MALVERN CAPITAL MANAGEMENT

Second Quarter 2019 Market Review and Outlook

June 2019

The Second Quarter 2019 Review

The equity markets in the 2nd quarter continued where they left off in the 1st quarter of this year by tacking on additional gains. Encouraged by positive economic data, growing corporate earnings and the appearance of a more accommodative Federal Reserve, investors bid up prices of financial assets. U.S. large-cap stocks (as represented by the S&P 500 Index) advanced by 4.3% in the quarter, while U.S. mid-cap stocks rose 4.13% and U.S. small-cap stocks were up a modest 2.1%. Even developed international stocks, which have lagged domestic stocks over the past several years moved forward by 3.68%.

Volatility was high in the quarter due to China trade talks as the President's "Tweets" concerned market participants. We saw a sharp sell-off in the month of May, but those concerns were put to rest in June and as such a strong rebound followed. It appears as if China trade issues are going to be with us for the foreseeable future.

Interest rates also fell in the quarter and as a result bonds were also up. The Bloomberg Barclays U.S. Aggregate Bond Index saw a total return of 3.08% in the quarter. Expectations for fixed income assets had been tempered in recent quarters after a multi-year bull market in bonds seemed to be coming to an end. But instead of ending it has continued for now.

It has been a great year so far for financial assets, especially equities. But where do we go from here? We look at some of the factors that will impact the markets for the 2nd half of this year and beyond.

Index Performance

Category	Representative index	2nd Qtr 2019	Y-T-D 2019	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Company	DJ Industrial Average	3.21	15.40	12.20	16.80	12.29	15.03
Broad US Large Companies	S&P 500 Index	4.30	18.54	10.42	14.19	10.71	14.70
US Small Cap Companies	Russell 2000 Index	2.10	16.98	-3.31	12.30	7.06	13.45
US Mid Cap Companies	Russell Mid Cap Index	4.13	21.35	7.83	12.16	8.63	15.16
Largest 100 NASDAQ Companies	NASDAQ 100 Index	4.25	21.85	10.16	21.56	16.14	19.24
Developed International	MSCI EAFE Index	3.68	14.03	1.08	9.11	2.25	6.90
Emerging Markets	FTSE All Emerging	1.21	11.74	4.02	10.28	2.87	6.00
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	3.08	6.11	7.87	2.31	2.95	3.90
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	2.50	9.94	7.48	7.52	4.70	9.24
Commodities	Bloomberg Commodity	-1.19	5.06	-6.75	-2.18	-9.15	-3.74
Total US Market (all cap stocks)	Russell 3000 Index	4.10	18.71	8.98	14.02	10.19	14.67
Real Estate Investment Trusts	Wilshire US REIT Index	1.63	17.92	10.53	4.11	7.84	15.66
Oil	West Texas Crude Intermediate Oil	-3.31	28.90	-21.49	6.43	-11.31	-1.80
Cash	US T-Bill 90 Day	0.57	1.16	2.26	1.41	0.88	0.48

** 3 year, 5 year and 10 year returns are annualized. All periods ending June 30, 2019.*
All returns include the reinvestment of dividends.

Market Outlook

As we move into the 2nd half of 2019, there are many concerns which could impact the financial markets. Among the most impactful at this time would be tensions with Iran, the China trade issues (or outright trade war) and the inverted yield curve. What the Federal Reserve does or does not do will also have great impact on the markets. What happens or does not happen in Washington cannot be overlooked. Where does the economy stand right now and going forward? Corporate earnings drive stock prices; how do they look right now? We look at each of these issues a little closer as well as the current valuation of the equity markets.

Iran Tensions

The current tensions between Iran and the U.S. go back to at least May 2018 when the United States withdrew from the 2015 international nuclear deal with Iran followed by the reinstitution of sanctions on Iran. More recently however, Iran reportedly downed an American drone which it claimed was flying in its airspace. Iran has also threatened in the recent past to block the Strait of Hormuz which is a major passage way for Middle Eastern oil.

These tensions weigh heavily on oil prices and any possible military conflict can have a lasting negative impact on the global equity markets. No one wants another war in the Middle East. Any conflict in or around the very important Strait of Hormuz could send oil prices climbing and such an increase in oil prices could be devesting to global growth not to mention equity prices.

China Trade War?

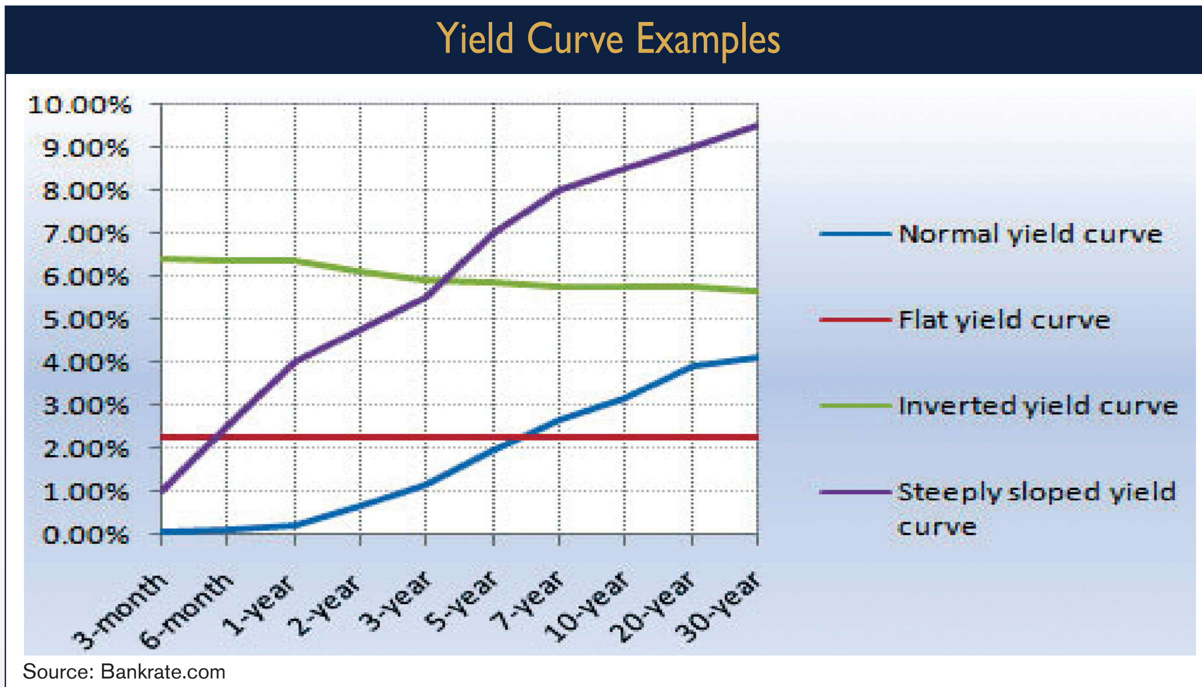
China's economy probably will be hurt more than the United States' from a trade war because about 20% of China's exports are with the United States and we export far less to China than it exports to us. However, China is a dictatorship and in the U.S. the President and Congress have to face elections. For example, in America's Midwest soybeans are grown and exported to China. Tariffs have threatened those farmers' ability to sell their soybeans in China. These farmers voted for Trump largely in his first election and Trump risks losing their support in his re-election bid. Tariffs could decrease sales of goods and services between both China and the United States and less trade between them could adversely affect both countries' gross domestic products (GDPs). Trump touts the strong economy as one of his major accomplishments and any adverse pressure of the United States' GDP could negatively affect the President's re-election prospects.

China holds a lot of U.S. debt and if it were to sell some of this debt in retaliation to tariffs, it could have a volatile impact on interest rates. China also is in the backyard of North Korea and it may stop its involvement in negotiations between the U.S. and North Korea. Although we send about one-fifth the goods and services to China that China sends us, there is much downside to the U.S. from a prolonged trade war. It is likely that the equity markets will be somewhat beholden to every nuanced statement regarding tariffs on China. Markets will continue to sell off on headlines regarding the placing of tariffs and rally on the appearance of a resolution to tariffs.

Inverted Yield Curve

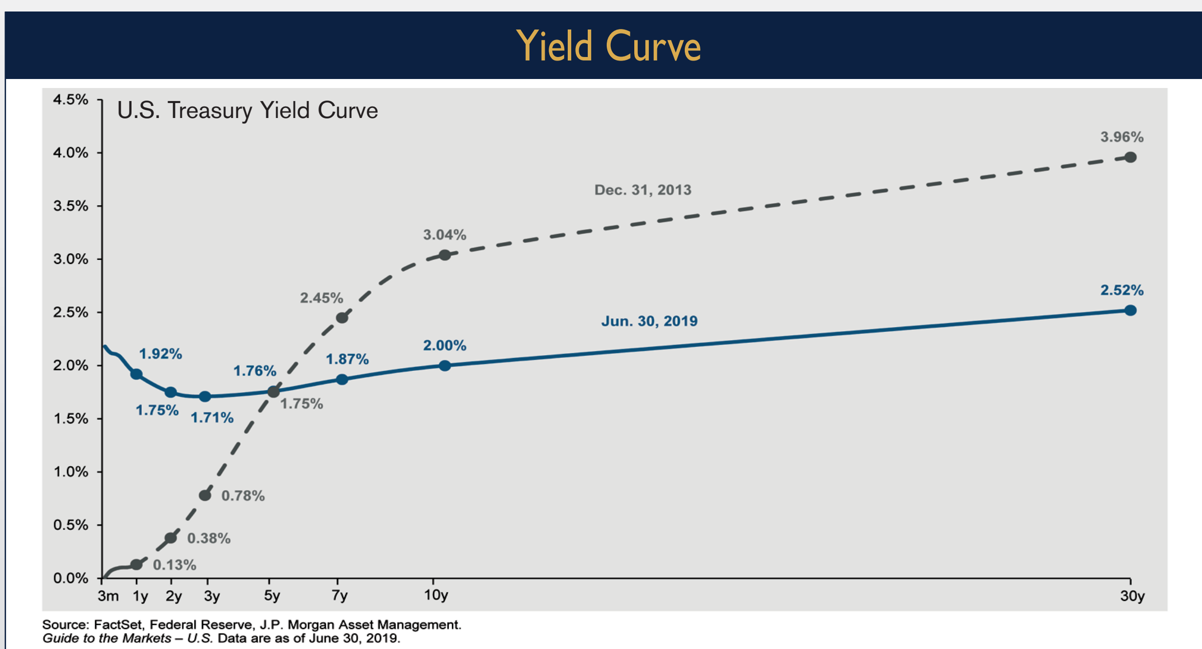
What is the yield curve? Think graphically of a chart where the horizontal line depicts the maturities left to right, shortest to longest maturity. The vertical line charts the interest rates, bottom to top, lowest to highest interest rates. The intersection of the interest rates and the maturities is plotted inside the graph and a line is drawn from left to right.

Usually we see the line lower on the left-hand side representing the shorter maturity bonds and higher as we go longer the maturity. This is referred to as a "normal yield curve." Sometimes shorter-term interest rates are higher than longer term interest rates and the line slopes downward left to right. This is referred to as an "inverted yield curve."



Source: Bankrate.com

At present (June 30, 2019) we can observe an inverted yield curve whereby the Three-month U.S. Treasury bill and one-year U.S. Treasury bill yields are higher than the Two-year U.S. Treasury note, Five-year U.S. Treasury note and Seven-year U.S. Treasury note yields.



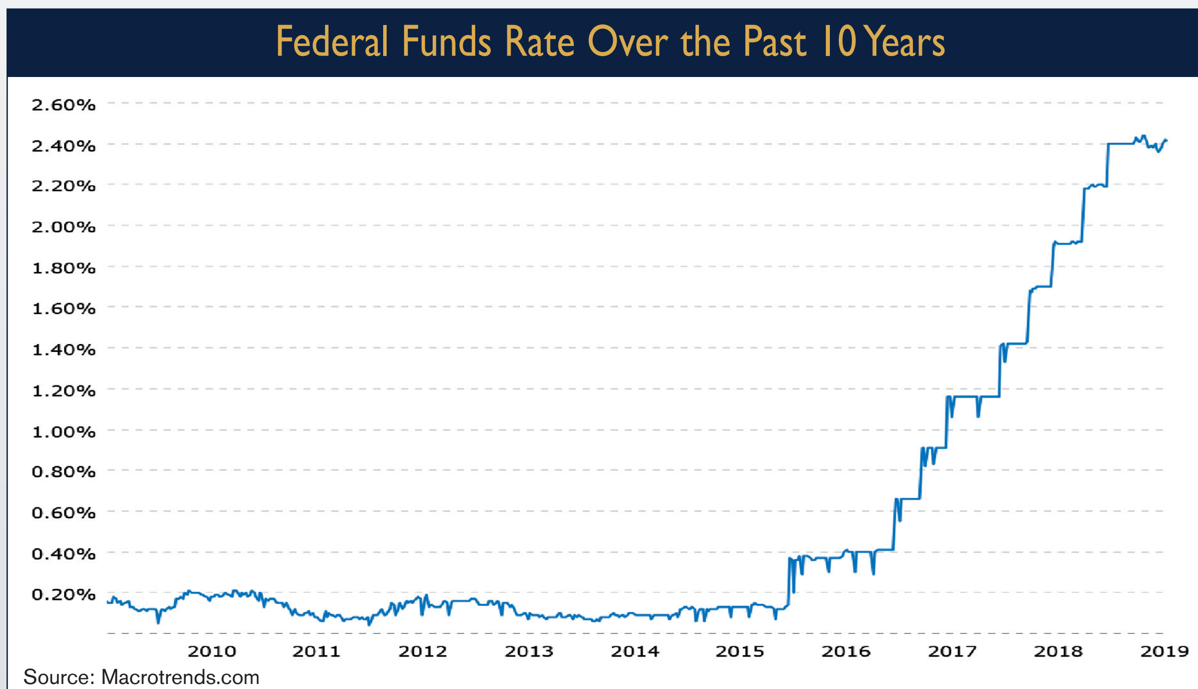
Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of June 30, 2019.

Why is this a problem? Because typically when the yield curve inverts a recession soon follows. It isn't necessarily that the inversion itself causes a recession but that it is signaling that investors feel more uncertainty about the future as they buy the longer-term maturity Treasury bonds, a so-called "flight to quality." When the yield curve inverts, we also tend to see commercial lenders tighten their credit standards as they lend to businesses. This can contribute to a slowing economy as businesses are starved of necessary credit.

Could things be different this time? Perhaps. Typically, when we observe an inverted yield curve, we see the Two-year U.S. Treasury note yield higher than the 10-Year U.S. Treasury note yield. This is not the case so far. The 10-year U.S. Treasury note yield is currently higher than the Two-year U.S. Treasury note yield, although the spread is very narrow. Nonetheless, we are slightly concerned about the inversion we see.

Federal Reserve and Interest Rates

The Federal Reserve began raising interest rates in December 2015 and did so steadily through December 2018 when it paused temporarily. The Fed Funds rate is currently at 2.5%. Despite President Trump's attempts to influence or suggest that the Fed needs to reduce interest rates, the Fed remains independent and unmoved by such outside pressure. Since the Fed's pause in raising interest rates at the end of last year there has been a lot of accommodative commentary coming from the Fed governors including Chairman Powell. The Federal Reserve has a dual mandate of full employment and price stability. It can be argued that the U.S. is at full employment right now given the current historically low unemployment rate while inflation is under the Fed's target rate. The Fed looks at a lot of different data to help determine where employment is going in the near future as well as what may happen to the inflation rate. Its shift to a more accommodative Fed policy may signal that it sees some underlying data that it is interpreting as negative. Many economists and market participants believe that Fed's next move will be a cut in interest rates and such a cut will be positive for equity prices.



Source: Macrotrends.com

It is our view that the Fed will in fact start cutting the Fed Funds rate as soon as its July 2019 meeting. It is also our view that the 10-year U.S. Treasury note yield will rise from its very low current level. The 10-year U.S. Treasury note yield closed the first half of the year (6/30/19) at 2.0%. If, in fact, the short-term Fed Funds rate falls and short-term U.S. Treasury yields subsequently fall, and the 10-year U.S. Treasury note yield rises, we will see a steepening of the yield curve.

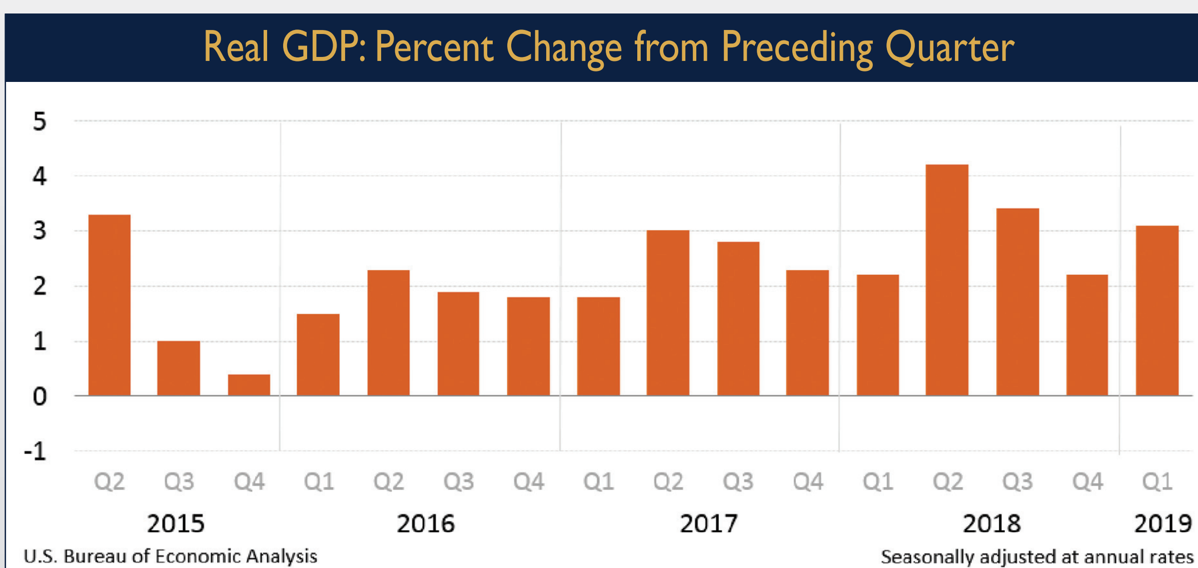
The probable reason for the recent decline in the 10-year U.S. Treasury note yield is because it is seen as among the highest quality investments in the world and we are likely seeing a flight to quality globally. Another reason for its recent yield decline is that market participants may be perceiving the economy as slowing. Although the economic data points have been mixed, overall it is our view that the economy is quite strong.

Washington and Politics

It does not appear that any major legislative initiatives will take place between now and the 2020 elections. The Democrats control the House of Representatives and the leadership appears to not want President Trump to have any victories or accomplishments to run on. Also, many of the Bills that have been passed in the House this year, are stuck in the Republican controlled Senate likely to go nowhere. We do not expect any progress to be made toward advancing healthcare or improving infrastructure in this country. It has looked like some progress could be made toward reducing the costs of prescriptions drugs but that is not likely to occur either. That may be the reality of politics today. It is more likely that the House is going to spend much of its time investigating the President with the Democrats' hopes that it leads to his impeachment. It is our view that the markets would respond very favorably to an infrastructure bill and that it could be impactful on GDP growth, at least in the short run. It just does not appear that it can happen with the current state of government today.

The Economy

The economy in the U.S. is very healthy. The annualized GDP rate for the 1st quarter of 2019 stands at a rate of 3.1%. We are adding new jobs every month and the unemployment rate as of June 2019 is 3.7%.



Personal income grew .5% in both April and May of this year. As of May 2019, the Consumer Price Index (inflation rate) increased by 1.8% for the preceding 12 months which is below the Federal Reserve's target inflation rate of 2%.

A recession is defined as two consecutive quarters of negative GDP growth. Despite the inverted yield curve, there are no other glaring signs of a recession at this time and so we will continue to maintain our cautiously optimistic outlook. However, we can't ignore the fact that the yield curve has inverted and it may be signaling something brewing in the near future.

Corporate Earnings Are Positive and Growing

U.S. corporations are enjoying healthy earnings growth. A combination of strong economic conditions and a lower corporate income tax rate have both contributed to the growth. Also, companies are able to show attractive profit margins on their sales.

S&P 500 companies are projected to earn $154.31 (Source: Standard & Poor's) which is a year-over-year increase of 9.9% (from $140.37 at the end of June 2018). Further, earnings are projected to grow to $173.73 by the end of June 2020. An additional increase of 12.5% year-over-year. Companies have been able to extract a higher earnings growth rate partly from increased profit margins and also from lower income tax rates.

Year-over-year revenue growth 1st quarter 2018 to 1st quarter 2019 is 5.76%. The profit margin on S&P 500 Companies was 11.21% for 1st quarter of 2019 versus 10.10% in the 4th quarter of 2018. The quarterly income tax rate fell to 13.22% in the 4th quarter 2018 from 20.38% in the 4th quarter of 2017.

Also contributing to the strong earnings growth is the reduction of outstanding shares. According to Standard & Poor's there has been at least a 4% tailwind added to the S&P 500 Index companies' earnings through the reduction of outstanding shares.

Lastly, the five-year projected annualized earnings growth rate for the S&P 500 Index is 12.12%. For mid-cap stocks the five-year annualized growth rate is 11.73% while small-cap Stocks it is 12.61%.

Market Valuation and Forecast

Based on the estimate for earnings, is the market expensive right now? In short, not really. The current trailing Price to Earnings (P/E) ratio is 19.06 (June 30, 2019). The 20-year average of quarter-end P/E ratios is 19.08. In that 20-year period we saw a high P/E ratio of 29.5 (December 2001) and a low of 11.95 (September 2011). The 10-year average P/E ratio is 17.90.

The forward P/E ratio (calculating the P/E based on earnings projected 12-months from now) is 16.93. It is our view that the current trailing P/E ratio is a little expensive right now although it is in-line with the 20-year historical average. The S&P 500 Index is certainly not cheap but we would not call it overly expensive either.

If the earnings estimates materialize over the next 12 months as projected, and assuming that the S&P 500 Index can support a P/E ratio of 17.90 (the 10-year average quarter-end P/E ratio) we project a total return (with dividends reinvested) of 7.6% over the next twelve months.

Conclusion

The 1st half of 2019 has been a tremendous quarter for the financial markets. There is much optimism as we move into the 2nd half of the year. An accommodative Federal Reserve, a strong and growing economy, a positive outlook for corporate earnings and a not overly expensive stock market bode well for the remainder of the year. We are in the 10th year of an economic expansion which started following the financial crisis of 2008 with few signs of slowdown or a recession. There are certainly concerns and issues which could derail the markets. Tensions with Iran, a prolonged trade war with China and the implications of an inverted yield curve, could all interrupt further gains and result in a long drawdown of the equity markets. There is little to expect coming out of Washington and that will probably continue at least until the next election.

We expect to see continued gains in the equity markets as well as the bond markets. As such, we are here to listen, counsel and provide direction to all of our clients.

James L. Olsen, CFA, CFP®
President & Chief Investment Officer

Michael P. Czajka
Chief Executive Officer

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