ICR® 2nd Quarter Newsletter – July 2019

Equity markets continued to rise in the second quarter, though it was a bumpier road than in the first quarter. The S&P 500 gained 3.8%, but saw an almost 7% decline in May, before bouncing back strongly in June. Financials (+8.0%) was the leading sector while energy (-2.8%) was the only sector that posted a negative return. Growth stocks once again outpaced value stocks – a trend that has persisted for some time now.

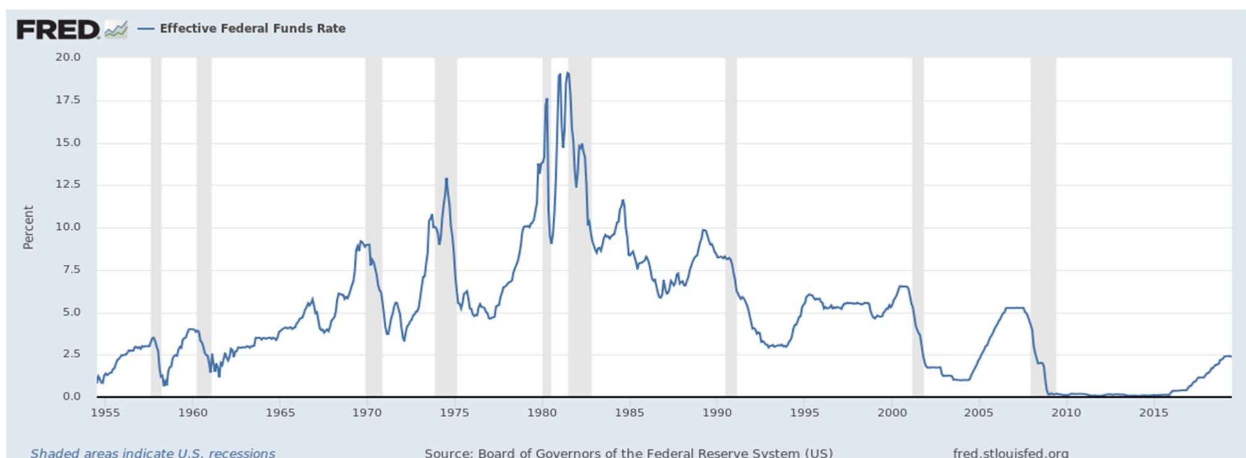
Global markets mostly saw gains during the quarter as the MSCI EAFE index for developed foreign markets rose 2.5%, though the emerging markets index posted a small loss of 0.3%. Trade tensions between the U.S. and China along with continued uncertainties around trade with Mexico and Canada kept investors on edge.

Bond yields continued their descent in the second quarter, with the 10-year Treasury yield falling 40 basis points from 2.41% to 2.01%. In our last newsletter, we mentioned that, since 1960, whenever the five-year Treasury yield remained lower than the three-month yield for at least a full quarter, a recession has followed within the next 12-18 months. Indeed, that inversion has now persisted for over four months and extends even farther out the yield curve. Since May 23, the yield curve has been inverted out to ten years. In fact, even the 20-year yield briefly dipped below the three-month yield. Time will tell if an inverted yield curve will once again be the predictor of a recession. Given its track record, it cannot be ignored.

In December of 2015, then-Fed chairperson Janet Yellen said, "I think it's a myth that expansions die of old age. So, the fact that this has been quite a long expansion doesn't lead me to believe that … its days are numbered." That same expansion is still going today – at least, as far as we know. It is now entering its eleventh year, which is the longest economic expansion in U.S. history. While it certainly "feels" as though we may be overdue for a recession, Australia probably proves Yellen's statement as they are now in their 28th year without a recession.

So, what does cause the end of economic expansions? Generally, it is some type of economic shock. Since World War II, there have been three different types of shocks: monetary tightening in response to inflation that has gotten out of control (e.g. the early 1980s), a financial crisis resulting from an asset and credit bubble (e.g. 2007-09), or an external shock – like a spike in energy prices (e.g. 1973-75). Let's look at each of these causes to see how exposed our current expansion is to them.

First, the Federal Reserve has been gradually raising the Fed Funds rate over the past three years in order to get to a more "normal" level, as opposed to the 0-0.25% range where we were, due to the financial crisis. As seen in the chart below, a number of recessions (the shaded bars) have been preceded by a rate-raising campaign. The Fed is surely aware of this and it is one of the reasons they are now likely to reverse course and begin cutting rates, starting with their July 30-31 meeting.



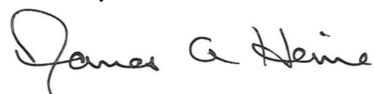
The second potential risk to this expansion is a financial crisis, which is a difficult event to predict. While there are certain assets that have displayed bubble-like characteristics (some tech stocks and Bitcoin come to mind), we doubt that a sell-off of these richly valued assets would precipitate a full blown financial crisis in the same way the bursting of the real estate bubble did in 2007. As we mentioned in our 2018 3rd quarter newsletter, we have some concerns about the corporate debt market. We fear that too many companies have overextended balance sheets and may have trouble meeting their debt obligations in a slowdown or a higher rate environment. Of course, the decrease in interest rates this year alleviates some of those concerns as companies with floating rate loans or the need to roll over debt have seen their debt-service costs decrease.

Finally, exogenous forces that create dislocations in the economy are always a possibility. The 1973 OPEC oil embargo that saw the price of oil quadruple was one of the major factors in the 1973-75 recession. And, today, we are seeing political tensions with Iran stemming from America's withdrawal from a 2015 nuclear deal. Should this situation intensify, a shock to oil prices might not be far behind. But, the more challenging threat might still be the ongoing trade and technology tensions with China along with continued uncertainty around other trade agreements – including between the United Kingdom and the European Union and the free trade area encompassing Canada, Mexico, and the U.S. It's not difficult to see how increased trade tensions – or simply the continuation of the current ones – could further erode business confidence and significantly hamper global growth, potentially leading to a global recession.

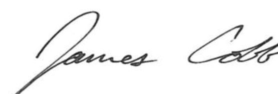
We hope this doesn't sound like doom-and-gloom. We're not predicting a recession and/or a market crash. Actually, we take heart in the fact that what we see as the greatest threats are things within the control of policymakers, and we are hopeful they will do their jobs. However, we remain committed to doing our job, which includes always asking ourselves what could go wrong. We then make what we believe to be the appropriate adjustments to your portfolio. Our goal is to help you participate in the economic march of mankind while avoiding – as much as possible – the potholes along the way.

As always, we truly appreciate the relationship we have with every one of our clients. Please don't hesitate to reach out to us for any reason at all. The best part of our job and what keeps us motivated is our clients, so let us know what's on your mind and if there is anything else we can be doing for you.

Sincerely,



James A. Heine



James L. Cobb

Market Report (as of 6/30/19)

Index	**2019 YTD (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	17.36	11.91	8.46
Dow Jones Industrial Average	14.03	14.05	9.59
U.S. Aggregate Bond Index	6.11	2.32	2.95
MSCI EAFE (Foreign Index)	11.77	6.12	-0.51

Disclaimer: The views expressed herein are those of ICR as of July 15, 2019 and are subject to change at any time based on market and other conditions. This is not a recommendation or solicitation for the purchase or sale of any security and should not be construed as such.