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Portfolio Comments
For the Quarter Ending June 30, 2019

The past quarter might be characterized as one of high-water marks, both literally and figuratively. While the Arkansas River breached record levels in places due to prolonged heavy rainfall, affecting many of us or our neighbors, so too did the S&P 500, a major U.S. stock index, breach its previous high. In extending this parallel between the weather and the markets, an oft-cited piece of advice comes to mind: "Never make forecasts, especially about the future." The markets continue to be volatile, and we know better than to predict their next direction, but we are in the happy position of reporting at the time of an upswing.

The S&P 500 closed on June 28th at 2,942, representing a return of 4.31% for the second quarter, and 18.54% for the first six months of 2019. The Dow Jones Industrial Average (DJIA) ended June at 26,600 for a return of 3.20% in the past three months and 15.38% for the year to date. The S&P 500 registered a record closing high of 2,954 on June 20th, and the DJIA came close, but it was not a straight climb. Both indices fell close to six percent between the beginning of May and the start of June, but avoided repeating the correction experienced at the end of last year.

The same themes continue to dominate headlines and stir an atmosphere of unrest. Trading relationships with major partners, notably China, but also Mexico more recently, continue to be tense with threats of new or higher tariffs. The economic recovery hasn't faltered per se, but there isn't much of a boom sentiment either amid evidence that investors are exercising caution. Economic and military tensions in the Middle East have escalated of late, rallying oil prices from their downward trend for the quarter, and raising the question of whether events are escalating towards another war in the region. Britain's leadership race is in its final stages and a 'no deal Brexit' is not out of the question. Meanwhile an army of Democratic candidates, or so it seems, is gearing up for the opportunity to replace our President in 2020.

The Federal Reserve announced after its June meeting that it is holding the short-term benchmark rate steady in a range between 2.25% - 2.50%. At the same time, some Fed officials foresee that a weakening in economic outlook, arguably tied to the current administration's trade policies, could justify lowering rates before the end of the year. President Trump, who has become increasingly vocal in his dissatisfaction with the Central Bank's interest rate stances, expressed in a Tweet: "Now they stick, like a stubborn child, when we need rate cuts, & easing, to make up for what other countries are doing against us. Blew it!" Things got decidedly personal when Mr. Trump flat-out said Fed Chair Jerome Powell was "not doing a good job" and that "we should have Draghi instead of our Fed person." The Mr. Draghi in question is the President of the European Central Bank, who isn't afraid of negative interest rates as the region faces its own prolonged economic slowdown and an inflation rate below goal.

"Blew it!" seems a bit harsh given that the U.S. is experiencing the longest economic expansion on record – ten years and counting – and the official unemployment rate is at its lowest level in almost 50 years, while inflation is close to the Central Bank's target of 2%. By slowly stepping up rates away from zero, and shrinking its balance sheet, the Federal Reserve has at least bought itself some policy maneuver room for the next downturn that many seem to be bracing for. Even Mr. Powell conceded in remarks that many Fed officials "judge that the case for somewhat more accommodative policy has strengthened," although cautioned against intervening based on single data points or short-term sentiment. He has pointed out that Congress chose to insulate the Fed from short-term political pressures through protecting its independence.

Investment sentiment, it appears, is skewing towards the cautious although not so fearful, as evidenced by recent market highs, to eschew equity investment in general. After all, 10-year Treasury yields dipped below 2% at the end of June, skirting two-and-a half year lows, and further diminishing the appeal of bonds. Rather, there has been a recent shift in demand towards traditionally defensive sectors, in contrast to the price surge in recent years of the big-name technology darlings. A recent Wall Street Journal article highlighted the fact that from the S&P 500's closing high at the end of April to the index high in the last week of June, "four of the five sectors to beat the wider market were defensive: real estate, utilities, health care and consumer staples." The piece went on to say that large capitalization stocks with more solid balance sheets and earnings are faring better than their more leveraged or speculative counterparts.

Business stakeholders and consumers alike stand to be affected by the magnitude and duration of the current administration's ongoing trade war with China. As we headed to the end of the month, President Trump was scheduled to meet with Chinese President Xi Jinping at the G20 (or Group of 20) international economic summit in Osaka, Japan. Mr. Trump was not ruling out a deal, if China made enough palatable concessions on its side, but the U.S. leader also stated he stood prepared to impose tariffs on a further $300 billion of Chinese products, in addition to the 25 percent levy already placed on Chinese imports of $250 billion.

As a separate retaliatory measure, purportedly aimed at helping to protect domestic intellectual property, the United States had sought to limit certain prominent Chinese technology companies' access to American components. Beijing fought back with its own higher tariffs on U.S. goods and talked of compiling a blacklist of American companies deemed "unreliable" to do business with. With stocks markets rising and dipping in response to leaders' remarks on the likelihood of a deal, and the Federal Reserve explicitly citing the trade tensions as a factor in their interest rate policy, incentives were high to reach a resolution to restore some stability.

As it turned out at their meeting, President Trump agreed to lift some restrictions surrounding Chinese technology companies doing business with American companies and postpone the threatened additional tariffs. For his part, President Xi agreed China would buy more U.S. agricultural products. Details are to be worked out. In an eventful weekend, Mr. Trump went on to become first sitting U.S. president to step across the boundary dividing North and South Korea following a last-minute organized meeting with North Korean leader Kim Jong Un resulting in a commitment to restart talks.

Mexico, the number one trading partner of the United States, managed to avert the carrying out of the threat of American tariffs in an unusual measure that would have tied trade to immigration control at the countries' shared border. President Trump issued the tariff warning in conjunction with his discontent over our neighbor's measure to stem the flow of migrants from Central America. To avoid the economic punitive measures, Mexico agreed to deploy 6,000 troops to our Southern border, leading Mr. Trump to back down, for now. The Mexican economy is already fragile, having contracted in the first quarter of 2019, and the 5 per cent tariffs would have hit very hard, especially at a time the United States-Mexico-Canada Agreement, or U.S.M.C.A., is mired down in its path through Congress. Even the mention of tariffs was enough for two of three credit agencies to downgrade Mexico's sovereign debt on June 5th.

Strained foreign relations have also reigned in the Middle East, in the form of escalating tensions with Iran. In May 2018, President Trump announced the United States' withdrawal from the Joint Comprehensive Plan of Action (JCPOA), commonly known as the Iran Nuclear Deal. The JCPOA was achieved between Iran and the P5+1 world powers (the five permanent members of the United Nations Security Council - China, France, Russia, United Kingdom, and United States - plus Germany), as well as the European Union. Against the backdrop of concerns over Iran's capabilities of developing a nuclear weapon, under the accord, Iran agreed to limit its nuclear activities and allow international inspections in return for the lifting of economic sanctions. Specifically, Iran was able to resume selling oil on international markets and using the global financial system for trade, and gained access to more than $100 billion in assets frozen overseas.

Before pulling out, Mr. Trump expressed dissatisfaction with certain terms of the deal and was not convinced that Iran was living up to the spirit of it, nor that Iran could ever be considered an ally when it came to U.S. interests in the Middle East. Subsequently, in November 2018, President Trump reinstated sanctions targeting Iran and its trading partners. Iran's economy and currency has suffered and inflation has quadrupled in the country. JCPOA signatories Germany and France and the UK, openly opposed the sanctions, on the basis of Iran passing required inspections, and have tried to facilitate trading mechanisms for Iran to circumvent U.S. measures. However, Tehran is losing patience with keeping up what it now sees as a one-sided deal, and President Hassan Rouhani has threatened to stop abiding by certain elements of the accord at the end of a 60-day period ending in early July. U.S. sanctions, meanwhile, continue to ratchet up with calls for American allies and trading partners to act in solidarity, or at least to act in their own best commercial interests and side with the U.S.

Further putting all sides on high alert, Iran admitted to downing a U.S. unmanned drone that it claimed entered its air space in the second half of June, which prompted the planning of an American retaliatory strike that Mr. Trump said he quashed at the final moment to avert loss of Iranian lives. A spate of attacks on oil tankers in the region, with no country or faction claiming responsibility, but with the U.S. blaming Iran, have added to the unrest. Hopefully the current impasse can be overcome by diplomatic means, as the cost of military interventions could be extraordinarily high on many levels.

The mere threat of conflict introduces a geopolitical risk premium in the price of oil, compounding the supply restriction resulting from embargos on Iranian oil. Immediately following the downing of the U.S. drone, the price of oil jumped over 5 percent, with West Texas Intermediate Crude now close to $60 / barrel, although still well shy of the $76 / barrel 12-month high of last October.

Over in Europe, the run-off to replace Theresa May as the leader of the Conservative Party in the U.K, and hence the current British Prime Minister, has been narrowed down to two candidates: the oft-ebullient Boris Johnson and his more restrained opponent Jeremy Hunt. Mr. Johnson, the current frontrunner and former Mayor of London and Foreign Secretary, is adopting a particularly hardline stance on Brexit, outlining a series of new proposals (all of which have been roundly rejected previously by the European Union) and stating his resolve to leave "do or die, come what may" on October 31st. The leadership decision will be concluded by July 23rd.

Back at home, candidacy runs are already in full swing with the most crowded Democratic field in history, with over two dozen contenders, entering the first debates. Polling front runner is former Vice President Joe Biden, who hopes the third time's a charm in his White House bid despite some early campaign stumbles. Prominent rivals include self-described democratic socialist Bernie Sanders in his second Presidential bid, and Massachusetts Senator Elizabeth Warren. The party appears divided along ideological lines concerning how centrist or progressive a candidate they aim to field against the Republicans in 2020. Immigration, healthcare, social security, student debt and tax policies are major talking points.

So, where are we heading next? Back to not making predictions about the future is the only sure thing we can say. We do know that U.S. economic growth remained at a strong 3.1% annual rate in the first three months of the year, significantly up from the 2.2% rate in the fourth quarter of 2018, yet sentiment remains a little glum reflected in dampened consumer spending and signs of investor pessimism. The underlying culprit for this atmosphere is likely mixed signals from economic data and the catch-all of 'uncertainty'. History tells us a downturn is coming, but not when. For now, the median forecast from Fed officials for GDP growth in 2019 stands at 2.1%

We, however, remain optimistic that by sticking to our discipline of investing in securities we understand, at a price we believe is below their intrinsic value, that time will reward our consistency and patience. Going out on a limb, we anticipate some sunny weather over the next few months and wish you an enjoyable summer! As always, we thank you for your continued confidence in us as your trusted financial advisor.