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ASSET MANAGEMENT

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U.S. Financial Markets
June 2019

Stock Market Development

The S&P 500 Index corrected 6.3% in May as a reaction to anew flare-up of trade tensions with China, and ended up 10.47% year to date 05/31. The leading sectors were REITs (+17%) and Information Technology (+15.65%) followed by Communication Services (+13.50%), Consumer Discretionary (+12.42%) and Industrials (+11.55%). Healthcare was last with 0.58%.

Fixed-Income Market Developments

The bond market reacted positively to the Fed's more dovish tone, as U.S. Treasury yields fell and credit spreads tightened throughout the first quarter. The Bloomberg Barclays U.S. Aggregate Bond Index, a proxy for the U.S. investment-grade market, gained 2.9% during the quarter - a strong start after a seesawing 2018 in which the index ended the year roughly flat. The index's main sectors - agency mortgages, investment-grade corporates, and U.S. Treasuries - all experienced gains. Investment-grade corporate credit was the index's key driver for the period, returning 5.1%, while agency mortgages and U.S. Treasuries each gained just over 2%. U.S. Treasury yields have remained low in 2019, and the yield curve inverted at the end of the quarter. The three-month U.S. Treasury yield, which is heavily influenced by the federal-funds target rate, remained roughly stable, ending the quarter at 2.4%. Meanwhile, the 10-year U.S. Treasury note's yield declined to 2.4% from 2.7%, slightly lower than the six-month yield. That modest yield-curve inversion temporarily spooked the markets, as is was seen as an early sign of a recession. But the market ultimately shrugged off these concerns. Following a credit sell-off in late 2018, corporate credit was buoyed in early 2019 as credit spreads tightened, supported by the Fed's dovish stance. Risk-taking generally rewarded strategies that had larger stakes in lower-quality credit over their more conservative peers. Energy-related debt, in particular, benefited as the West Texas Intermediate crude-oil price rose to just over $60 per barrel from $45 to start the year, representing one of the largest quarterly increases in recent years. Energy's large presence in the high-yield bond space fueled gains. High-yield bonds generated gains between 5.6% and 10.3% depending on investment strategies (aggressive versus conservative).Convertible securities, which combine corporate bonds and an equity call option, also posted strong returns for the period.

The Economy

Q1 GDP growth topped the most optimistic of forecasts. Large stockpiling of inventories, in anticipation of ongoing trade tensions with China, propelled GDP growth in Q1 to 3.2% after 2.2% in Q4 2018. Q1 GDP showed a shift in the composition of top-line growth away from personal consumption toward a continued inventory build-up and weaker imports. The inventory overhang in particular is likely to have a dampening effect on growth in Q2, which is expected to be considerably weaker. The pace of business-investment growth for example fell to 2.7% from 5.4% prior. While investment in intellectual property posted another robust increase of 8.6% following average growth of 10.2% in 2018, equipment investment barely grew in the quarter (0.2% vs. 5.8% average growth in 2018). Growth in the consumer driven (70%) economy will, therefore, depend increasingly on consumption in the next quarters and should remain resilient due to the strong labor market. As consumer confidence, however, rose to a six months high in May, there is strong indication that the U.S. economy should be sufficiently supported through this trade issues related period of uncertainties.

Federal Reserve Policy

The Fed noted a more sluggish underlying profile of a stellar headline GDP in Q1. Given that more than half of GDP growth came from a temporary build-up in inventories and trade, a significant slowdown in the current quarter is expected. To reach the FOMC's current projection of 2.1% for the year, GDP will need to rise by 1.7% on average in the remaining three quarters. This seems like a relatively low bar, even taking into account the recent disappointing economic data. The Fed also announced in March that it will end its balance-sheet unwinding process by September, not by the end of the year which should provide additional liquidity to the market. The Fed will need to reevaluate their expectations of their unemployment rate target for 2019, as the rate fell already to 3.6% below their year-end target of 3.7%. It also remains to be seen whether the dip in inflation due to sharp declines in apparel prices and financial services was "transitory." There are two scenarios that can unfold in our opinion: a series of upward surprises on inflation reaching 2% combined with increasing financial stability concerns could result in the next policy move being a tightening, or a sharp intensification of the trade war could lead to lowering interest rates. Changes in monetary policy, either way, are not expected before 2020. For now the markets respond favorably to the wait and see stance of the Fed.

Outlook

Equity markets are likely to remain volatile. In light of the trade salvos, there has been a shift in May away from sectors that have led the S&P 500 for most of the year towards defensive-focused segments including treasuries. With 10-year treasury yields reaching a new low, the spread between the S&P 500 earnings yield and the 10-year treasury is near the highest since January, when equities were in the midst of a recovery from the deep Q4 selloff. This should provide a safety margin for equity investments, while it remains to be seen what the likely ramifications of the trade tensions for the economy and markets will be.

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For the first quarter, S&P 500 companies have reported a decline in earnings of 0.4% and growth in revenues of 5.3%. For the remainder of 2019 a decline in earnings is expected in Q2, slight growth in Q3, and single digit growth in Q4. 76% of all companies issued a lower EPS guidance for Q2 and single digit growth for 2019. Forward market PE is 16.1 above the 10-year average of 14.7, with consumer discretionary sporting the highest and financials the lowest forward PE.

We continue to prefer a high quality aggregate of diversified investments. Our outlook on the market continues to be positive as the economy is sound and there is still good value to be found across all sectors in the equity market. In fixed income, we see little value right now as this market is overpriced. We recommend to stay short or ladder maturities to be prepared for a correction at some point. We expect the trade tensions with China to remain for some time. Our finance system, however, is sound and our economy is likely to continue to perform sufficiently despite some ramifications from the trade war. There is ample evidence that this economic cycle can continue well into the future.

Your Terra Nova Team!