growth continued to beat value. We comment more on this historic trend below. Financials was the top sector in Q2, as the approaching round of rate cuts will initially steepen the yield curve, helping banks' profitability.

Technology was the top contributor in Q2, powered by the continuing rally in the software space. Much of the current growth rally has been propelled by the technology sector, particularly software as a service ("SAAS") companies. Huge moves in these stocks and a hot IPO market are signs that the software rally may be approaching bubble territory. The chart below shows the top quintile (20%) of expensive tech stocks versus the cheapest. This shows the bubble, if there is one, is concentrated in the highest growth, most expensive stocks.



While stocks have outperformed year to date, bonds beat stocks in Q2. The prospects for Federal Reserve cuts and slower growth pushed the 10-year Treasury yield to 2%, a multi-year low. Longer-term Treasuries returned 6.0%, beating the S&P 500 1.7%. Duration, a.k.a. interest rate sensitivity, contributed more to aggregate bond returns than did credit spreads tightening. On the back of this decline in yields, Long-Term Treasuries gained almost 11% in the first half.

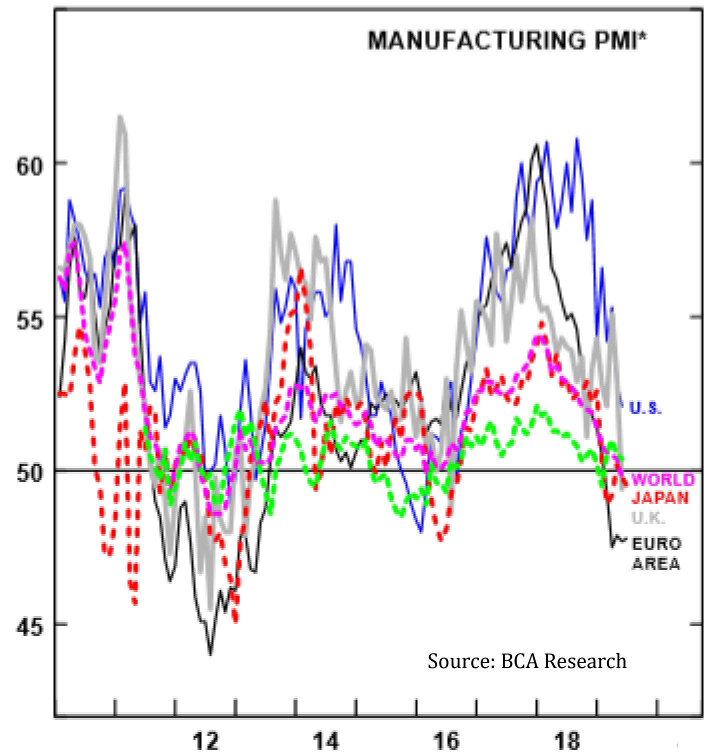
Reflecting stocks' strength, the S&P 500's 6.4% drop in May marked the only down month in the first half. The U.S. continued to outperform international equities as the MSCI EAFE and Emerging Market indices trailed the S&P 500 in Q2 and YTD. China fell -5.5% in the quarter, dragging the emerging markets lower, although other Asian markets had gains.

Second Half 2019 Outlook

<u>Federal Reserve & Foreign Central Banks</u>

Central bank action is clearly the most important factor in the financial markets today. Trade war progress, or lack thereof, comes in second, but market watchers are fixed on the Fed and ECB. Usually, when markets clamoring this loudly for rate cuts, the economy is in dire shape and stocks are tanking. Instead, the S&P 500 is near an all-time high, while credit spreads have narrowed by nearly 1.5% since the start of the year. Outside the manufacturing sector, the economy continues to grow at an above-trend pace and the unemployment rate is low.

So why are we headed for a rate cutting cycle? There are a few key reasons. First, manufacturing is weakening, especially abroad. Global growth has slowed, as the adjacent chart shows.

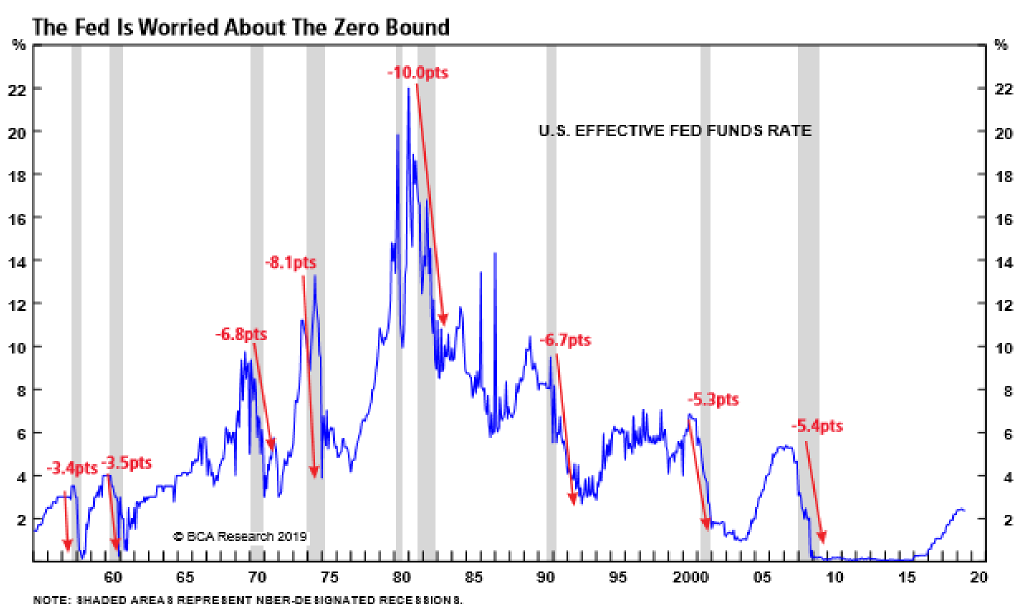


Second, the trade war has heated up again following President Trump's decision to further increase tariffs on Chinese goods.

Third, Inflation expectations have fallen in the U.S. as well as around the world. With inflation this contained, the Fed has room to cut without triggering inflation.

To an extent, Fed cuts are an insurance policy against a worse outcome. Policymakers are thinking this way: if inflation starts to accelerate, central banks can always raise rates. Yet, if monetary policy is too tight, the decision to leave interest rates alone could plunge the economy into a downward spiral.

Historically, the Fed has cut rates by over five percentage points during recessions (see chart below). The already nominally low interest rate isn't far from zero, at which point monetary policy would become largely impotent. The Fed is very worried about being "out of bullets."



Economic Fundamentals

This month, the current U.S. economic expansion enters a record 11th year and the bull market is almost as old. Our analysis points to both being intact throughout 2019. However, returns should be lower and both are likely to be more fragile as time goes on. Yet in the absence of a shock, the economy should be able to avoid recession and expand into 2020.

We don't see major credit imbalances that could pressure the economy. First, none of the cyclical sectors of the economy, such as autos, housing, or business investment spending seem to have over-expanded – if anything capex has been restrained. And while there is financial excess in some pockets of lending, there doesn't seem to be a system-wide problem. Major bank balance sheets remain in great shape.

Housing also looks solid. Homebuilder confidence has bounced back this year and purchase mortgage applications have indeed responded to lower rates. Vacancies remain near an all-time lows and housing starts have been restrained.

Corporate debt is the weakest link in the financial system, but perspective is warranted. Profitability and interest coverage are high, and yield-seeking investors are keeping borrowing costs low. Even after the recent run-up, net corporate debt is only modestly higher than it was in the late 1980s, a period where the fed funds rate averaged nearly 10%. Thanks to low interest rates and rapid asset accumulation, the economy-wide interest coverage ratio is above its long-term average, while the ratio of debt-to-assets is below.

Emerging Market Growth / China:

Growth has slowed overseas. Retarding factors include political turmoil in France and Italy, manufacturing weakness in Germany in the auto sector, and the Gordian knot called Brexit. Trade tensions cross-fire between the U.S. and China has caught other countries as well, including the back and forth over Huawei telecom equipment and software that is critical for 5G expansion. This caused disruption in global trade and depressed manufacturing, as surveys showed. A likely important offset to trade tensions is a more robust stimulus response from the Chinese government, which we think is likely.

A reversal of the hiking cycle by the Federal Reserve may relieve some pressure on emerging markets. Most notably, the dollar has recently stopped rising against international currencies. In the short-term, prospects for developed country growth look poor, but we could see a turnaround with the resolution of trade tensions and Brexit. As we've noted, valuation measures suggest that international stocks are simply cheaper, both relative to U.S. stocks and relative to their own long-term history. Consequently, we don't think investors should abandon international stocks despite notable underperformance.

Conclusion

Our view is not much changed from our last letter. Second quarter profitability will be modest, and economic weakness will likely continue. However, these factors are already well anticipated. If the dollar remains rangebound or weakens, it could be a near term impetus for better international market returns. We see the risk of major imbalances and recession as low. This supports a prudently balanced, not defensive portfolio despite a long bull market in stocks and bonds.

Given muted expectations overall, we continue to seek more niche investments within the alternative and fixed income space to enhance both diversification and returns, depending on the specific investments.

Thank you again for trusting Berman Capital to be your investment advisor. We encourage you to contact your Wealth Advisor with any questions or concerns.