2019
Q2 Market Review

Trade Winds

SHEPHERD
FINANCIAL PARTNERS

Trade Winds

July, 2019

Q2 2019 Market Review

By Brian Davies, CFA | Director of Investment Management & Sam Shepherd | Portfolio Analyst

- The U.S. economy peaked in Q1 and is decelerating with uncertainty around ever-changing global trade winds.
- Despite uncertainty, risk assets were solid. Just like in Q1, U.S. equities continue to perform well. This is due to the expectation of loose monetary policy.
- Bonds saw a historic rally as rates fell rapidly during the quarter. Investors expect the Fed to cut rates soon.
- We will discuss how we are positioned as we head into the 3rd quarter and consider catalysts for market moves ahead.

Trade winds in the Caribbean are usually a welcomed occurrence, as they cool off beachgoers. In the global economy, the trade winds have been shifting dramatically and causing a great deal of angst. The current administration in the U.S. is taking a much harder stance on trade than most predecessors. China is bearing the brunt of this as the U.S. has a sizeable trade imbalance with the second biggest economy in the world. The sentiment around trade swung widely during the quarter and risk assets behaved accordingly. The S&P 500 was up over 4.0% in April, down over 6.0% in May, and then up 7.0% in June, as investors reacted to the news flow. We ended the quarter on positive footing as the parties involved came to a truce on future tariffs and are maintaining a dialogue to move forward on a long-term deal. We will use the rest of this market review to further discuss the impact of trade winds on all aspects of the economy and capital markets, and lay out our current positioning in light of recent developments.

Economic Review

Q2 2019 By the Numbers[1]	Q2 2019	Q1 2019
GDP	1.60%	3.10%
Inflation (CPI)	2.10%	1.90%
S&P 500	4.23%	13.50%
Bloomberg Barclays Agg Index	2.81%	2.90%
Bloomberg Commodity Index	-1.77%	5.70%

After the surprisingly strong Q1'19 GDP growth of over 3.0%[2] , we are seeing the U.S. economy slowing with estimates now looking for growth around 1.6%[3] for Q2. As mentioned above, this is driven somewhat by the uncertainty around trade and tariffs. Amidst the uncertainty, companies have paused across the globe and the U.S. is not immune to this. We have seen a decline in the growth rate of activity in factors like manufacturing and services. Project Management Institution (PMI), a survey measuring manufacturing activity, has slowed from its robust growth last year. The indicator is still showing an expanding economy, but much less than we have seen in prior quarters. Services activity has also slowed a bit recently but, still remains at levels that show a healthy economic expansion.

Global economic activity has been more impacted by the trade uncertainty. Foreign countries tend to be more sensitive to trade than the U.S. The International Monetary Fund (IMF) now estimates global growth for 2019 to be 3.3%. This is down from estimates earlier this year of 3.5% and has been adjusted downward a few times this year. The uncertainty surrounding trade was a major factor in this downgrade. China's growth for '19 is now estimated to be 6.3%[4] . This would be much lower in the north of 7.0%[5] growth they have averaged over the last three years.

The uncertainty around trade is clearly impactful and central banks around the world are taking notice. Coming into the year, only 40% of the world's central banks had rate cuts as their most recent rate change. As of this writing, that number is close to 56% and increasing. Central banks are aggressively shifting gears to address the concerns around slowing global growth. Normally, this is positive for risk assets but, in the near-term we have to gauge whether the central banks are ahead or behind in the game.

[1,2,3]Source: FACTSET
[4]Source: IMF.org
[5]Source: IMF.org

One thing that allows for the U.S. Federal Reserve bank (The Fed) to shift gears is the lack of inflation. Inflation has been subdued for some time and there does not seem to be any near-term catalyst to propel core prices much beyond where they are today. The inability of inflation to move and stay above 2.0% is giving the Fed the chance to introduce looser policy to offset the uncertainty around trade. Wage growth has been growing: however, during the quarter this stalled out a bit. At this point in the cycle we would expect to see an increase in wage growth (3.4% today vs. 2.5% a year ago[6]) and we continue to believe this is positive for consumer spending. Past cycles have seen wage growth peak out at over 4.0%[7] growth. This indicates that we have room to run if past cycles are any indication.

Equity Markets

U.S. Sector Returns[8]	Q2 2019	Q1 2019
Financials	7.9	8.5
Materials	6.0	10.3
Information Technology	5.8	19.8
Consumer Discretionary	5.1	15.4
Consumer Staples	4.3	11.1
Telecommunication Services	4.0	13.0
Industrials	3.6	17.2
Utilities	3.3	10.7
Health Care	1.4	6.5
Real Estate	1.1	17.0
Energy	-2.8	16.2

The U.S. equity markets continued their strong performance with the S&P 500 up over 4.0% in Q2 and up over 18%[9] year-to-date. During the quarter, stocks were led by the financials, materials, and technology sectors. While a sharp drop in interest rates hurt companies like regional banks, large financial companies with diverse revenue streams rallied. The materials sector had another strong quarter, showing a mean reversion with the group down almost 15%[10] in 2018. Technology

[6,8,9,10,11]Source: FACTSET
[7]Source: Ned Davis Research

continues to be the winner this year, appreciating over 25%[11] year-to-date and up 5.8% in Q2. In a slower growth environment, investors are putting a premium on growth names in the technology space.

Energy, real estate and health care sectors pulled up the rear in the quarter. After a strong Q1, the Energy sector was the only one to see negative returns in Q2. The price of oil peaked in mid-April. It had a quick 23%[12] drop over the next eight weeks because over-supply fears and weak global growth concerns weighed on the commodity. Oil did rally a bit into the end of the quarter but, was still slightly negative for the quarter.

The real estate sector lagged a bit in Q2 after a strong start to the year in Q1, although the group still produced a positive return of just over 1.0%. The sector might have been little ahead of itself coming into the quarter. The sector is used as a bond proxy and with the dovish shift in Fed policy happening, investors bid the sector up aggressively. Over the past year, defensive and income minded investors have flocked to the real estate sector. This made it one of the best performing sectors in the equity markets. Unfortunately, this momentum has also pushed valuations in the group up to all-time high valuations. It is tough to find quality and risk-adjusted opportunities at these levels.

The health care sector also lagged in the quarter. It has been the worst performing sector so far this year. The political winds have not been in their favor and as such the group has underperformed the broader market. While we cannot be certain the political winds will change anytime soon, there are opportunities starting to appear in the sector. Valuations are not nearly as stretched as other sectors and risk seems like it might be starting to be priced more appropriately.

Equity valuations increased in the quarter with the market moving higher and consensus earnings estimates staying flat. We came into the year expecting about 5% growth in earnings for 2019. The consensus numbers are now at or slightly below that growth target. The forward price to earnings ratio (PE) is just over 17.0x[13] as of the quarter-end. While that number is higher than long-term averages, it is not excessively high in our view.

[12]Source: FACTSET

Emerging and Developed International Markets

Country - Index (USD)[14]	Q2 2019	Q1 2019
Brazil - Bovespa	8.0	7.3
Germany - DAX	6.9	6.2
Europe - Stoxx 50	6.9	10.2
France - CAC 40	6.5	11.1
Europe - Stoxx 600	5.1	10.1
America - S&P 500	4.2	13.5
India - Sensex	1.0	5.7
Emerging Markets - MSCI EM	0.7	9.9
Japan - Nikkei 225	0.6	8.0
Hong Kong - Hang Seng	0.5	16.1
UK - FTSE 100	0.4	12.5
China - Shanghai	-4.2	18.6

Emerging markets (EM), while positive, lagged most equity benchmarks during Q2. With China representing a large percentage of EM's holdings; trade tensions represented a strong headwind for the group. Emerging market equities have underperformed the S&P 500 by almost 800 basis points[15] (bps) this year. This comes after the group underperformed U.S. equities in 2018 by almost 1,100 bps[16]. China was one of the few negative return stories in Q2. Hong Kong is closely correlated with China, and the recent political unrest in Hong Kong has not helped equity markets there.

In developed international equity markets, Europe was a standout in the quarter with some value buyers stepping into Germany and France. The UK was the worst performer as it barely broke even. With Brexit and other political shifts happening, investors seem to be taking a cautious approach on UK equites. Japan also lagged as the structural low growth story is normally seen as a risk-off play.

While emerging equity markets and developed international equity markets continue to lag the U.S., the valuation story is very compelling. International stocks' forward PE's are, on average, below 13.0x[17]. This is a big disconnect compared to their historical valuation difference vs. U.S. stocks. This continues to represent an opportunity for long-term orientated investors like us. While we are still below our global benchmarks from an allocation standpoint, the valuation dislocation is starting to get too wide to ignore.

[13,17]Source: Ned Davis Research
[14,15,16] Source: FACTSET

Fixed Income Markets

Bond Index Returns [18]	Q2 2019	Q1 2019
20+ Year Treasury Bonds	5.7	4.5
Investment Grade Corporates	5.4	6.2
Emerging Market Corporate Bonds	3.2	5.8
Core U.S. Aggregate Bonds	2.8	2.9
U.S. Preferred Stocks	2.2	7.8
High Yield Corporate Bonds	2.1	7.6
Mortgage Backed Securities	1.9	2.2
Senior Floating Rate Loans	1.8	4.0
Convertible Securities	1.7	12.0
1-3 Year Treasury Bonds	1.4	1.0

The second quarter in the fixed income market was all about duration and credit. The expectations for a Fed rate cut rose throughout the quarter and as a result long-duration bonds performed very well. The dovish shift that started in the 1st quarter continued and gathered steam with a rapid acceleration in the months of May and June. Long rates dropped 50 basis points[19] (bps) during the last two months of the quarter. The 10-yr treasury bill started May at 2.50% and ended June at 2.0%. In a short period of time, the market swung from anticipating no rate cuts at the end of FY 19 to pricing in 50bps[20] of cuts this summer, and maybe more by year-end. We think the market is ahead of itself in expecting that amount of cutting by the Fed. However, we expect the Fed will cut at least 25bps in July.

With long-bonds (20+ year Treasury Bonds) up 5.7% in Q2, that brings their 6-month performance to +10%[21]. That means stocks and bonds were both up over 10% in the first 6-months of the year. Ned Davis Research notes this is a very rare occurrence for a six-month period. According to their data, since 1945 this has only happened ten times prior to this year. While this is in no way a prediction, their data states that in those past ten times, equity markets were positive over the next twelve months 100% of the time. Bond markets were positive over the next twelve months 60% of the time. Again, not a prediction but, some interesting data points none the less.

Credit markets performed very well with both investment grade and high yield bonds off to a solid start in 2019. Spreads are very tight as we enter Q3 and thus

[18,21] Source: FACTSET
[19]Source: Y-Charts
[20]Source: CME Group.com

pricing is not very attractive for putting new money to work in high yield credit. Given these historically tight spreads, we have chosen to minimize the exposure in balanced accounts. Instead, we favor equities over fixed income sectors that are highly correlated to equities. During the quarter, this was a mixed bag as investment grade outperformed equities but, high yield lagged equities by over 200 bps. As we have written in past reviews, we believe the credit markets could represent the one area of frothiness in the capital markets. Non-financial corporate debt levels are hitting record highs. Underwriting, while nowhere near as bad as the past cycle, has seen some deterioration. With spreads tight and underwriting questionable, we still believe minimizing exposure to these areas is prudent.

Summary: Positioning heading into Q3'19

In summary, we continue to favor an overweight position in equities versus fixed income and domestic equities versus international. While we are still overweight equities in our total allocation, we have taken steps to reduce risk exposure as we have moved through 2019. We have done this by taking advantage of strong equity market returns to reduce the equity allocation. Recently, we took advantage of a strong year-to-date move in the technology sector, reduced our position in tech, and initiated a new position in preferred equity securities in balanced portfolios. We felt taking some risk off the table was prudent at this time. We favor the yield and credit profile of preferred securities which typically yields 5.5% to 6.0% today. This compares favorably with high yield bonds but, with less credit risk in our estimation. Preferreds are mostly issued by financial institutions. We believe that the credit profile of that group is dramatically better than at any point in recent history, due to government regulation. Preferred securities tend to have less downside participation with equities than other asset classes. While stock market volatility has been low recently, we do not expect that to be the case forever. When equity volatility does reappear, preferred securities could help dampen swings while providing an attractive level of income.

Duration of our bond portfolios remain about 85% of the Bloomberg Barclays Aggregate Bond Index. At this time, we do not feel the need to chase the bond market and add duration. We would like to be more selective adding duration, as most of the bond market is not providing income at these rate levels. Investors are viewing bonds as insurance against equity volatility. As stated earlier, we have constructed balanced portfolios to minimize equity correlated fixed income, like high yield or floating rate. Even our investment grade credit exposure is below benchmark. We would add more insurance if the price of the insurance was attractive.

As always, we make investment decisions based on our analysis of risk adjusted returns. As markets change and opportunities present themselves, we study the risk dynamics and determine if it is prudent to add to client portfolios. The winds have shifted a lot over the past year and to date we have adjusted well to them. We will continue to navigate the winds with the hopes of earning risk adjusted returns that allow our clients to stay on course and achieve their long-term financial plan.

We will be reaching out to you soon and look forward to our discussion on your long-term investment goals and any concerns you may have about the markets.

Shepherd Financial Partners
1004 Main Street, Winchester, MA 01890
Tel 781.756.1804 Fax 781.729.4356
ShepherdFinancialPartners.com

Disclosures

* Forward Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12-months
** A basis point is commonly used to express differences in expenses or interest rates. 1bp=0.01%

Bond Indexes Definitions:
iShares 20+ Year Treasury Bond ETF – invest in 20+year U.S Treasury Bonds
iShares iBoxx Investment Grade Corporates Corporate Bond ETF – Invests in U.S Investment Grade Corporate Bonds that have ratings between AAA to BBB.
iShares iBoxx EM Corporate Bonds Corporate Bond ETF – Invests in Emerging Market Corporate Bonds
iShares Core U.S Aggregate Bond ETF - The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. invest¬ment-grade fixed-rate bond market, including both government and corporate bonds.
iShares U.S. Preferred Stock ETF – Invests in U.S. Preferred equity securities
iShares iBoxx High Yield Corporate Bond ETF – Invests in U.S. Corporate Credits that are non- investment grade meaning they are rated BB or worse.
iShares Mortgage Bond Security ETF – Invests in U.S. Mortgage backed securities.
SPDR Blackstone/GSO Senior Loan ETF – Invests in bank loans that are tradeable.
SPDR Bloomberg Barclays Convertible Securities – Invests in U.S Convertible Securities. These are fixed income instruments that have an option to convert into equity (shares) of a company.
iShares 1-3-year Treasury Bond ETF – invests in 1-3 years U.S. treasury bonds.

Bloomberg Barclays U.S. aggregate bond: The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. invest¬ment-grade fixed-rate bond market, including both government and corporate bonds.
S&P 500: The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Commodity Index (BCOM) is a broadly diversified commodity price index.

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommen¬dations for any individual. Economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly.

Stock investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.
Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. It is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Floating-rate loans are often lower-quality debt securities and may involve greater risk of price changes and greater risk of default on interest and principal payments. The market for floating-rate loans is largely unregulated and these assets usually do not trade on an organized exchange. As a result, floating-rate loans can be relatively illiquid and hard to value.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

Investment advice offered through Shepherd Financial Partners, LLC, a registered investment advisor. Registration as an investment advisor does not imply any level of skill or training.
Securities offered through LPL Financial, member FINRA/SIPC. Shepherd Financial Partners and LPL Financial are separate entities.
Additional information, including management fees and expenses, is provided on Shepherd Financial Partners, LLC's Form ADV Part 2, which is available by request.