

SECOND QUARTER 2019 REVIEW AND OUTLOOK

EXECUTIVE SUMMARY

Portfolio Themes

- **Quality Tilt:** We prefer equities with stronger balance sheets and consistent margins.
- **Overweight to Information Technology:** The Information Technology sector is heavily skewed toward large, high-quality firms. The sector should benefit from robust global IT spending driven by the growing demand for products and services related to mobile, cloud computing and the “Internet of Things.”
- **Overweight to Energy:** Energy demand remains robust and the sector often outperforms late-cycle, with tailwinds from physical demand via economic growth and financial demand via inflation.

Market Outlook

- **Expect the Bull Market to Continue:** We expect the market to keep climbing, though the pace likely slows in the year’s second half.
- **Strong Economic Drivers:** In both developed and emerging markets, economic drivers remain strong. We believe these fundamentals will come to the forefront as sentiment improves.
- **Global Political Gridlock:** In much of the developed world political gridlock persists decreasing the likelihood that sweeping legislation, potentially hurting equities, passes. This gridlock tempers current political volatility.

Global equities added another 3.6% in Q2, capping the strongest first-half since the late 1980s.ⁱ As we anticipated, Q2 brought more volatility than Q1, but robust returns in June carried equities to all-time highs, with the MSCI All Country World index returning 16.2% year to date.ⁱⁱ Now that the sharp, V-shaped rebound is behind us, it would be unrealistic to expect this pace to continue. US equities also tend to slow somewhat in the back-half of a president’s third year. That being said, we still see plenty of room for the bull market to continue.

Emerging Markets (EM) equities are nicely positive for the year, up 10.6% through the end of June.ⁱⁱⁱ EM should continue to do well from here as fundamental health in EM economies surprises skeptical investors—a positive for equities.

Markets are behaving largely as we would expect during a later-stage bull market. Larger and higher-quality equities are outperforming as investors reward fast-growing companies with healthy gross margins. Market breadth—the percentage of companies outperforming the index—is narrowing, which is normal in the later stages of a market cycle.

Many see the United States’ rising trade tensions with China and Mexico as driving volatility and souring sentiment. After US and Chinese negotiators seemingly made progress toward a deal earlier in the year, negotiations stalled during the quarter and the US announced a new round of tariffs. However, at the conclusion of the late June G-20 summit, US President Trump and Chinese President Xi Jinping announced a pause on further tariffs. President Trump also reversed course from May and stated his administration will allow US firms to sell products such as semiconductors to Chinese telecom giant Huawei. Regardless, we continue to believe US tariffs’ impact on China’s economy is far smaller than many fear. Meanwhile, Mexico ratified the USMCA—NAFTA’s replacement. Congressional approval from the US and Canada is still pending, and neither country has a clear ratification timeline. However, we largely see this as a non-factor, given the revised agreement doesn’t materially change NAFTA-established terms of trade.

ⁱ Source: FactSet, as of 06/30/2019. MSCI All Country World Index return with net dividends, 03/31/2019 – 06/30/2019.

ⁱⁱ Source: FactSet, as of 06/30/2019. MSCI All Country World Index return with net dividends, 12/31/2018 – 06/28/2019.

ⁱⁱⁱ Source: FactSet, as of 06/28/2019. MSCI Emerging Markets Index return with net dividends, 12/31/2018 – 06/30/2019.

The economic backdrop looks favorable for equities. Low interest rates, low inflation and moderate economic growth collide, resulting in an ongoing global economic expansion that is neither too hot nor too cold. Many pundits see this incorrectly, predicting the current cycle is coming to an end based on the bull market's age and the recent global growth slowdown. Economic ebbs and flows are normal. Fear of heights—prevalent today—is just another brick in the bull market's proverbial wall of worry.

Politics took center stage in Q2 with June's Democratic debates in the US. We think it is too early to parse next year's election. With 25 Democrats vying to challenge President Trump, there is still far too much uncertainty. The time to focus on the election will come, but only once the nominees are apparent. In the meantime, while we remain in the presidential cycle's best year, we are also at the point where gains typically slow, partly due to campaign chatter's drag on sentiment.

Yet European political tailwinds are powering up. We just entered the aftermath of May's European Parliamentary election, usually a sweet spot as falling uncertainty boosts Continental European equities. Further, in Spain, the center-left Socialists, led by former Prime Minister Pedro Sánchez, won the lower house with the best showing for a single party. However, the election still left them far from a majority. Both elections further entrench gridlock across the continent, as multiparty governments will be required to lead. This should prevent sweeping legislation from passing—another plus for equities, which dislike the associated uncertainty. Meanwhile in the UK, Prime Minister Theresa May announced she will resign as Conservative Party leader.

In EM politics, Indonesian voters elected President Joko Widodo, who ran on a market-friendly platform, to a second five-year term in April. Reform hopes tied to his election likely support Indonesian equities in the near term. In Turkey, opposition candidate Ekrem Imamoglu emerged victorious in a redo of Istanbul's mayoral election, ordered by President Recep Tayyip Erdoğan's government after his party's candidate lost the first vote. While it is possible that consecutive defeats in the country's commercial capital will cause him to moderate his more authoritarian impulses, the possibility of moderation doesn't outweigh the negative of his persistent economic meddling.

One distinct characteristic of this long, grinding bull market is its seemingly endless wall of worry. Headlines today discuss oil, Iran, tariffs, Brexit, the inverted US yield curve, a seemingly weak global economy and more. In our view, all are either too old, small or misunderstood to derail the bull. Some are a combination of the three. Given significant advances in energy efficiency compared to the 1970s, oil markets are well supplied—coupled with moderate demand growth, oil is unlikely to be a major factor either way. Tariffs are too small to have a meaningful impact, even with the latest threats, altogether totaling just 0.3% of global GDP.^{iv} Brexit stokes uncertainty but seems likely to end soon, and sentiment is too dour in our view, giving way for potential upside. As for the US yield curve, the time to worry is when people lose interest and the global yield curve inverts. Lastly, slower growth isn't a self-fulfilling prophecy, and equities don't rely on rapid GDP growth. While we continuously monitor for signs of a bear market developing, there is little pointing to that happening now.

^{iv} Source: FactSet, US Trade Representative, Bloomberg and US Census Bureau, as of 06/27/2019. Includes threatened US tariffs on global autos and \$300 billion in Chinese goods.

Should you have any questions about any of the information in the Second Quarter 2019 Review and Outlook, please contact us at (800) 851-8845 or FisherInstitutional@fi.com.

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