MARKET Insights

Webster Private Bank®

July 2019

Mid-Year Update: The Wall of Worry

As we cross the midyear point, it's time to review the investment themes that we laid out at the beginning of 2019. The old saying ***"The market climbs a wall of worry"*** is especially meaningful at the moment, as investors are faced with many conflicting economic & geopolitical signals ranging from tariff wars with China to an escalation of tensions with Iran.

After the best first quarter in over 20 years, the second quarter saw greater volatility, as the S&P 500 declined **-6.35%** in May, only to rebound **7.05%** in June and end Q2 with a **4.30%** return.

"US large cap stocks are leading as of the end of June"

As the chart below shows, US large cap stocks are leading as of the end of June, and US markets continue to outperform international developed and emerging markets year-to-date. The US Bond market, as measured by the Barclays Aggregate Bond Index, is up **6.1%**, with the 10-year Treasury dropping from **2.69%** at year end to **2.00%** at the end of June. The 10-year Treasury was as high as **3.23%** on November 8, 2018. US High Yield gained **9.9%** in the first half, with TIPS up **6.15%** on a year-to-date basis.

Asset Class	Category	Index	YTD 2019
Equity	US Large Cap	S&P 500	18.5
	US Small Cap	Russell 2000	17
	International Developed	MSCI EAFE	14.5
	Emerging Markets	MSCI EM	10.8
Fixed Income	US Investment Grade	Barclays US Agg	6.1
	US Inflation-Indexed	Barclays US TIPS	6.2
	US High Yield	Barclays US Corp High Yield	9.9
	EM US$ Debt	JPM EMBI Global	12
Alternatives	Absolute Return	Credit Suisse Equity Mkt Neutral	1.8
Cash	US T-Bill 90 day	US T-Bill 90 Day	1.2

Source: FactSet Indexes, total returns in USD as of June 30, 2019. US Large Cap is S&P 500 index, US Small Cap is Russell 200 index, Intl Developed is MSCI EAFE index, Emerging Markets is MSCI EM index, Investment Grade is Barclays US Aggregate index, High Yield is Barclays Corporate US High Yield index, Absolute Return is Credit Suisse Equity Market Neutral index (through May 31, 2019), Commodities is S&P GSCI index, REITs is MSCI US REIT Diversified index.

For US large cap sectors, information technology and consumer discretionary led the pack while energy and health care brought up the rear. Growth stocks continued to outpace value in 2019, with growth and value returning **21.5%** and **16.2%** as measured by the Russell 1000 growth and value indices.

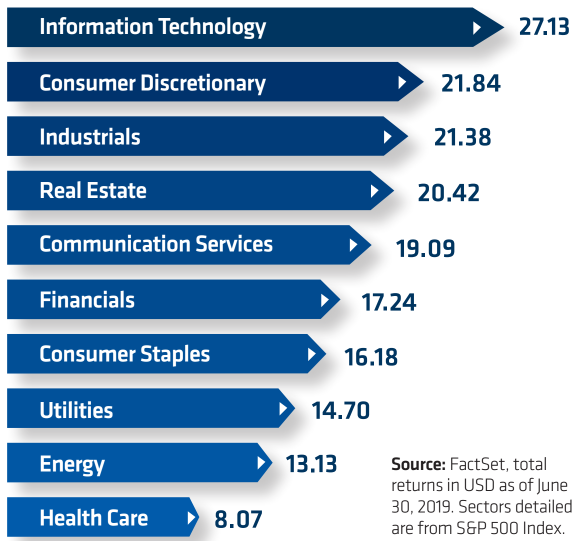
Overall, we have experienced solid, broad-based performance thus far in 2019, but where do we go from here? To help answer that, we review our progress on the themes we laid out at the beginning of 2019:

THEME 1: *The Path of Interest Rates Is Changing*

At the start of the year, the general expectation was that the Fed would continue raising interest rates. We laid out two possible scenarios for the bond market: long rates would rise due to accelerating growth, inflation and treasury issuance to pay for last year's tax cut, or short rates would decline as the Fed cut the overnight rate in the face of a slowing economy, increasing unemployment, and a decline in inflation. As improbable as a rate cut seemed in January, the path of rates has changed dramatically, with the probability of at least a 25 basis point cut at the July Fed meeting approaching **100%** (76% for 25bps, 24% for 50 bps).

Fed Chairman Jerome Powell recently stated, "The case for somewhat more accommodative policy has strengthened," while also indicating that the economic expansion, strong labor market conditions, and the Fed's **2%** inflation target were all on track. Causing the mixed messaging could be concern among Fed officials with the softening economic data coming in as of late. The Fed could also be bending to pressure from the executive branch for "insurance" in the event of a further ratcheting up of trade tensions between the US and China. The effectiveness of such cuts over the longer term is unclear at present and would diminish the Fed's toolkit in the future should a recession take hold.

YTD Total Return Change - Top/Bottom 5



Source: FactSet, total returns in USD as of June 30, 2019. Sectors detailed are from S&P 500 Index.

THEME 2: *Volatility Is Here To Stay*

After the S&P 500 posted its best start to a year since 1998, the second quarter saw volatility increase. Q2 saw a **4.05%** return in April, followed by a **6.35%** drop in May, and a **7.05%** move back up in June. This type of volatility is likely to continue going forward as the laundry list of potential issues for investors to worry about continues to grow.

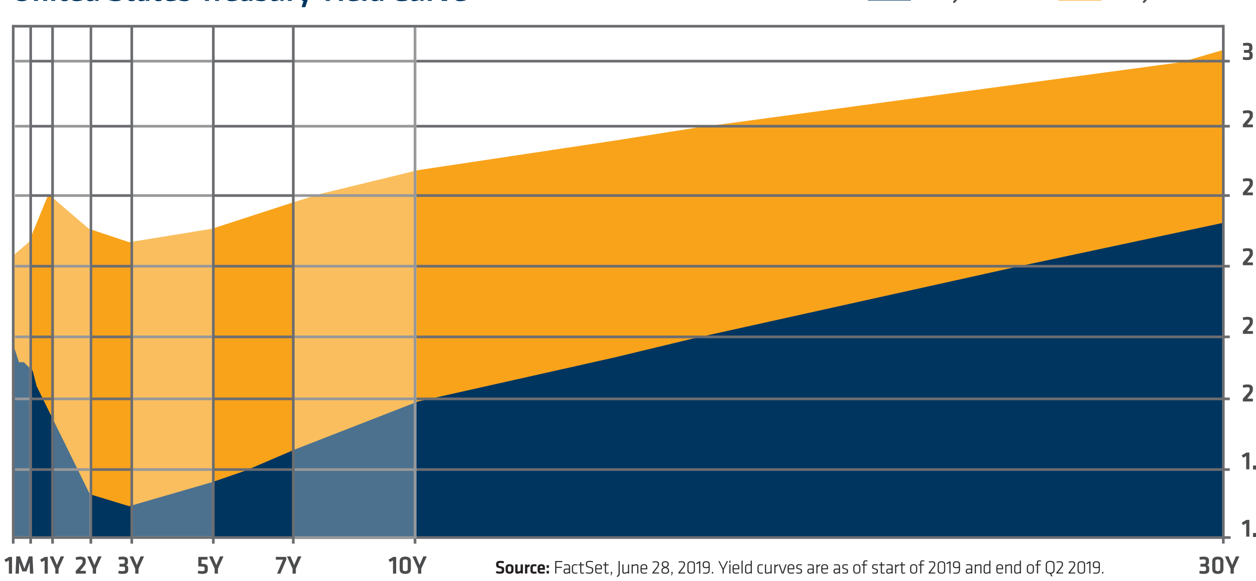
Concerns for global investors include trade talks between the US & China which continue haltingly, tensions between the US and Iran ratcheting up and slowing global growth especially in Europe and Asia. All of these concerns are likely to keep volatility elevated going forward. With that said we believe staying the course in the face of this volatility is the best course of action for investors, albeit in a modestly more defensive posture. As a result we are inclined to remain focused on US assets versus Foreign due to the relative strength of the US economy versus foreign economies and the United States historical track record of generating lower levels of volatility.

THEME 3: *Earnings Growth Becomes More Difficult*

Earnings growth has indeed been more difficult as compared to the blistering **20%+** growth seen in 2018. Initial 2019 estimates called for a first quarter decline of **-5%** at the end of March. Actual results were far better with S&P 500 companies in aggregate only seeing a **-0.5%** drop in profits on a year-over-year basis. For the second quarter, Wall Street analysts currently expect a **-2.6%** earnings decline year-over-year. If that decline were to come to fruition it would mark the first time the index has reported two straight quarters of year-over-year earnings declines since Q1 & Q2 of 2016.

While the earnings picture is not as robust as it was last year it does not necessarily mean weak returns will be seen from markets going forward. In our last Market Insights piece, we noted that earnings and stock prices are not perfectly correlated in the short-term. Our example was the earnings decline of **-3.2%** in Q2 2016 being followed by a return of **+17.9%** over the next twelve months. In the face of poor expectations, modest upside surprises have historically rewarded patient investors who have stayed the course. We feel this time should be no different.

United States Treasury Yield Curve



Source: FactSet, June 28, 2019. Yield curves are as of start of 2019 and end of Q2 2019.

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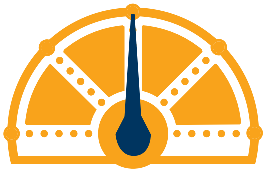
Conclusion: Current Positioning

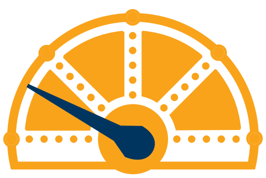
EQUITIES



Neutral Weight

Our positioning over the last three months has not changed dramatically. We continue to prudently rebalance client accounts, trimming back equity allocations when they exceed their long-term targets for each investment objective. We remain modestly overweight US versus International equities. Our US exposure is predominately invested in large cap equities complemented with a modest allocation to fast growing, but more volatile small capitalization stocks.

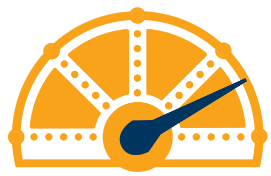
FIXED INCOME



Underweight

In the bond portion of portfolios, we remain underweight relative to long-term targets. We had previously shortened duration, so the move from **3.23%** in November 2018 to **2%** on the 10-year Treasury has been surprising to us. We feel that the downside move in long-term yields is overdone and that there is too much risk with too little reward to invest in the long end of the yield curve. We feel the most likely direction for longer bond rates is higher over the coming quarters and as a result are allocating to corporate and securitized bonds with shorter maturities in the lower tiers of investment grade paper. For taxable investors, the municipal yield curve is still positively sloped (you get paid more for extending maturities) so we remain allocated to intermediate maturities.

ALTERNATIVES



Overweight

Lastly, we like liquid alternatives due to their ability to hold their value in either a stock market rout or bond market sell off. As a result we have been moving client portfolio's towards an overweight positioning relative to long term targets.

We welcome your comments, insights and concerns. Please contact your Webster Private Bank Portfolio Manager at any time for a discussion about your personal investment portfolio.

TO VIEW A MORE DETAILED DESCRIPTION AND ANALYSIS OF THESE INSIGHTS, VISIT WEBSTERBANK.COM/PB

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