Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

QUARTERLY NEWSLETTER

2019: SECOND QUARTER **122ND EDITION**

> ***"Capitalism does millions of things better than the alternatives. It balances supply and demand in an elegant way that central planning has never come close to."***
>
> ***~ Jeremy Grantham***

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Capital Markets Scoreboard

Equities					
Indices	**2Q19 Total Return (%)**	**2019 Total Return (%)**	**Index Characteristics**		
Domestic			**NTM P/E**	**P/B**	**Div. Yld. (%)**
S&P 500	4.3	18.5	16.8	3.3	1.9
DJIA	3.2	15.4	15.7	3.8	2.2
NASDAQ	3.9	21.3	22.6	4.4	1.0
Russell 1000 Growth	4.6	21.5	20.9	7.3	1.2
Russell 1000 Value	3.8	16.2	14.1	2.0	2.5
Russell 2000	2.1	17.0	21.0	2.1	1.3
International*					
MSCI EAFE	4.0	14.5	13.6	1.6	3.1
MSCI Emerging Markets	0.7	10.8	12.2	1.7	2.3
MSCI United Kingdom	0.9	13.0	12.6	1.7	4.1
MSCI France	7.3	18.9	13.9	1.8	2.9
MSCI Germany	7.8	15.4	12.7	1.6	2.9
MSCI Japan	1.0	8.0	12.7	1.3	2.4

Fixed Income		
Indices**	**2Q19 Total Return (%)**	**2019 Total Return (%)**
Domestic		
U.S. Corp - Gov (1-3 Years)	1.5	2.7
U.S. Corp - Gov (3-5 Years)	2.5	4.8
U.S. Corp - Gov (10+ Years)	6.4	13.0
U.S. Treasuries Master	3.1	5.3
U.S. Corporates Master	4.3	9.6
U.S. Municipals Master	2.3	5.3
U.S. High Yield Master	2.5	10.1
International*		
Developed Markets Sov Bond	3.5	5.1

Commodities		
Resource	**2Q19 Total Return (%)**	**2019 Total Return (%)**
Precious Metals		
Gold	9.0	10.3
Silver	0.8	-1.6
Industrial Metals		
Copper	-7.9	2.9
Aluminum	-6.7	-5.1
Energy		
Brent Crude Oil	-4.8	27.8
WTI Crude Oil	-2.9	29.4
Natural Gas	-13.3	-21.5

Key Rates				
Rates	**6/30/2019**	**3/31/2019**	**12/31/2018**	**6/30/2018**
U.S. Target Fed Funds Rate	2.50	2.50	2.50	2.00
2-Year U.S. Treasury	1.75	2.27	2.48	2.52
10-Year U.S. Treasury	2.00	2.41	2.69	2.85
30-Year U.S. Treasury	2.52	2.81	3.02	2.98
10-Year German Bund	-0.33	-0.07	0.24	0.30
10-Year Japanese Bond	-0.16	-0.09	-0.01	0.03
30-Year Fixed Mortgage	3.80	4.27	4.64	4.57

Currencies				
Indices/ Exchange Rates	**6/30/2019**	**3/31/2019**	**12/31/2018**	**6/30/2018**
ICE U.S. Dollar Index	96.13	97.28	96.17	94.64
USD per EUR	1.14	1.12	1.14	1.17
USD per GBP	1.27	1.30	1.27	1.32
JPY per USD	107.74	110.69	109.72	110.77
CAD per USD	1.31	1.34	1.37	1.32

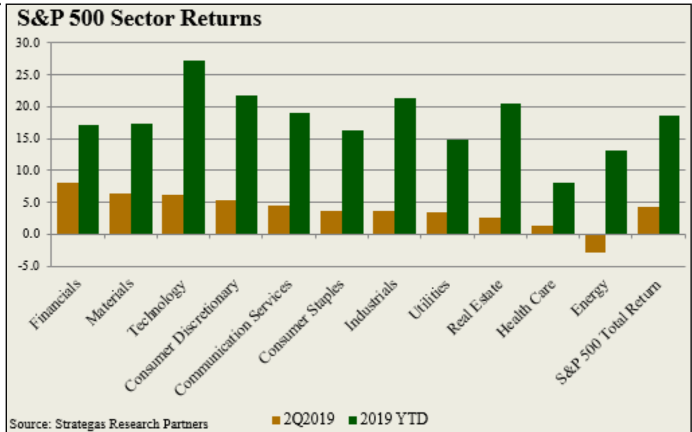
*Returns denominated in U.S. dollars

**ICE Bank of America Merrill Lynch (BofA-ML) indices

EQUITIES

- The Standard & Poor's 500 (S&P 500) index generated a positive total return (price appreciation plus dividends) of 4.3% for the second quarter, bringing its year-to-date (YTD) return to 18.5%. The index sold off sharply in May but swiftly recovered, setting a new all-time closing high of 2,954.18 on June 20. Small cap stocks underperformed larger stocks with the Russell 2000 Index returning 2.1%. On a global basis, the MSCI Europe, Australasia, and Far East (EAFE) Index generated a total return of 4.0% when priced in U.S. dollars, or 3.1% priced in local currencies. The MSCI Emerging Markets Index produced total returns of 0.7% in U.S. dollar terms and 0.3% in local currencies.

- Growth stocks continued a trend of outperformance in the second quarter as the S&P 500 Growth Index returned 4.6% versus 4.0% for the S&P 500 Value Index. On a sector basis, financial stocks led the way with an 8.0% total return. Only the Energy Sector (-2.8%) had a negative total return during the quarter. The Communication Services and Technology Sectors corrected during the quarter on antitrust concerns but finished with total returns of 4.5% and 6.1%, respectively.



- Aggregate earnings for S&P 500 companies are expected to decline by 2.8% year-over-year (Y/Y) for the second quarter as operating margins have come under pressure. Y/Y earnings have not declined for two consecutive quarters since the first half of 2016. Operating margins are facing headwinds of slower global growth, lower oil prices, and an appreciating U.S. dollar, which makes exports less profitable. While the market is currently in an earnings recession, many analysts are optimistic about the future and broadly project earnings growth of 11% in 2020.

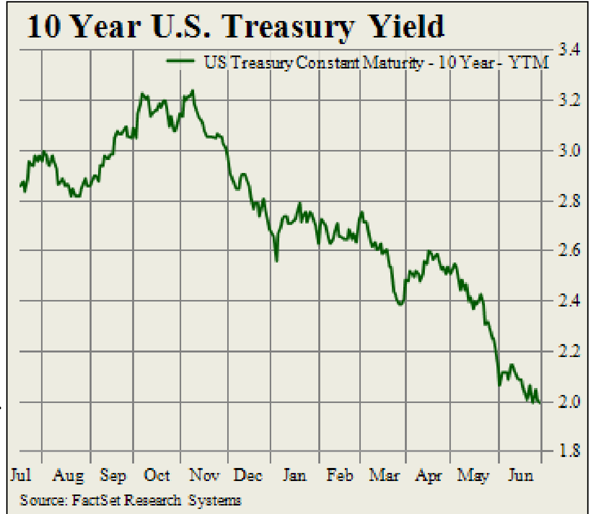
- Various metrics are utilized to analyze equity valuations, and as the second quarter closed, they were somewhat mixed. The price-to-earnings (P/E) ratio is one of the most widely-used. For the S&P 500, this ratio finished the quarter at 16.8x next twelve months (NTM) earnings versus its 20-year mean of 15.8x. While slightly overvalued on a forward P/E basis, many interest rate-based valuation models indicate the stock market may in fact be undervalued given today's historically low interest rates. The Fed model, which compares the stock market's earnings yield (earnings/price) to the yield on long-term government bonds, is one such model that suggests the S&P 500 is significantly undervalued. The Rule of 20 model, which states that the fair value of the market can be derived by subtracting the current inflation rate (1.8% for the previous 12 months through May 2019) from 20, also suggests that stocks are undervalued.

- The initial public offering (IPO) market is expected to raise record funds in 2019 despite the poor debut for ride-hailing companies Lyft and Uber. These high-profile IPOs may have performed poorly in part because the 2012 JOBS Act made it easier to invest in private businesses, pushing up company valuations often years before their IPOs. Large companies, particularly in the Technology and Communication Services Sectors, have become more active in their investment and purchasing of private companies, also serving to push up valuations. The poor performance of IPOs is not a new phenomenon – IPOs have outperformed the broad market only once in the past five years. Ironically, despite the major flops, technology IPOs have outperformed the NASDAQ through the first two quarters of 2019 according to Dealogic. Investor appetite for smaller technology companies has increased as tech giants such as Facebook and Alphabet (Google) face heightened regulatory scrutiny.

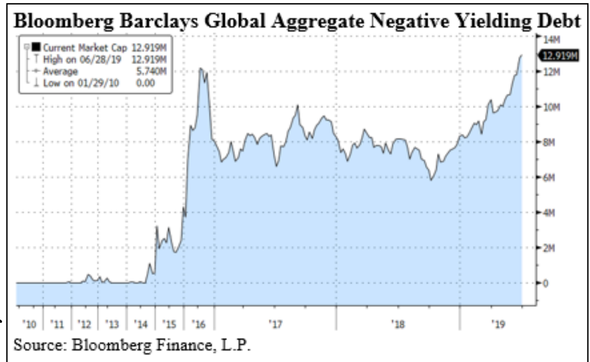
FIXED INCOME

- During the second quarter, interest rates decreased in both the government and corporate sectors, leading to broad-based strength in fixed income markets. U.S. Treasuries (USTs) as measured by BofA-ML indices provided a 3.1% total return for the quarter, bringing their YTD return to 5.3%. This was the strongest quarter for USTs since the first quarter of 2016. Investment-grade corporate bonds outperformed USTs, returning 4.3% in the second quarter and 9.6% through the first half of the year. High-yield ("junk") bonds slightly underperformed for the quarter, returning 2.5%, but have provided a 10.1% total return YTD.

- The yield curve provides a broad spectrum of UST yields across varying maturities. It is normally upward sloping as investors require more return to assume more risk, but segments of the curve have recently inverted. Notably, 10-year UST yields finished the quarter at 2.00% compared to 2.12% for 3-month UST yields. Thus, 10-year UST holders are willing to accept lower yields under the assumption the Federal Reserve (Fed) will need to cut interest rates, decreasing the future total returns on short-term bonds. As the quarter ended, Fed funds rate futures markets were projecting three rate cuts by the end of 2019. Since the Fed generally cuts interest rates to ward off a recession, an inversion in the curve is typically viewed as a foreboding economic signal. Of note, the 2-to-10-year segment of the UST curve has not yet inverted. If 10-year USTs begin yielding less than 2-year USTs, the general thought is this would signal deeper economic concerns.

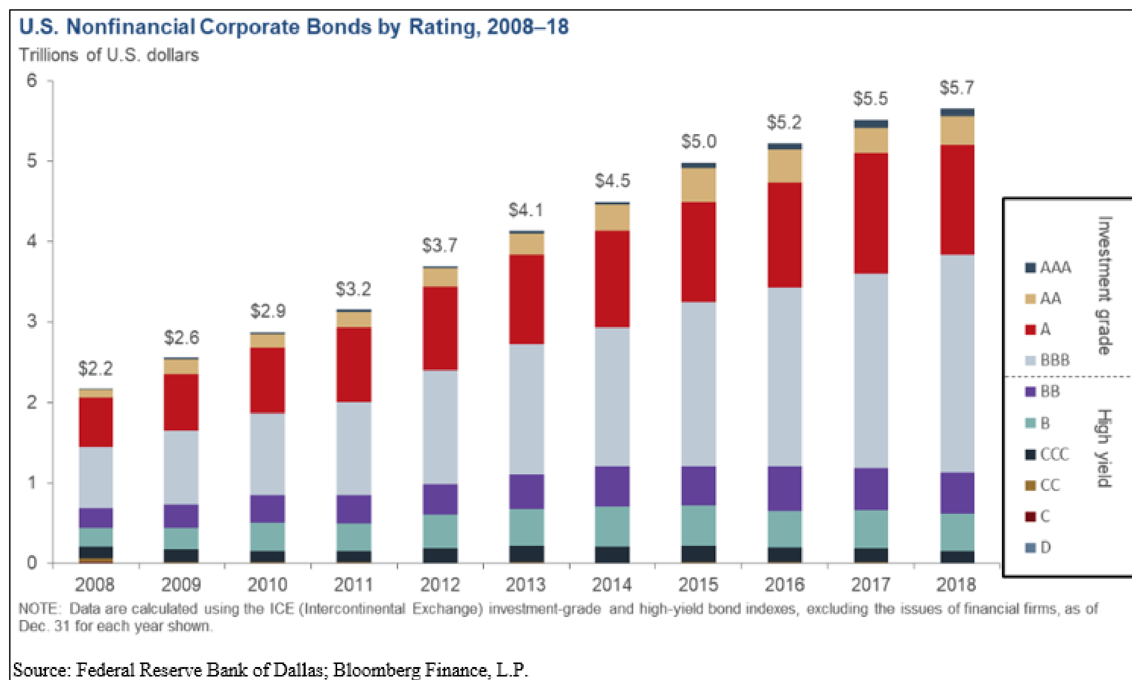


- Decreases in interest rates were not just a U.S. phenomenon as 10-year German bund yields dropped from -0.07% to -0.33%, an all-time low. Japanese 10-year bond yields decreased from -0.09% to -0.16% and French 10-year bond yields turned negative for the first time ever. According to the Bloomberg Barclays Global Aggregate Index, the amount of negative-yielding debt surged to nearly $13 trillion over the course of the quarter. Rate decreases were catalyzed by European Central Bank (ECB) President Mario Draghi, who noted a new round of monetary stimulus "will be required" if the bloc's economic outlook does not improve. The ECB's benchmark rate on overnight deposits has been negative since 2014 and currently sits at -0.40%. These extreme levels put downward pressure on UST rates, as foreign investors can purchase USTs and pay to hedge away currency risk, potentially locking in a higher "risk-free" rate than they could receive by investing in their domestic government bonds.



- China has threatened to liquidate over $1.1 trillion in UST holdings as part of ongoing posturing in U.S.-China trade negotiations. This has mostly been considered an empty threat to the financial markets for a variety of technical and empirical reasons. While the threat would imply an increase in U.S. interest rates and borrowing costs, a yield-starved world with trillions of dollars in negative-yielding debt would likely absorb the newfound supply of USTs at only marginally higher rates. Further, China dumping their UST holdings could very well strengthen the yuan relative to the dollar, effectively making their exports more expensive and weakening their negotiating position. While a strong currency has advantages to the populace and helps mitigate cost-of-living increases, it is generally seen as a negative contributor to economic growth. Other tools China may utilize to combat U.S. tariffs, such as a ban on exports of rare earth metals, could ultimately prove more painful to investors.

- A side effect of the low interest rate policy in place since the Great Recession has been the leveraging up of the nonfinancial corporate sector. While logical, as monetary policy has helped keep debt financing cheap relative to equity financing, BBB-rated bonds now comprise over 47% of nonfinancial corporate debt; an all-time high as a percentage of U.S. Gross Domestic Product (GDP). This is notable as BBB is the lowest credit rating in the investment-grade space, only one notch above junk bonds, and an impactful recession could cause a significant amount of companies to be downgraded out of the investment grade classification. Since the amount of BBB bonds is now more than double the size of the high-yield market (they were nearly equivalent in 2008), investors could face a slew of downgrades in an economic downturn. Investors can take some solace, however, in the fact that interest coverage metrics, or measures of profits relative to interest expenses, have remained contained and are near post-recession levels due to low rates, tight credit spreads, and respectable corporate profitability.



Source: Federal Reserve Bank of Dallas; Bloomberg Finance, L.P.

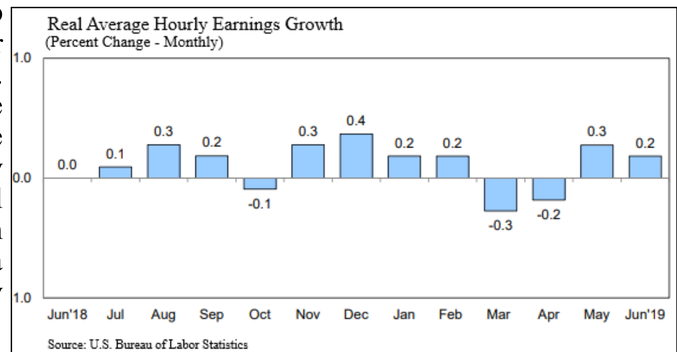
ECONOMICS

- On June 27, the U.S. Bureau of Economic Analysis released its third and final estimate of GDP growth for the first quarter of 2019. While growth of 3.1% appeared strong on the surface, about half of the growth was attributed to two volatile components – a large gain in business inventories and a better-than-expected trade deficit, both trade-tension related. Without these two components, first-quarter GDP growth would have been closer to 1.7%, less than the 2.2% growth in the fourth quarter of 2018.

- It appears the first-quarter trade results (exports up 5.4% and imports down 1.9%) were transitory; the May trade deficit was $55.52 billion, up 8.4% from April. Imports rose 3.3% while exports increased 2.0%. The goods trade deficit with China increased 12% as well. A narrowing trade deficit in the first quarter helped GDP growth, but its reversal will be a headwind in the second quarter.

- Expectations for GDP growth for the second quarter are in the 1.5-2.0% range. Manufacturing is growing at a slower pace in the U.S. and is contracting in China, Japan, and Europe. The service sector is stronger, posting its 113th consecutive month of growth. Consumer confidence is near a record high. Retail sales increased 0.3% in April and 0.5% in May, lending support for positive second-quarter GDP growth despite trade deficit headwinds. For 2019, the World Bank forecast for U.S. GDP growth is 2.5%.

- The jobs market rebounded in June as the U.S. Labor Department reported 224,000 new jobs were created compared to a revised 72,000 in May. Job creation this year has averaged 172,166 per month, which is down from 223,350 in 2018. The unemployment rate inched up to 3.7% due to 335,000 new entrants into the workforce. The labor force participation rate increased slightly to 62.9% with the entrants, but there are still potential workers on the sidelines. Wage growth was also steady at 3.1%, and was positive on a real (inflation-adjusted) basis. Wages grew fastest for low-wage earners.

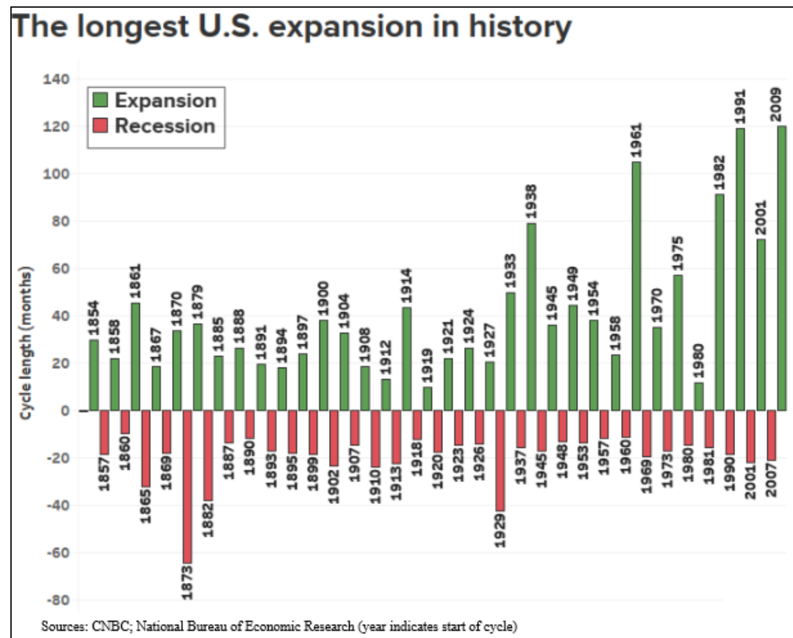


- The pace of inflation remains moderate both in the U.S. and abroad. The U.S. Consumer Price Index (CPI) was up 1.8% in May on an annual basis. Excluding volatile food and energy prices, core inflation was up 2.0%. The Fed's preferred inflation measure, the personal consumption expenditures (PCE) deflator, was up 1.5% in May on an annual basis with core inflation 1.6%. The Fed still has a 2.0% inflation target but has adopted a symmetrical inflation policy, meaning they will tolerate inflation rates above 2.0% to offset rates below 2.0%, shooting for a 2.0% average. The PCE deflator has been at or above 2.0% for only eight months since 2012.

- Housing continues to be a drag on the economy. Existing home sales increased 2.5% in May from April but have declined on a Y/Y basis for 15 straight months. Some of this is due to mortgage rates rising to almost 5% in 2018, but they are now below 4% for the first time since January 2018. Affordability should be less of an issue in 2019 as housing price growth has declined from over 5% in 2017 and 2018 to less than 4% today. Housing prices have increased on an annual basis for 87 consecutive months. Inventory continues to be a constraint at the lower end of the market as institutional investors are buying roughly 20% of those homes to rent. There are plenty of higher-priced homes for sale. Fewer renters expect to be homeowners; only 24% of renters said it was "extremely likely" they would ever own a home, 11% lower than four years ago.

Ten Years and Counting

The U.S. is on pace to set a record in July for its longest economic expansion in 100 years barring the unlikely event of a recession starting during the month. Since WWII there have been 11 U.S. economic expansions that have lasted an average of 58 months; the longest one prior to this expansion was 120 months from 1991 to 2001, and the shortest was 12 months from 1980-1981. The current expansion is more than twice as long as the U.S. norm but is nowhere near a global record. China and Australia are in their 28th year, and India and Taiwan both have experienced more than 20 years of economic expansion. Several European countries along with South Korea and Japan have also experienced economic expansions of more than 10 years.



Sources: CNBC; National Bureau of Economic Research (year indicates start of cycle)

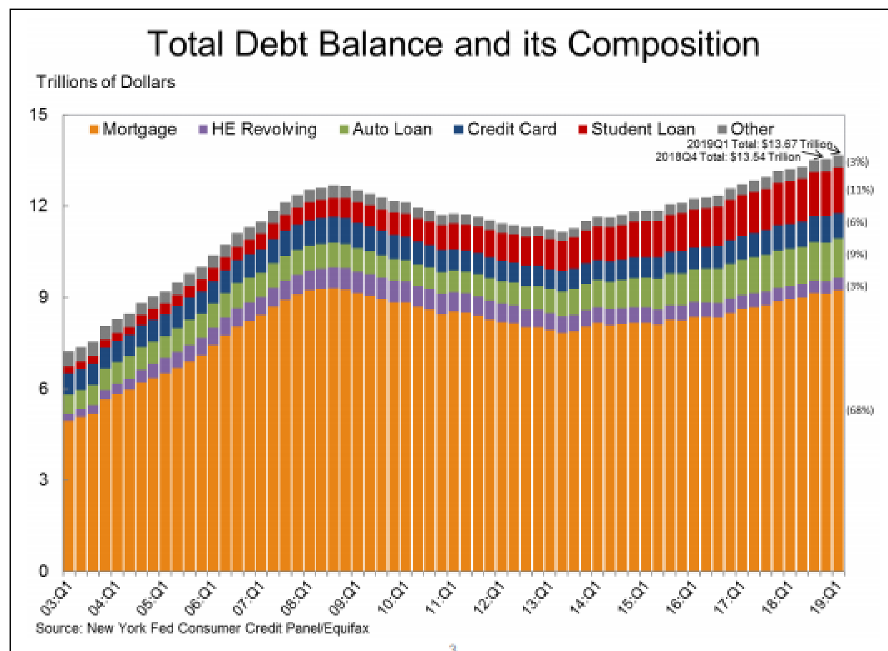
While this U.S. expansion has longevity, it has lacked rigor in terms of economic growth. The growth of GDP, the final output of goods and services, has averaged an anemic 2.2% annually, the slowest of any economic expansion since WWII. The expansion has benefitted some sectors of the economy more than others. Jobs have been the most notable achievement of the current expansion, with 105 consecutive months of job creation and more than 20 million jobs added to the workforce in total. The unemployment rate of 3.6% in May was a 50-year low, down from 10.0% in October 2009, and job openings are at their highest level relative to unemployed workers (7.45 million openings versus 5.82 million workers respectively) since recordkeeping began in 2000. At the end of 2009, there were over 15 million unemployed workers and only 2.49 million openings. There is a worker shortage – that is the good news for the labor force. However, almost half the increase in jobs is due to those ages 65 and older. Still, the labor force participation rate is at 82.1% for those aged 25-54, below 2007 levels, indicating some remaining slack in the labor force. Workers have also experienced anemic wage growth despite the surplus in job openings. Average hourly earnings growth has averaged 2.0-2.5% for much of the expansion. Although it recently rose above 3.0%, it still falls significantly below the 50-year average of 4.1%. As a result, labor's share of national income has fallen from 69.9% to 66.4%.

Despite the decline in labor's share of national income, the net worth of households has surged from $57.8 trillion to $108.6 trillion in the last decade. This has been due to appreciating stock and home prices, and to a lesser extent, the performance of bonds. The median price of an existing home has increased from $182,000 in 2009 to $277,700 today and the S&P 500 has provided a total return of nearly 440% from its March 9, 2009 bottom through the close of the second quarter. The yield on the 10-year Treasury bond fell from over 4% in June 2008 to 2.00% at the quarter's close (bond prices rise as yields fall). However, this wealth creation has not been distributed evenly throughout society as only 54% of households own stocks and 64% own homes. The result is record-high wealth inequality. Today, according to the World Inequality Database, the top 0.1% of U.S. households control 20% of U.S. wealth, the top 1% control 36%, and the top 10% control 74%. The bottom 50% have zero wealth, and

the bottom 30% have negative wealth. While the U.S. continues beyond its 10th anniversary of uninterrupted economic growth, unequal distribution of the expansion's fruits has left many people in no mood to celebrate. This has led to populism, anti-globalism, and lost faith in capitalism. A recent Gallup Poll showed only 45% of young adults had a favorable view of capitalism versus 51% for socialism. Among all adults, 56% have a favorable view of capitalism, the lowest since 2010. Wealth inequality will continue to be a major political issue going forward.

While income inequality directly fosters wealth inequality, the Fed's near-zero interest rate policy and quantitative easing (the purchasing of more than $3.5 trillion of U.S. Treasury and mortgage-backed securities) have also played a major role. Fed policy has kept interest rates at historically low levels, supporting high stock, bond, and home prices. The Fed has pursued this loose monetary policy to combat ongoing anemic economic growth and low inflation. In 2012, the Fed set a 2.0% inflation target due to worries about deflationary pressures and lowered inflationary expectations. Since then, the PCE deflator has been at or above 2.0% in only eight months, and core inflation (which excludes volatile food and energy prices) has exceeded 2.0% in only two months.

The Fed's near-zero interest rate policy has also resulted in total U.S. debt recently reaching an all-time high at 230% of GDP. Most of this increase in debt relative to GDP can be attributed to the federal government and corporate sectors. Government public debt has more than doubled from 34.8% of GDP in 2007 to 76.8% in fiscal year 2018. It used to be that the government was supposed to run fiscal surpluses during economic expansions, but that has not happened since fiscal years 1999-2001. The U.S. Government's fiscal deficit is heading toward a trillion dollars per fiscal year with no political will to reduce it, as reflected by a recent article in *The Wall Street Journal* headlined, "Washington Puts Aside Fears and Embraces Debt." On the corporate side, U.S. nonfinancial business debt rose to $15 trillion in 2018 from $9 trillion in 2007 as companies have taken advantage of cheap financing due to historically-low interest rates. Debt was a major cause of the 2008-2009 financial crisis, especially in the household and financial sectors. However, it appears more manageable this time around, at least without a large upward spike in interest rates, which would be painful. The financial industry has reduced its debt and leverage due to new laws and regulations. The household sector has more debt today in dollar terms, but it stands at only 76% of GDP versus 98% in 2008. Mortgage debt, which was the problem during the 2001-2007 economic expansion, is about the same in dollar terms, but student, auto, and credit card debt are collectively much larger today. Households have had a personal savings rate of 7.01% during this expansion versus 4.68% from 2001-2007. Historically-low interest rates have forced higher savings rates to overcome what some refer to as financial repression for savers, encouraging more risk taking.



An economic recession does not appear imminent, so the U.S. is all but assured to set a record for economic expansion longevity. The underperformance of economic growth for this expansion may be the primary reason for its longevity; there are no glaring price pressures, imbalances, or bubbles in the economy or financial markets. The question is whether 2.0% economic growth is the new norm, or can it be ramped up as in 2018? Many economists, such as Harvard economist Lawrence Summers, believe the U.S. economy is in a period of secular stagnation with sustainable subpar growth. The Fed also believes the economic growth potential is around 2.0% based on slow growth in the workforce plus subpar growth in productivity.

It is difficult to determine whether this expansion is mid-cycle or late-cycle. The only certainty is what Yogi Berra may have said: “It’s later than it used to be.” Economic expansions do not normally die of old age; it takes outside forces like the Fed raising interest rates and starting a run-of-the-mill cyclical recession, supply side shocks like oil in the 1970s, or a financial crisis like that of 2007-2009 to end an expansion. Many economists and CEOs believe the risks of a recession are growing. When a recession does occur, the public will not know for six or more months. The National Bureau of Economic Research has a Business Cycle Dating Committee that will decide its official start date retroactively. The committee will look at many data points and metrics. Many believe that two quarters of negative economic growth automatically qualifies as a recession, but there is no such rule of thumb in the U.S. Economists do not have a good record of forecasting recessions before they happen. Hopefully this expansion still has a long way to go, even if it is at a slow pace. Not only would a prolonged expansion be beneficial for U.S. consumers, but also for the rest of the world so dependent at this point on the U.S. economy. To quote Yogi Berra, “It ain’t over ‘til it’s over.”

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