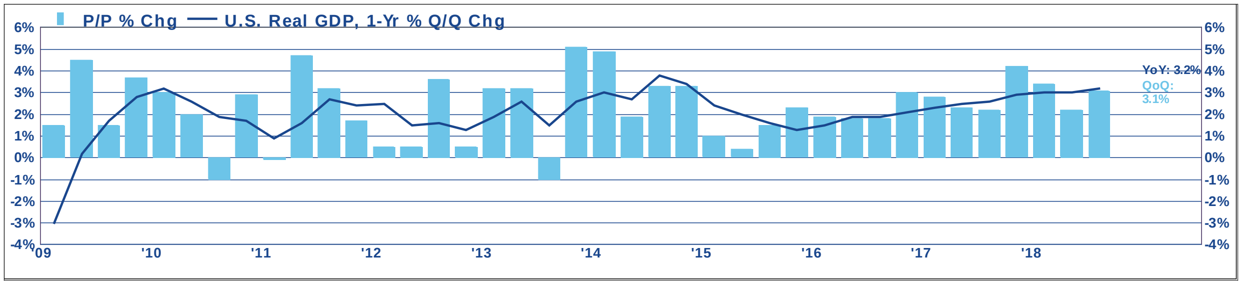
WEST SHORE BANK

Ten years ago, coming out of the depths of the Great Recession when millions of people experienced severe financial hardships, would you have believed the economy was starting its longest economic expansion in history? Most likely not. Well, with the close of second-quarter 2019, the U.S. economy is now embarking on its 121st month of growth marking the longest economic expansion in history and surpassing the previous record of 120 months from March 1991 to March 2001.

Chart 1 – U.S. Real GDP



When compared to previous post-World War II expansions, the annual growth pace of this 10-year expansion has been sub-par averaging just 2.3% vs. the historical average of 4.3%. Although the rate of economic growth has increased over the past year, there has been rising angst about the sustainability of this economic expansion driven particularly by tariffs and Federal Reserve monetary policy. Since October 2018, these two primary influences have been swaying investor sentiment and market direction.

Stock markets ended last year under tremendous pressure as investors feared monetary policy was becoming too tight and could begin to restrain growth. Additionally, escalating tariff rhetoric and uncertainty surrounding the economic impact of imposed tariffs also weighed heavily on investors. These concerns subsided the first four months of 2019 and stock markets sharply rallied as the Federal Reserve started to pivot away from their hawkish monetary policy stance, trade negotiations with China appeared to be progressing positively, and U.S. economic data trends, while mixed, remained positive.

All seemed to be going well, until Sunday May 5th, when President Trump sent a tweet disclosing that trade talks with China had basically collapsed and the administration would be raising the tariff rate on $200 billion of Chinese goods from 10% to 25%. Also, the administration would be giving serious consideration to imposing tariffs on an additional $300 billion worth of Chinese products basically levying tariffs on all Chinese imports. As expected, China retaliated by raising tariffs on $60 billion worth of U.S. goods.

These negative trade developments rocked investor sentiment, greatly heightened investor uncertainty, increased volatility and resulted in steep stock market declines for the month of May. It also sent investors flocking to the safety of treasury bonds, sent treasury yields to multi-year lows, and further inverted the yield curve.

Markets began advancing again in early June when Federal Reserve Chair Powell, who was giving a speech, signaled in his opening remarks that the Fed was monitoring trade developments and ready to respond to any adverse effects in order to sustain economic growth. Markets then pushed higher after the June 19th FOMC meeting when it became evident the Fed was becoming more concerned about the economy, and there was increasing willingness for a rate cut as eight policymakers lowered their target rate forecast for 2019 seven of which reflected a half-point cut by year end.

As quickly as stock markets unraveled in May, they posted strong returns in June, and finished the quarter moderately higher. According to a CNBC article, the Dow had its best June return since 1938 and the S&P 500 had its best first half of the year since 1997. The S&P 500 also set new closing highs in the quarter. Bonds also posted strong returns during the quarter as yields fell across the curve on growth concerns and lower than expected inflation. Expectations for multiple rate cuts are now priced into the stock market.

Table 1 - Index Total Returns – as of June 28, 2019

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	7.51	3.87	21.33	7.78	19.56	13.97	17.19
S&P 500	7.05	4.30	18.54	10.42	14.19	10.71	14.70
S&P 400	7.64	3.05	17.97	1.36	10.90	8.02	14.64
Russell 2000	7.07	2.10	16.98	-3.31	12.30	7.06	13.45
Dow Jones Industrial	7.31	3.21	15.40	12.20	16.80	12.29	15.03
MSCI Developed	5.93	3.68	14.03	1.08	9.11	2.25	6.90
MSCI Emerging	6.24	0.61	10.58	1.21	10.66	2.49	5.81
Fixed Income	**1-Month**	**3-Month**	**YTD**	**1-Year**	**3-Year**	**5-Year**	**10-Year**
Barclays High Yield	2.28	2.50	9.94	7.48	7.52	4.70	9.24
Barclays Aggregate	1.26	3.08	6.11	7.87	2.31	2.95	3.90
Barclays Municipal	0.37	2.14	5.09	6.71	2.55	3.64	4.72
Barclays Inter Gov't/Credit	1.07	2.59	4.97	6.93	1.99	2.39	3.24

So, in roughly a six-month span, the Fed's 2019 monetary policy stance went from raising rates, to holding rates steady, to lowering rates. For bond market professionals and a humble local bank president, this rapid change in policy was not totally unanticipated.

Since fourth-quarter 2018, the CME Group FedWatch Tool, which gauges the fed fund futures probability of Federal Reserve target rate moves, was already showing the increasing likelihood of a rate cut(s) happening later in 2019. After the May trade talk setback, this likelihood accelerated up to July. The chart below shows the current probability of a quarter-point rate cut in July stands at 92.0%, a 62.3% chance of an additional quarter-point rate cut in September, and roughly a 36% chance of a third quarter-point rate cut late this year or early next year.

Chart 2 – CME Group FedWatch Tool – as of July 5, 2019

FED FUND FUTURES

ZQN9	ZQQ9	ZQU9	ZQV9	ZQX9	ZQZ9	ZQF0	ZQG0	ZQH0	ZQJ0	ZQK0	ZQM0	ZQN0
97.6063	97.8675	97.9375	98.0525	98.1275	98.2000	98.2475	98.3075	98.3325	98.3675	98.4025	98.4325	98.4525

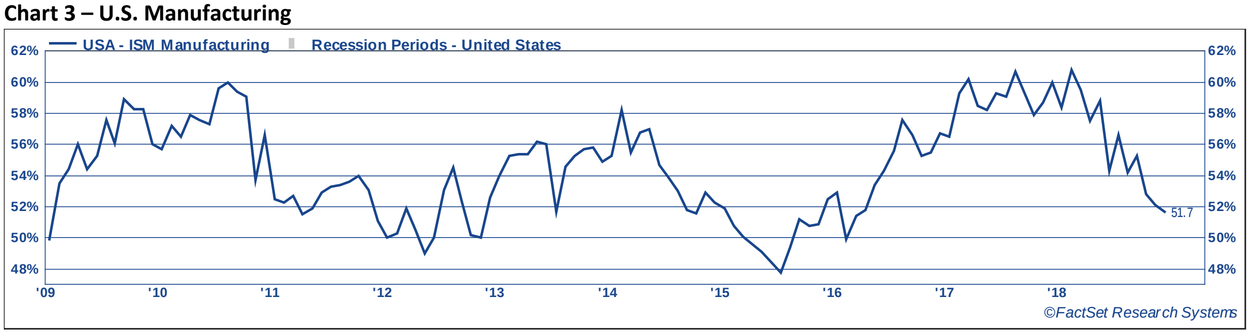
MEETING PROBABILITIES

MEETING DATE	0-25	25-50	50-75	75-100	100-125	125-150	150-175	175-200	200-225	225-250	250-275	275-300	300-325	325-350	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550
7/31/2019								8.0%	92.0%	0.0%	0.0%	0.0%										
9/18/2019						0.0%	5.2%	62.3%	32.6%	0.0%	0.0%	0.0%	0.0%	0.0%								
10/30/2019				0.0%	0.0%	1.7%	23.5%	52.8%	22.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%						
12/11/2019		0.0%	0.0%	0.0%	0.7%	11.0%	36.0%	39.6%	12.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%				
1/29/2020	0.0%	0.0%	0.0%	0.2%	3.4%	17.6%	37.0%	32.5%	9.3%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%		
3/18/2020	0.0%	0.0%	0.0%	0.9%	6.6%	21.9%	36.0%	27.3%	7.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
4/29/2020	0.0%	0.0%	0.2%	1.8%	8.9%	24.0%	34.7%	24.3%	6.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

Two projected rate cuts this year, and possibly three by early next year. Really? The U.S. economy just posted a much higher than expected 3.1% growth rate in 1Q19, the labor market remains quite strong and consumer household wealth and spending are in good shape. So why all the worry? In a nutshell, because of mixed economic data and tariff related uncertainty.

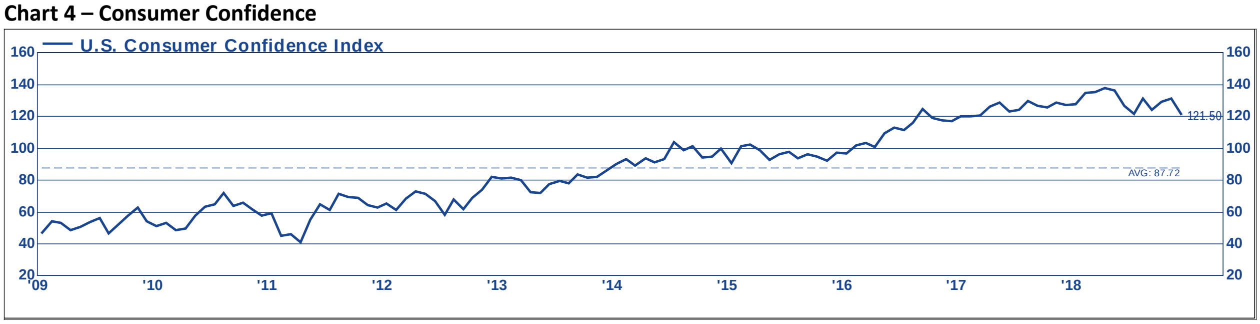
Economic data has been mixed on many fronts. The labor market in May posted job gains of only 72,000, which was much weaker than the 180,000 expected. Global manufacturing is in contraction mode and U.S. manufacturing isn't far behind. In June, China, the Eurozone, and Japan all posted contractionary readings. The June ISM U.S. manufacturing survey posted an activity level of 51.7%, which is the lowest reading since September 2016, and many sub-component readings were below 50. Readings below 50 suggest contraction and vice versa. Many survey respondents cited that tariffs are increasing costs and disrupting supply chains.

Chart 3 – U.S. Manufacturing



Business and consumer confidence, which remains historically elevated, has waned of late on rising trade tensions and the fear is that it may continue to do so. Despite much lower mortgage rates and strong employment, new and existing home sales growth has been basically stagnant. This has resulted in rising inventories and a deceleration of home price gains. Although annual wage growth has ramped to +3.1%, inflation has fallen. Personal consumption expenditure prices fell from a 2.0% annual rate in October 2018 to 1.5% in May 2019. The Fed's inflation rate objective is 2.0%. Finally, the bond market is and has been signaling caution. Bond yields have fallen sharply, and the yield curve remains inverted which indicates an increasing likelihood of a recession. These and other factors have shifted some policymakers stance on rates, but the most pressing uncertainty is the potential fallout from trade developments.

Chart 4 – Consumer Confidence



In 2018, the U.S. imported $540 billion worth of goods from China which is only roughly 2.9% of the United States $18.9 trillion real GDP. So why all the fuss? It is simply because we are in uncharted tariff waters and there is much concern as to which economic course the winds will blow, namely: great uncertainty related to the potential effects of tariffs including disruptions in global supply chains; shortage of some goods and supplies for production and consumption; cost and risks of moving production facilities; higher prices paid by consumers and businesses; lower margins and earnings; negative impact on consumer and business confidence and reluctance to invest due to all of the associated uncertainty. Ultimately, the longer tariffs persist, it increases the likelihood they could lead to a slowdown in economic and earnings growth.

The key questions for the markets going forward are the number of Fed rate cuts and whether corporate earnings growth will rebound. It appears a July rate cut is basically locked in. The Fed is currently in a kind of quandary as roughly half of the policymakers favor rate cuts while the other half prefer holding rates steady. If economic data in the next couple of months firms or improves, the likelihood of additional rate cuts is much less compelling. The Fed has been trying to normalize rates for the past few years and would likely prefer to keep as much dry powder available to use in the event of an actual recession as opposed to trying to sustain an economy they forecast to grow 2.1% this year.

There is high correlation between earnings growth and market performance although often one may lead while the other lags. Presently, the market is leading while earnings growth is lagging. It is possible the S&P 500 Index may post its first earnings recession since the first half of 2016. Earnings in 1Q19 declined -0.3% y/y and current estimates call for a -2.6% decline in 2Q19. It is important to note that 2019 quarterly earnings are being compared to very strong 2018 growth rates. For full-year 2019 and 2020, respectively, earnings are forecasted to grow 2.6% and 10.9%. Operating margins in the S&P 500 Index have held steady, which is consistent with recent productivity gains, but will be closely watched for signs of deterioration as they typically decline prior to meaningful earnings declines.

Equity markets have posted very strong gains so far this year propelled by changes in Fed policy position, optimism on U.S. and China trade talks, and continued favorable albeit softening economic conditions. Countering the stock market euphoria is the bond market. Treasury yields have plummeted, the yield curve has further inverted, and the bond market is signaling economic weakness and continued low inflation. The missing piece is earnings growth, and given current stretched valuations, hopefully it does emerge.

The significant market swings of the past nine months provide an excellent example of why it is vitally important to have a disciplined investment approach and a well thought out asset allocation. Whether to the upside or downside, market movements appear to be accelerating in much shorter time frames than in the past, thus making it even much more difficult and costly to time the market. As we have often written, we strongly believe that time in the market greatly outweighs timing the market.

Prepared by Perry Adams – Investment Director – West Shore Bank Wealth Management

Sources: FactSet, Federal Reserve, National Bureau of Economic Research, FASH455, CNBC, CME Group, U.S. Dept. of Labor, U.S. Census Bureau, U.S. Dept. of Commerce, Institute for Supply Management, and The Conference Board