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Second Quarter Investment Commentary
July 2019

"History never repeats itself. Man always does." – Voltaire

The Quarter

- S&P 500 Index +3.8% following a 13.1% gain in 1Q19.

- Cyclical sectors (stocks that follow the cycles of the economy) of the S&P 500 are down 14% from their prior peak, while the defensive space has risen 2% since that time. In the past year, Utilities have soared 17.6% and Consumer Staples are up 13.5%. Defensive sectors (those that tend to maintain more price stability in a down market) do well in recessions.

- Trade tensions increase with China as U.S. increases tariffs on $200 billion worth of Chinese goods from 10% to 25%, bans Huawei Technologies Co. Ltd. from purchasing from U.S. companies, and threatened tariffs on $325 billion more. China increased tariffs on $600 billion worth of American goods.

- Tensions increased between the U.S. and Iran as Iran downed an unmanned U.S. drone, and the White House and Pentagon considered military strikes.

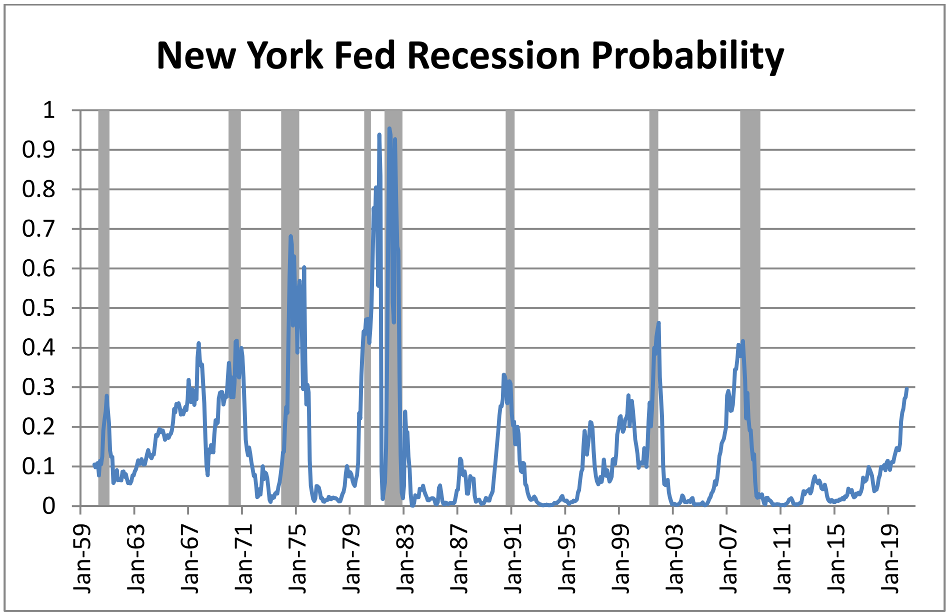
- Political upheaval in UK as talks between Britain's Conservative government and the opposition Labour Party over Brexit break down, and Prime Minister Theresa May steps down as Conservative Party leader. Brexit uncertainty continues.

Economic and Market Review and Update

Increased trade tensions and slowing global economic growth have increased concerns about the possibility of recession in major economies, and increased expectations for Central Bankers to ease monetary policy (reduce interest rates). Global trade has slowed dramatically from 5.5% annual rate in 2017 to 2.1% so far this year. Economic growth has eased in Europe, China, India, and in many Emerging Markets, and stagnated in Japan. The Ned Davis Research (NDR) Global Recession Probability Model indicates high recession risk in the global economy; however, its U.S. Recession Probability Model indicates recession unlikely in the U.S.

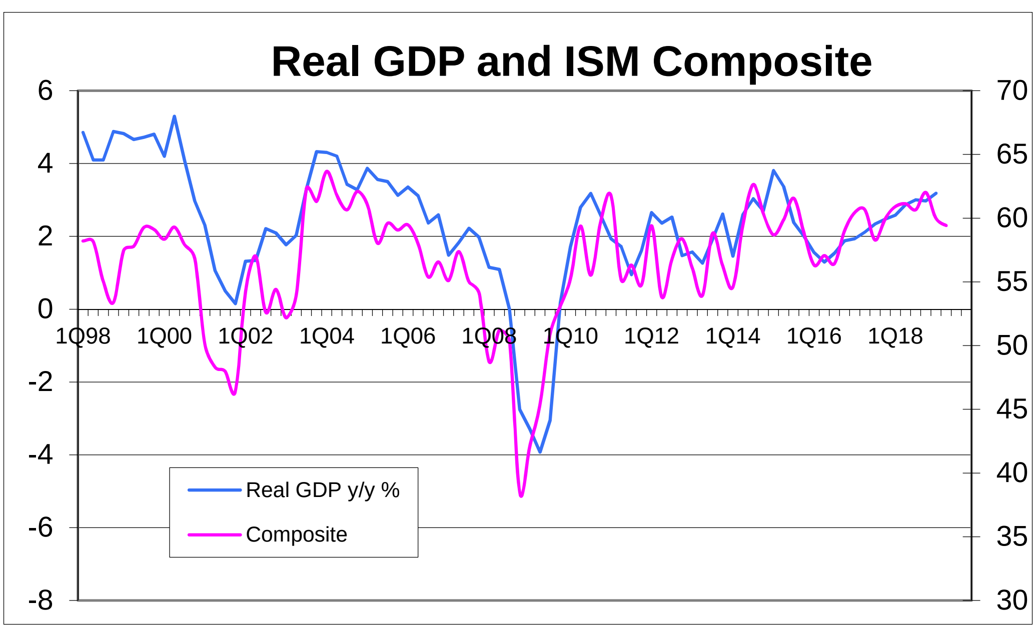
There are many mixed signals of U.S. economic growth, with a range of forecasts from the economy is currently in recession, to no recession in sight. We err on the side of caution and do not think this is a good time to be overly optimistic. The New York Fed's Recession

Indicator, based on the yield curve (difference between long and short term interest rates) is near 30%, which historically has preceded recession (see chart below).

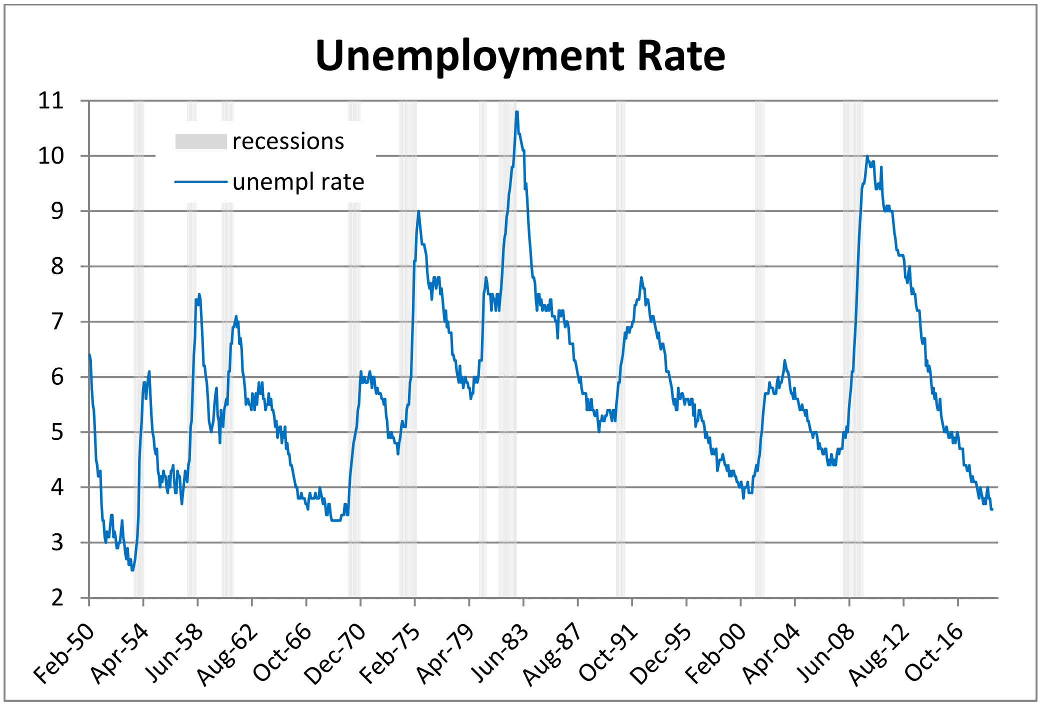


U.S. economic data has been mixed but is trending weaker. The Institute for Supply Management (ISM) surveys manufacturing and non-manufacturing firms to create an index that monitors changes in production levels and economic conditions from month to month. As seen in the chart below, this composite index closely tracks economic growth and provides a more timely indication of where the economy is headed. A reading below 50 coincides with an economic recession.

A recession is defined by the National Bureau of Economic Research (NBER) as "a significant decline in economic activity spread across the economy, lasting more that a few months, normally visible in real gross domestic product (GDP), real income, employment, industrial production and wholesale-retail sales."



Employment growth has begun to moderate but the unemployment rate recently fell to 3.6%, lowest since 1969, indicating a tight labor market. Typically, the unemployment rate increases sharply in a recession.



The unemployment rate remains low but recent data from the Conference Board suggests this too may begin to weaken. In the recent consumer confidence report, the survey's so-called labor market differential, derived from data about respondents who think jobs are hard to get and those who think jobs are plentiful, fell to a one-year low of 27.6% in June from 33.5% in May. That measure closely correlates to the unemployment rate in the Labor Department's employment report.

"The rolling-over that we are seeing here in jobs plentiful is worryingly reminiscent of what we have seen late in prior cycles," said Tim Quinlan, a senior economist at Wells Fargo Securities in Charlotte, North Carolina. "If past patterns hold, without a turnaround in this series, job growth could slow in coming months." - Reuters

<u>Putting Recession in Perspective</u>

Recessions typically are the result of imbalances that build up in the economy and ultimately need to be corrected. They are not pleasant, as credit tightens, production slows, and jobs are lost. However, recessions generally do not last very long. Since 1950 recessions have lasted between eight and 18 months, with the average spanning about 11 months, compared to the average expansion of 67 months. Recessions are painful but expansions have been powerful.

Consider:

	Average Expansion	Average Recession
Months	67	11
GDP growth	24.3%	-1.8%
S&P 500 return	117%	3%
Net jobs added	12 Mln	-1.9 Mln

Source: Capital Group

<u>Fed Expectations</u>

The Federal Open Market Committee (FOMC) met in late June to review the state of the economy and decide if a change in monetary policy was needed. The Committee members chose to wait to see more data and left short-term interest rates unchanged. There was a shift in sentiment, indicating the potential of a reduction in rates in the next year. Eight of the 17 participants in the meeting felt it would be appropriate to cut rates this year, while eight wanted to keep rates at their current target, 2.25%-2.5%. In its policy statement, the FOMC removed the language indicating that it would be *"patient"* in deciding its next policy move. Instead, *"the Committee will closely monitor the implications of incoming information for the economic outlook and <u>will act</u> as appropriate to sustain the expansion."*

Despite a ten year expansion and a tight labor market, inflation continues to run below the Fed's 2% target. (This may or may not accurately reflect your personal rate of inflation). Inflation continues to surprise on the down side. There are structural disinflationary forces of technology, globalization/competition, debt, and demographics at work. But historically, a tight labor market puts upward pressure on wages, leading to higher consumer inflation. Recent inflation reports globally suggest the rate of inflation is slowing year/year. Additionally, market-based inflation expectations are the lowest levels in two years and survey-based measures are at the low end of their historic ranges.

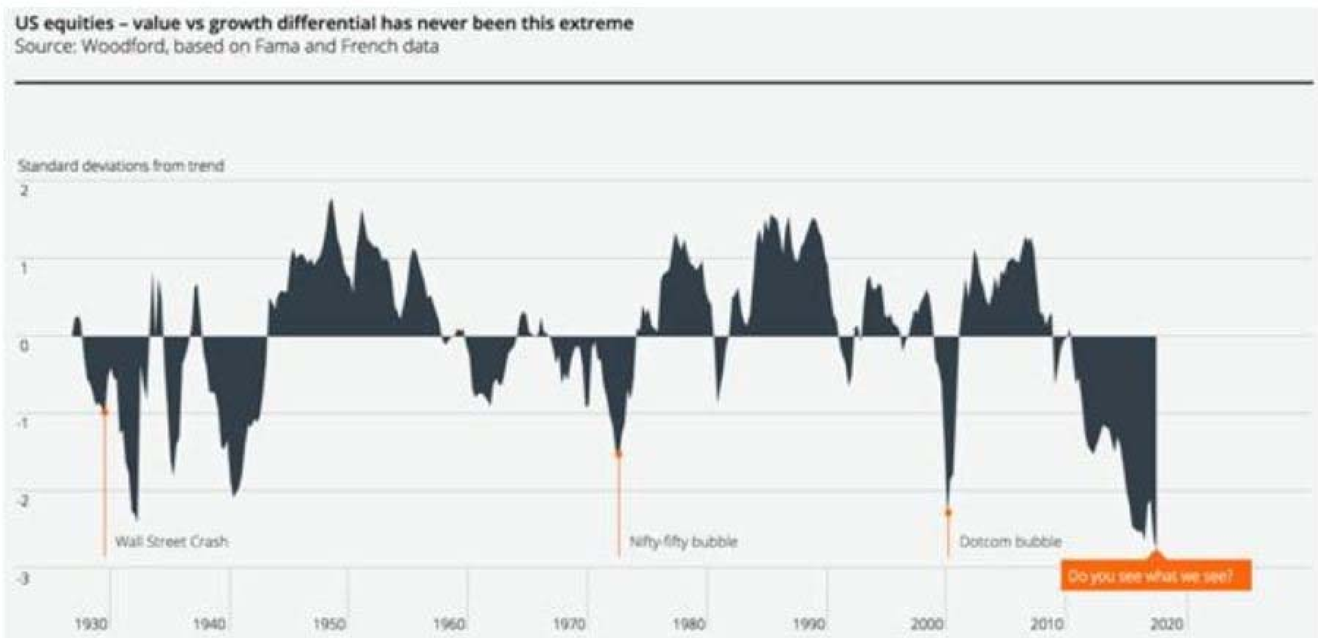
The market is far ahead of the Fed in terms of its policy expectations. Financial markets are pricing in up to a 1.0% cut in the federal funds rate this year. This is much greater than the FOMC has indicated and more reflective of a very weak economy. What does a cut mean for the market?

According to Ned Davis Research:

The clearest result of a rate cut is a steepening of the yield curve. After the initial rate cut, the 10-2 spread (10-year Treasury yield vs 2-year yield) 1 month later in all cases since 1980, and widened in 7 out of 8 cases 1 year later.

At first glance, the stock market's reaction to an initial rate cut is bullish as the Dow has climbed on average 16% in the year after the first cut. But the timing of the rate cut relative to a recession is important. In non-recession cases, the average increase of the DJIA is 23.8%. In recession cases the DJIA gained 6.1%. But this varies. The strongest average gains come when the economy was near the end of recession (23.3%). The DJIA has been adown an average of 5.9% in the year after the first cut when a recession started less than a year later.

Below is a Value vs. Growth real long term chart. Current underperformance of Value is the longest and deepest ever, rivaling even the Depression. Growth would include companies like Amazon and Google, while Value is represented by stocks such as Johnson and Johnson and other defensive names. Growth stocks are particularly sensitive to future earnings expectations, so can become quite volatile during recessionary periods. Our client portfolios are currently tilted towards Value.



Closing Comments

I find the quote at the beginning of this commentary to be interesting for a couple of reasons; first, I remember reading Voltaire's *Candide* while in college and thought it to be brilliant, and that the quote refutes the idea that it is *history* that repeats itself. George Santayana famously wrote, "Those who cannot remember the past are condemned to repeat it." But it is man who creates his own history, so it makes sense that it is easy for man to repeat the mistakes of the past, particularly if one has not personally experienced a certain period in history. The hugely successful initial public offerings of Uber, Lyft and Beyond Meat, all companies with no history of earnings, are reminiscent of the heady days of the dot com period. Residential real estate in many cities across the nation is becoming unaffordable, very similar to the period 2005-07. In finance and economics, the statement "this time is different" is often used, but is that really true? People still chase the market, spurred on by the fear of missing out; the same individuals vacate the market when the pain of loss becomes too great. Tariffs have not worked in the past, yet we find ourselves in a situation where they are once again being used as economic leverage. Lower interest rates, which have increased the price of financial assets, have failed to boost the economy as was expected, but there are calls for further cuts in interest rates, as

Diane has outlined above. While the circumstances may be different, our emotional responses to volatility in the financial markets are the same as they have always been.

On June 15th, Cindy Glenn marked her 20th year here at WMA. Only the owner has been at the firm for a longer period, and many of you may have an opinion as to which individual has had the more positive impact over the years. The next time you talk to or see Cindy, please congratulate her on this landmark, however, I would request that you refrain from any suggestion with regard to the possibility of a large bonus to celebrate this occasion.

Enjoy the Summer and if you are in KC, please take a trip to somewhere cooler for a few weeks.

Kevin	Paul	Matt	Diane
Kevin S. McGrew	Paul L. Watkins	Matthew D. Ison	Diane C. Dercher

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