



A&I FINANCIAL SERVICES LLC
Optimizing Assets and Income

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Second Quarter 2019 Key Takeaways

The first half of 2019 saw robust gains across most asset classes, but it certainly wasn't a smooth ride. Global stock markets got a jump start on the year thanks to progress in US-China trade negotiations and a newly "patient" Fed, but an abrupt breakdown in the trade talks (announced via Presidential tweet) spurred a sharp market sell-off in May. Stock markets subsequently shook off their swoon in June, rebounding on expectations of Fed rate cuts later in the year and (tentative) signs of re-engagement on the US-China trade front.

The S&P 500 hit a new high near the end of June. Large-cap U.S. stocks shot up 7.0% for the month – their best June since 1955. They were up 4.3% for the second quarter, and a remarkable 18.5% for the first six months of the year – their best first half since 1997 (1).

Foreign stocks also notched double-digit gains through the first half of the year. Developed international stocks gained 5.9% in June, 3.2% for the second quarter, and 14.2% for the year to date. European stocks have done a bit better, gaining 15.6% on the year so far. In April, the "Brexit can" was kicked down the road at least until October 31, but the risk of a disruptive "no-deal" exit remains. Emerging-market stocks also rebounded in June, gaining 5.4%. Although emerging-market stocks were only up 0.8% for the second quarter, their first-half gains stand at 12.6% (1).

Moving on to the fixed-income markets, the 10-year Treasury yield continued to plunge from its multi-year high of 3.2% last October, dipping below 2% following the Federal Reserve's June meeting. This was a near three-year low, and among its lowest levels ever. The 10-year yield ended the month at 2.0%. Bond prices rise as yields fall, driving the core bond index to a 3.0% gain for the quarter and a 6.1% return so far this year. Floating-rate loans gained 1.7% for the quarter and are up 5.7% for the year (1).

Looking ahead, we still see a high degree of uncertainty and a wide range of plausible outcomes looking out over the next 12 months (and beyond). But *at the margin* we think the macro risks have increased. Trade uncertainty has damaged global business confidence in what by many measures is an already weak global economy. While this is for now being offset by easier monetary conditions, the inevitable impact of any additional central bank rate easing is certainly muted.

We believe our portfolios are positioned to both generate potentially attractive returns over the next five to 10 years, and to be resilient across this wide range of potential shorter-term risk scenarios. If central banks are successful with their renewed stimulus efforts, we believe that will favor our positions in global equities, flexible income funds, and floating-rate loan funds.

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On the other hand, if markets turn south, our portfolios will potentially benefit from our “ballast” positions in core bonds, lower-risk hybrid and alternative strategies, and trend-following managed futures. These lower-risk, “insurance” positions have been a drag on our returns over the past several years as U.S. stocks have been in a record-long bull market. We’ve seen their benefits during the occasional market corrections, including in last year’s fourth quarter

Market and Portfolio Recap

In our year-end 2018 commentary, we emphasized the wide range of plausible macroeconomic scenarios and financial market outcomes for the year ahead with the potential for either a positive or negative shorter-term path. Through the first half of 2019 we’ve gotten a little bit of everything—signs of *both* scenarios, though so far the ups have outpaced the downs.

The first half of 2019 saw robust gains across nearly every asset class—including both core bonds *and* equities—but it certainly wasn’t a smooth ride. Among the primary drivers of the market sell-offs and their subsequent rebounds were on-again/off-again U.S.-China trade negotiations and *two* major shifts in central bank policy. Large-cap U.S. stocks gained 4.3% for the second quarter, and a remarkable 18.5% for the first six months of the year—largely earning back what was lost in the fourth quarter of 2018. Developed international stocks also experienced a healthy rebound from 2018’s losses, up 3.2% for the second quarter, and 14.2% for the year to date. European stocks have done a bit better, gaining 15.6% on the year so far (2).

| June Benchmark Returns | | | |
|---|------|-------|-------|
| | MTD | QTD | YTD |
| EQUITY BENCHMARKS | | | |
| Vanguard 500 Index | 7.0% | 4.3% | 18.5% |
| iShares Russell 1000 ETF | 6.9% | 4.0% | 18.5% |
| iShares Russell 1000 Value ETF | 7.0% | 3.6% | 15.8% |
| iShares Russell 1000 Growth ETF | 6.5% | 4.2% | 20.9% |
| iShares Russell 2000 ETF | 7.0% | 1.9% | 16.9% |
| Vanguard REIT | 1.7% | 1.7% | 19.2% |
| iShares MSCI ACWI ETF | 6.5% | 3.5% | 16.3% |
| Vanguard FTSE Developed Markets ETF | 5.9% | 3.2% | 14.2% |
| Vanguard FTSE Europe ETF | 6.4% | 4.3% | 15.6% |
| Vanguard FTSE Emerging Markets ETF | 5.4% | 0.8% | 12.6% |
| FIXED-INCOME BENCHMARKS | | | |
| Vanguard Total Bond Market Index | 1.2% | 3.1% | 6.1% |
| Vanguard Intermediate-Term Tax-Exempt | 0.4% | 2.0% | 4.7% |
| iShares TIPS Bond ETF | 0.8% | 2.7% | 6.1% |
| ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index | 2.5% | 2.6% | 10.2% |
| S&P/LSTA Leveraged Loan Index | 0.2% | 1.7% | 5.7% |
| ALTERNATIVE BENCHMARKS | | | |
| HFRX Global Hedge Fund Index | 1.6% | 1.6% | 4.2% |
| Bloomberg Commodity Index | 2.7% | -1.2% | 5.1% |
| SG Trend Index | 2.7% | 4.4% | 7.4% |
| 3-Month LIBOR | 0.2% | 0.7% | 1.4% |

Source: Morningstar Data as of 6/30/2019.

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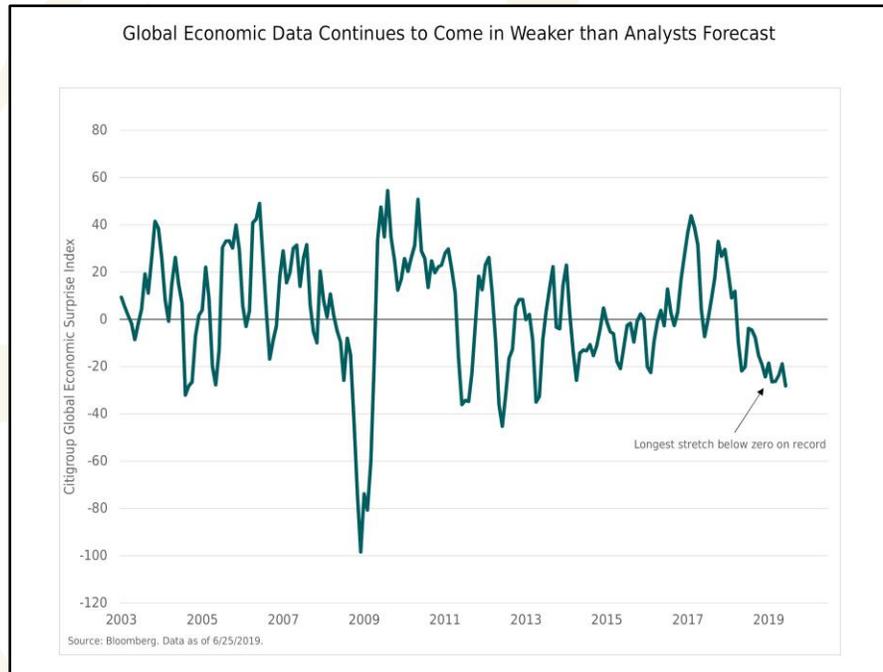
Market and Portfolio Outlook

The risk of a geopolitical shock on financial markets is also ever-present. There are many potential geopolitical flashpoints and unknowns: Brexit remains unresolved. The tug of war between democracy, populism, nationalism, and autocracy continues around the globe. The U.S. presidential election next year will likely create additional market uncertainty. China's rise and challenge of the United States as a global superpower goes well beyond just the current trade conflict. The Middle East (beyond Iran) remains a potential flashpoint, as does North Korea.

To what extent stock markets are already pricing in these fears and risks is also an unknown. On the heels of yet another strong quarter for U.S. stocks, their valuations are looking more stretched than ever. Our analysis of U.S. stock market valuations and expected returns implies the market consensus is discounting an overly optimistic outlook. And it can certainly be said that any investors chasing stocks higher simply because of the tailwind of more monetary stimulus face potential dangers. Our analysis—informed by history and applying forward-looking judgment—leads us to a base-case scenario where the expected annualized return from U.S. stocks over the next 5 to 10 years is below the expected return we require to compensate for the full risk of owning stocks (3). As such, we remain underweight to U.S. stocks across our portfolios until the risk/reward trade-off improves.

On the other hand, we continue to have modestly overweight positions to European and emerging-market stocks. Our analysis indicates their valuations are attractive relative to the U.S.

Over the shorter-term, if the global economy starts recovering from current depressed levels—with China's fiscal and monetary stimulus being a key to that outcome—and the United States avoids recession, we would not be surprised to see strong absolute returns from stocks, with outperformance from foreign stocks versus U.S. stocks. Further, if the growth differential between the United States and the rest of the



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world narrows, the U.S. dollar may depreciate, providing an additional tailwind to foreign stock returns for dollar-based investors (4).

A solid global economy would also be beneficial for our flexible fixed-income and floating-rate loan investments relative to core investment-grade bonds, which have much lower yields and would be hurt by rising interest rates.

On the other hand, if the global economy continues to weaken and the United States falls into a recession and bear market, our balanced (stock/bond) portfolios have “ballast” in the form of core bonds as well as lower-risk fixed income and alternative strategies that should hold up much better than stocks on the downside.

In Closing

As we experienced this past quarter, uncertainty is a constant presence and volatility can return to markets at the drop of a pin (or a tweet, it seems, these days). Regardless of our tactical diversification efforts, those of us who own stocks need to be prepared to ride through the inevitable down periods. It’s the shorter-term price we pay to potentially earn their higher expected returns over the longer term.

This has been an unusually long U.S. economic and market cycle. We firmly believe it is still a cycle, and that our patience and fundamental valuation discipline will be well-rewarded as it turns again. As always, we appreciate your continued confidence and trust, and we work hard every day to continue to earn it.

—A&I Investment Policy Committee, July 22, 2019

Sources

1. Yahoo Finance. Data as of 6/30/2019
2. Morningstar. Data as of 6/30/2019
3. Litman Gregory projections under base-case economic scenario. Measured by the S&P 500 and Barclays Capital US Aggregate Bond Index. Data as of 6/30/2019
4. Bloomberg. Data as of 6/25/2019

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