Dear Clients and Friends,

The second quarter of the year offered relative calm in most markets after the multi-year highs in volatility seen during the first three months of the year. The individual performances across asset classes were affected by continued strong U.S. economic and profit growth combined with higher interest rates and a firm dollar. Most domestic risk assets enjoyed a modest recovery during the period as the S&P 500 index posted a total return of 3.4% and the S&P Goldman Sachs Commodity Index returned 7.6%. Emerging markets, however, diverged dramatically from this trend with the MSCI Emerging Market exchanged traded fund posting a loss of 9.7%. The U.S. fixed income market continued to struggle with a negative 0.2% return for the quarter (as measured by the Bloomberg Barclays US Aggregate Bond Index).

The markets seem to have largely gotten numb to the factors that drove the turbulence in the first quarter of the year. Presidential tweets and heightened trade tensions have not recently had the same effect on the market. We believe that continued strong underlying economic and earnings growth has allowed investors to overlook those issues.

## Market Outlook

We believe that there are many reasons to suspect that the U.S. stock market and economy are in the late innings; the challenge is trying to determine whether they are in the top of the 7th or the bottom of the 9th. From an intermediate- to long-term perspective this doesn't make a lot of difference because equities will almost certainly remain the best asset class with which to build wealth. Over the short-term, though, an opinion on the current stage and what that means for the coming months does inform our equity sector weightings and fixed income credit-quality and duration exposures.

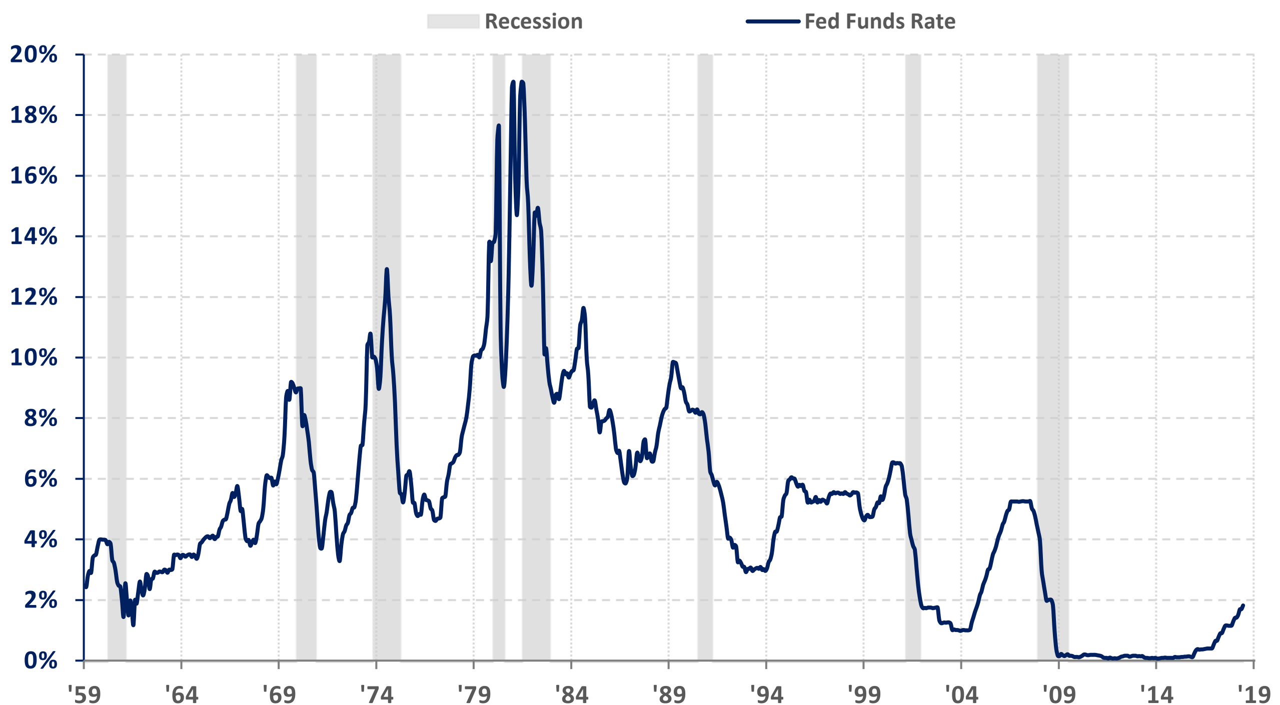
We begin with the basic facts for perspective.

- The U.S. economy is in the 82nd month of the current expansion and the stock market is in the tenth year of a bull market having approximately quadrupled since the 2009 lows; both of those count among the longest durations in the history of the country.

- The Federal Reserve shifted its monetary policy to one of tightening in December, 2015, by increasing the Federal Funds rate by 25 basis points. This was the first tightening move since 2006. The Fed's increase last month brings the total increase in the Fed Funds rate to 175 basis points since the start of its current campaign. The "dot plot" from the June meeting indicates that the median expectation of the Fed governors is for another 125 basis points of interest rate hikes by the end of 2019. Added to that was the end of six years of quantitative easing in October, 2014, and a move to begin the unwinding of the accumulated assets in October, 2017. The pace of the Fed's balance sheet shrinkage was $30 billion per month during the first half of this year, $40 billion per month during the second half, and $50 billion per month in October and beyond. Some economists estimate that the effect of these two

policy levers will equate to total tightening of approximately 500 basis points, which would be the most since the early 1980s when Paul Volcker was trying to lick runaway inflation. As you can see on **Chart 1**, this magnitude of tightening has always brought on a recession. The Treasury yield curve has also flattened considerably as long-term interest rates have increased much less than those at the short end. The difference between the yields on 2-year and 10-year Treasury notes has narrowed to only 25 basis points. Debate continues as to whether this is a signal of coming economic weakness or is being driven this time by the continued extremely low rates prevailing in Europe and Japan providing "competition" for our long end. The latter justification brings to mind the most dangerous four words in market history… "This time it's different".

**Chart 1:** Historical Federal Funds Rate with Recessions

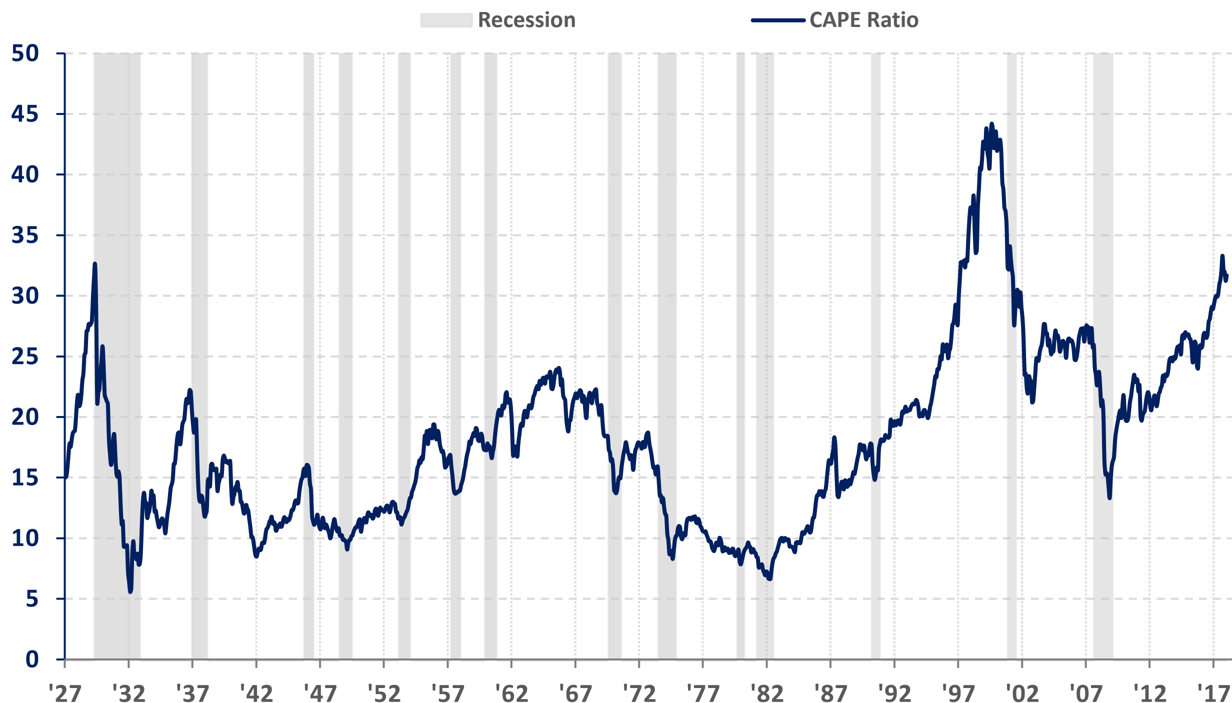



- Fiscal policy is extremely stimulative at present but will likely become less so as we move into 2019 as the effects of the tax law subside.

- In the political arena, President Trump is playing a high-stakes game of poker on the trade front which is increasingly looking as though it will have at least a short-term deleterious impact on economic growth no matter what the long-term benefits that might eventually be extracted.

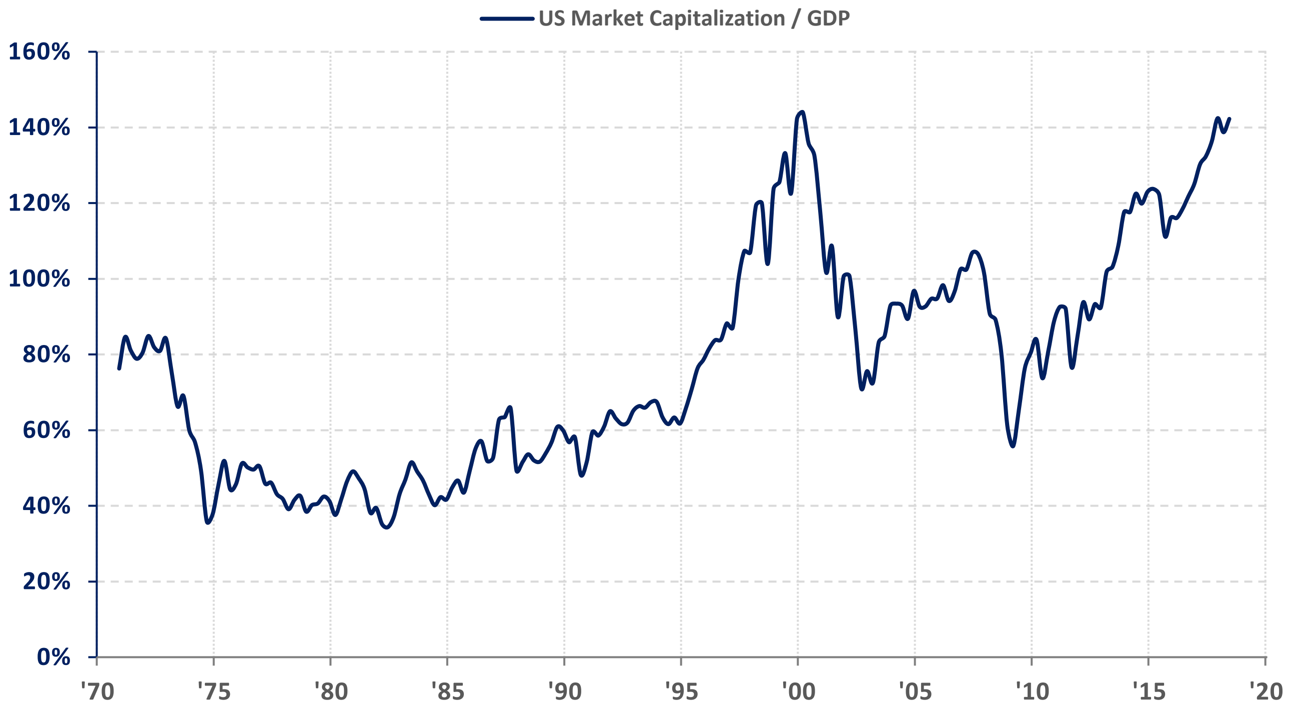
- Equity market valuations are mixed. As the result of strong current earnings growth, the S&P 500 is now trading at about 17.4 times estimated 2018 earnings which is only slightly above the historical average. However, there is an argument that can be made that on some longer-term measures the market is at an historically rich level. **Chart 2** shows the current CAPE price earnings multiple relative to the last 100 years of history. This measure attempts to account for inflation and compares current prices to a multi-year measure of earnings. On this basis, the market is about as expensive as it was in 1929 and is only surpassed by the time around the 2000 peak. **Chart 3** shows a similar picture in terms of the value of the stock market relative to the total economic output of the country as measured by Gross Domestic Product (one of Warren Buffett's favorite valuation indicators).

**Chart 2**: Long-term Historical Cyclically Adjusted PE Ratio with Recessions




Source: Factset / Case Shiller PE

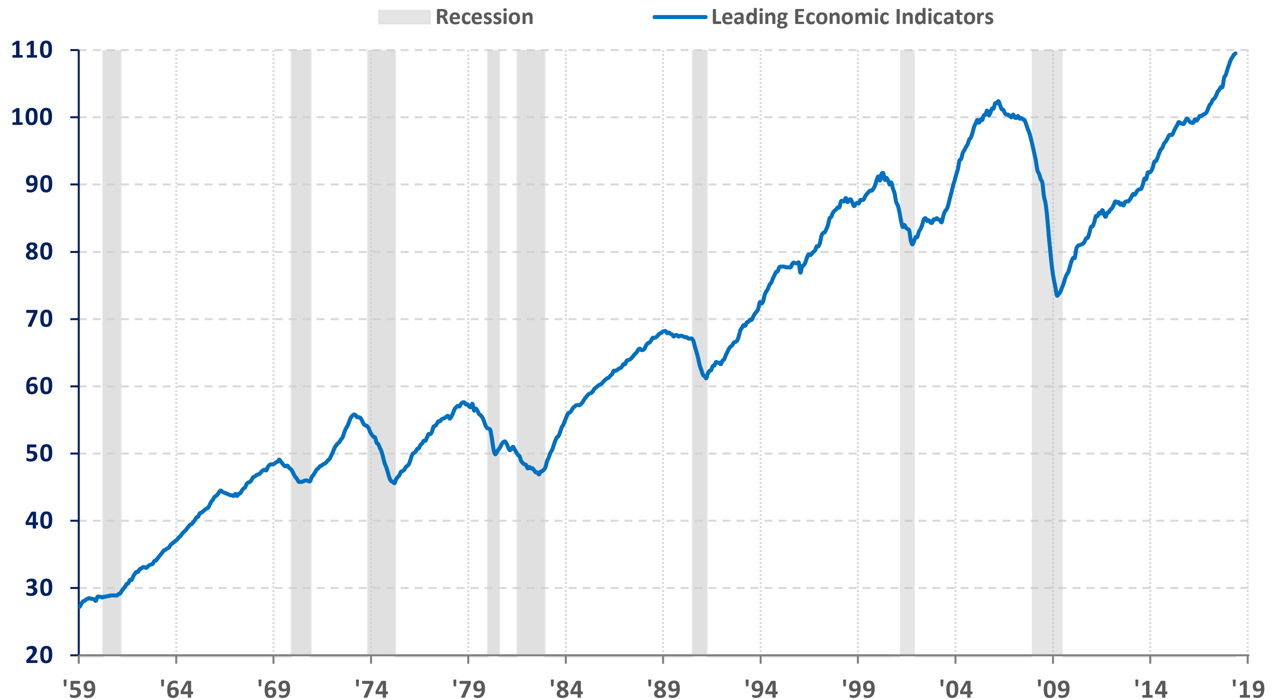
**Chart 3**: Wilshire 5000 Total Market Capitalization to Annual Nominal GDP




- Stock market performance so far this year has become very narrow. The entire increase in the S&P 500 index through midyear could be accounted for by the five largest companies: Apple, Amazon, Alphabet, Microsoft, and Facebook.

- Forward looking indicators that typically signal a future recession are still climbing. An example is the Commerce Board's Index of Leading Economic Indicators which has peaked six to twelve months before the beginning of every recession over the last sixty years (**Chart 4**).

**Chart 4**: Commerce Board's Index of Leading Economic Indicators with Recessions



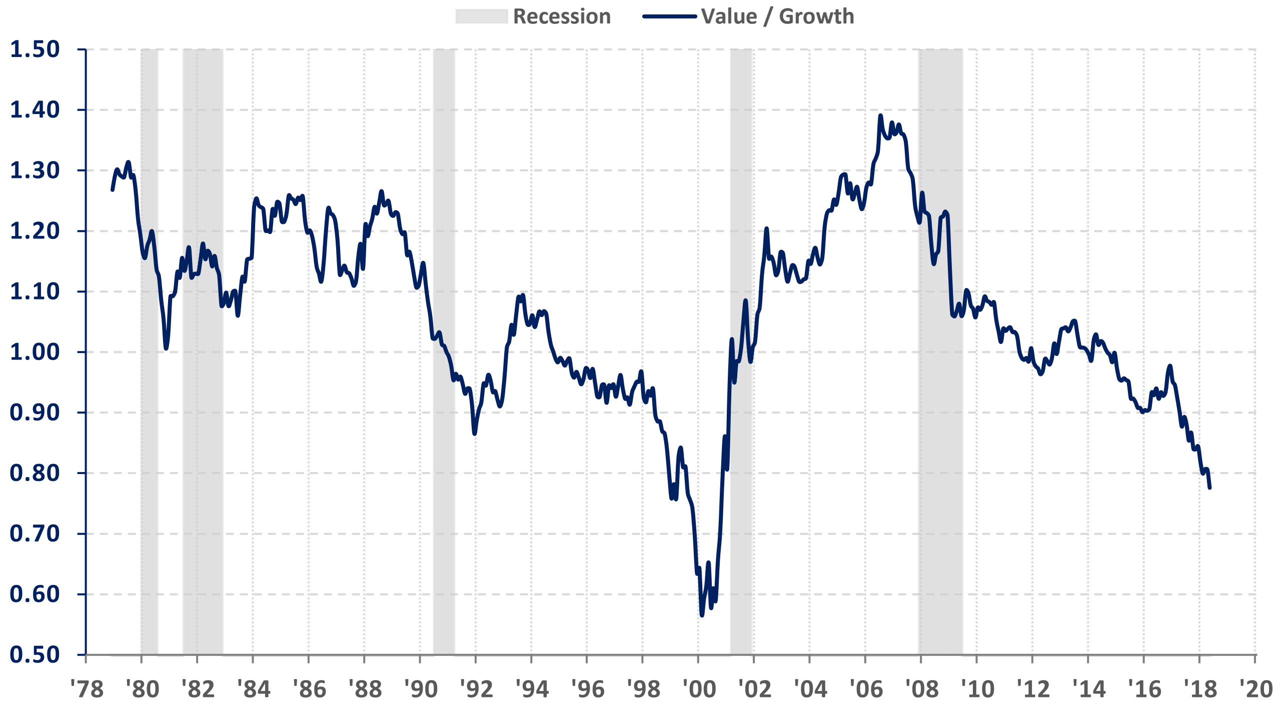

Taking all these factors together, we believe that the odds favor the onset of an economic recession and a stock market correction sometime over the next couple of years, but we do not expect that to happen over the near term.

## Current Portfolio Themes

Given our view that we are relatively late in the economic and stock market cycles, our focus has begun to shift to investment opportunities that outperform during slowing economic growth and/or offer compelling valuations relative to some of the more expensive areas of the markets. We recognize that those changes could cost some near-term relative performance as the bull market continues, but we believe that gradually moving to a more defensive posture is the correct thing to do for the intermediate term.

There are several themes that we think offer opportunity in the environment we envision over the next couple of years. The first is to favor value stocks over growth stocks in our equity portfolios. In recent decades growth and value stocks have tended to enjoy long periods of relative outperformance (**Chart 5**). Growth outperformed value from mid-1988 until early 2000; value then outperformed until mid-2006. Since mid-2006, growth has enjoyed a period of outperformance that is now several months longer then the 1988-2000 period. There is nothing to say when that trend will reverse, but we believe that the opportunities in the universe of value stocks are becoming more and more compelling relative to growth stocks.

**Chart 5**: Russell 1000 Value Index Relative to Russell 1000 Growth Index




Another theme that looks increasingly compelling is favoring stable, high-dividend stocks. We have been underweight those sectors due to their vulnerability to higher interest rates. However, we believe that in some cases they now represent compelling value compared to many other parts of the market and are not dependent on continued strong economic growth to maintain their earnings growth and dividends. As an example, the Consumer Staples sector (which is comprised of companies in industries such as food, beverage, household products, and food/drug retailers) represented only 7.0% of the S&P 500 Index at the end of June compared to 10.6% only two years earlier (**Chart 6**). The weighting of the sector has only been lower for a very brief period around the peak of the internet bubble in 2000. The sector was down 9.1% during the first half of this year compared to a gain of 2.6% for the total S&P 500 index. The sector now enjoys a dividend yield of 2.8% versus 1.8% for the market.

**Chart 6**: Consumer Staples Sector Weight as a Percent of the Total S&P 500

We continue to think that commodities are attractively valued relative to equities as they remain near multi-decade lows on a relative basis (**Chart 7**). This is against a current commodity market backdrop of steady global demand growth and limited supply increases which should translate into higher prices. Commodities have also tended to enjoy strong late cycle performance.

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**Chart 7**: S&P Goldman Sachs Commodity Index Relative to the S&P 500

A final thought is to look for opportunities to extend the duration of a portion of our fixed income exposures. Keeping minimal exposures to longer dated bonds has been the right posture over the last couple of years, but as the yield curve gets closer to inverting and economic growth peaks, the risk of further significant declines in the bond market diminish. We do not see value in the long end of the Treasury market at this time, but we view some other areas of the fixed income world as becoming increasingly more attractive. One such candidate is preferred stocks, which are a hybrid equity/fixed income security that offer relatively high yields (currently in the neighborhood of 6%) and favorable tax treatment, but do not participate in the growth of the issuing company.

## Company Developments

We are happy to let you know that Suzie has been promoted to "Vice President of Client Service". BAM's growth is allowing us to both provide more and better service to our clients and create new opportunities for our team members. This move is a good example of that. Suzie has been an invaluable member of the BAM team for more than seventeen years. During that time, she has been a "jack of all trades": fulfilling client needs, performing administrative tasks, acting as our in-house IT department, among other things. Yiorgos, who joined us last fall, has helped us automate many tasks and has taken on some of Suzie's former responsibilities as well as supporting us in research, trading, and other services. We plan to add an administrative position to our team in the coming months which will allow Suzie to focus even more of her time on what we see as her greatest strength: providing excellent service to our clients. Please join us in congratulating her!

### Administrative Items

We now offer a financial planning service and a new online document/information storage system. We can work with you to build a financial plan with the help of a program called MoneyGuidePro. We have found this to be a very effective tool in helping clients get a better understanding of where they are on their path to financial security.

Everplans is a very user-friendly and intuitive secure online system for storing personal information and financial data and documents. You can store information on subjects such as your home and pets, emergency contacts, and funeral preferences. You can also upload documents including insurance policies and estate plans. Once you have established a plan you can "deputize" specific people to have access to selected areas of it. For example, you could give access to certain areas to the executor of your estate and give access to other areas to your children. Please click on this link here to watch a video about Everplans.

Access your Pershing account by using the NetXInvestors website or better yet, download the app. This website and app will provide you with your account daily activity. If you need assistance, please contact our office.

As always, we welcome your comments and questions. Please don't hesitate to call, visit or email at any time.

*Scott, Brett, & Dave*