RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

SECOND QUARTER 2019 MARKET COMMENTARY
July 2019

STATE OF THE MARKETS

A possibility that we foreshadowed in last quarter's market commentary, equity markets corrected in the mid-second quarter due to a collapse in trade talks between the U.S. and China. However, optimism for high level talks between the two nations at the G-20 conference in late June led stocks back near record highs as the quarter ended. Further, dovish commentary from the Federal Reserve signaling that an interest rate cut or two could occur in 2019 supported the market's rebound. The S&P 500 closed the quarter up 3.8%, near record highs, and up 17% for year-to-date 2019, the best first half performance in 22 years.

Our base case assumption remains that the U.S. and China will agree to a comprehensive trade agreement this year that will relieve short-term economic uncertainty and calm markets. The longer the negotiations drag on, the higher the likelihood that the Fed may react to this extended economic uncertainty with a rate cut. Many Fed observers predict this could occur as early as the July Fed meeting. A rate cut at this time would represent a fairly abrupt about-face for the Fed after it committed to gradually higher interest rates as recently as 6 months ago. The Fed is clearly feeling pressure from the trade uncertainty, economic weakness and accommodative central banks in Europe, as well as pressure from the Trump administration to lower rates. As a result, the perceived willingness of the Fed to backstop the economy with rate cuts in the event of a further prolonging of the trade war helped to settle markets in the second quarter.

Looking ahead to the third quarter, we expect the following factors to influence market returns, in order of near-term importance: 1) progress in trade negotiations, 2) Fed rate policy, 3) sanctions and a potential conflict with Iran, 4) U.S. and global economic data, and 5) U.S. presidential campaigning/ D.C. political drama.

Review of the Second Quarter

Interplay Between Trade and Interest Rates Dictated Market Return

Equities in the second quarter were whipsawed by the negative pull of ongoing U.S.-China trade drama and the positive push of the Fed's seeming willingness to cut interest rates in 2019. In May, President Trump announced an increase of tariffs to 25% on $200 billion in Chinese goods while also threatening to institute 25% tariffs on the remaining $300 billion + of imported Chinese goods. In response, equities corrected nearly 10%. This is because, by some estimates, these additional threatened tariffs could reduce U.S. GDP by 0.4% if they are enacted.

As time passes, the economic harm and uncertainty of the trade wars has worsened. Recent surveys of U.S. purchasing managers have been the weakest in years. Importers that must pay tariffs on foreign good suffer the most from higher tariffs, however eventually these costs are passed onto consumers, which then impacts the overall economy. On average, U.S. consumers could face higher costs of $800+ per year due to the higher prices of goods from tariffs. Equity markets have reacted to these real costs of the trade war as well as the geopolitical uncertainty created by it. This is apparent from large

market swings in response to any hint of progress or delay in negotiations. Despite these trade headwinds, the U.S. economy appears on its surface to be on relatively sound footing with inflation moderate, unemployment low and GDP projected to achieve 2%+ growth in 2019. However, a deeper dive reflects some cracks in the foundation with business investment and confidence data reflecting some trade-related weakness. We expect the outlook to weaken further if the trade war deepens.

Markets, however, have been resilient. Clearly, investors expect a resolution at some point. Our expectation is that a trade deal will come to fruition, likely this year, as President Trump will want to tout the deal as a win for the U.S. during the next presidential campaign. However, there is no predicting just how long it will take and market will gyrate based on real time progress or setbacks. Therefore, the Fed's willingness to cut rates has importantly provided markets with a floor against trade uncertainty in the sense that the Fed is willing to act to support the economy in the near-term.

However, we think the market is likely over-estimating the extent of any future Fed rate cuts, as the economy is fairly healthy outside of the negative impact of tariffs and trade uncertainty. The Fed is an independent body that is tasked with managing interest rates based on hard economic data, namely employment and inflation data, not geopolitics. Further arguing against a rate cut in the near term is that rates are still historically low in the U.S. and the Fed currently has little ability to lower rates in a future recession. Due to this historic context, the Fed is surely wary of lowering rates prematurely and reducing its own ammunition if a deep crisis ensues. Nevertheless, the longer the trade uncertainty persists, the more it will impact fundamental economic conditions through higher prices for consumers and lower business investment, and at some point the Fed's hand may be forced to take stronger action.

Outlook for the Third Quarter

We think the market is set up for a positive third quarter, absent unpredictable geopolitical developments among U.S., China, and/or Iran. As discussed above, it is in the best interests of both sides to resolve the U.S. – China trade dispute. If the dispute lingers, it appears the Fed is willing to step in to support the U.S. economy with lower interest rates. Therefore, in the short-term, the equities markets could grind higher either way. Long term, the picture is far cloudier without a resolution of the trade dispute.

Politically, news headlines will begin to focus more and more on the 2020 presidential campaign. Much remains to be seen as to the economic ramifications of the presidential race depending on the agenda of the likely Democratic nominee. We are still likely 2-3 quarters away from the race influencing market returns, however we intend to keep a close eye on any potential impact for investors.

As at all times, but in particular in the late stages of a bull market, we recommend a periodic review of financial and retirement planning for all clients, especially retirees and pre-retirees. Given the recent and likely future fluctuations in interest rate policy and potential tax changes that could impact investors from a new presidential administration, the need for a thoughtful review is amplified. We do not foresee an imminent end to the historic bull market given current economic conditions and the relatively low cumulative economic growth for much of the past 10-year recovery, however it is always prudent to prepare for any eventuality.

With respect to stock sectors that currently look attractive, we have identified opportunities within energy, industrials, and multinational consumer businesses that have been impacted by the trade

war, which we expect to recover as the situation improves. Financials have been relatively solid in 2019, yet will benefit if rates rebound higher. Fixed income alternatives such as preferred stocks, REITs and the like have performed well as rates have declined and remain a staple of our client portfolios for those more conservative investors in or near retirement.

As always, all comments are welcome and appreciated.