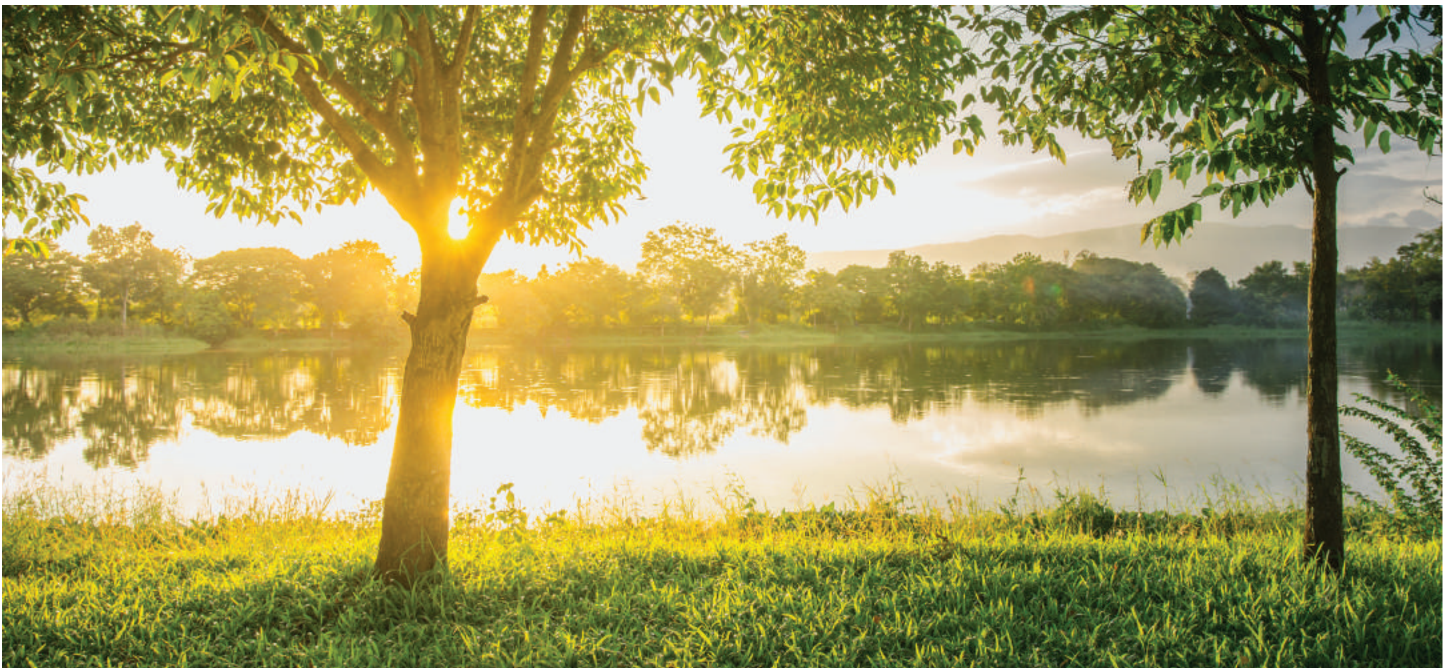
Trust Company of Illinois

BUILDING YOUR FUTURE

From the desks of William M. Giffin, CEO (left) and Kevin Rice, Investment Analyst (right)



BACK AND FORTH: WHERE SHOULD WE LOOK NEXT?

Back and forth. Back and forth.

Watching the fans at Wimbledon this past weekend, we were struck by the motion of the crowd. As their heads followed the tennis ball from one side to the other, it reminded us of people watching the market. We look one way at the Federal Reserve (Fed), and then the other way at the U.S.-China trade talks. Then back at the Fed, and again back at the U.S.-China trade talks. You get the picture.

We think we can expect more of this back-and-forth through the remainder of the year. And while there is obviously more at play in the market than the Fed and U.S.-China trade talks, let's turn our heads back to the Fed first.

FEDERAL RESERVE

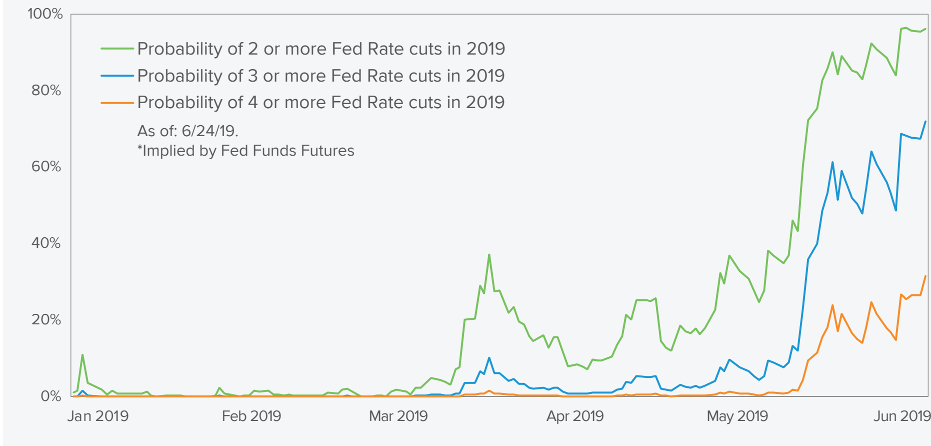
All eyes are on the Fed after the June Federal Open Market Committee (FOMC) meeting indicated a readiness to lower interest rates for the first time in more than a decade.

At the end of June, the Fed Funds futures had a probability of more than one rate cut this year (Exhibit 1). The Fed Funds futures are financial contracts that represent the market's opinion of where the federal funds rate will be in the future. Fed Chairman, Jerome Powell, solidified expectations for a rate cut after testifying to Congress in early July.

▶ ***Point of View***

We believe the pivot by the Fed toward an easier monetary policy

EXHIBIT 1: PROBABILITY OF FED RATE CUTS*



Source: Bloomberg.

shows that the trade war is slowing the economy's momentum and that rates are too restrictive given sluggish inflation. Inflation has been held down by a strong dollar offsetting any wage pressures seen in the labor market. As we enter the later stages of economic expansion, inflation and wages have begun to cool, the opposite of what the Fed hoped for and expected. We would be extremely surprised if we don't see a quarter point rate cut in the Fed Funds rate at the end of July.

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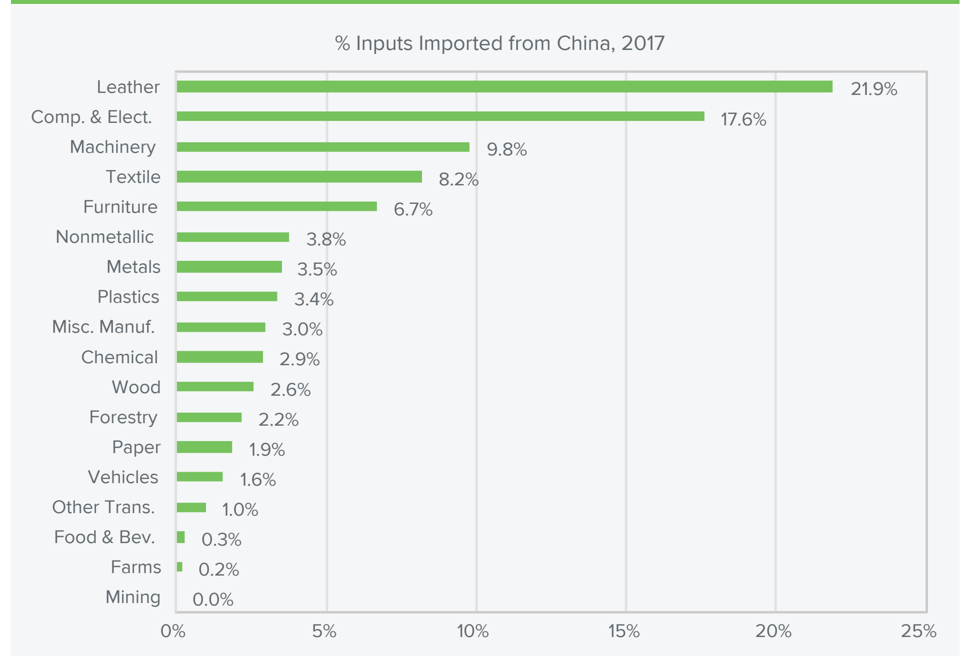
INTERNATIONAL TRADE

Trade tensions increased during the quarter, after U.S. and China talks broke down in early May and the Trump administration raised tariffs from 10% to 25% on $200 billion of Chinese exports. At the end of the quarter Trump said no new tariffs would be added, after the U.S. and China agreed to return to the negotiating table.

During the quarter the U.S. also threatened, and then postponed, auto tariffs on Europe, Japan and Korea. In addition, the administration threatened to use tariffs to address immigration issues with Mexico. Ultimately, the U.S. reached a deal with Mexico and the tariffs were not implemented. Finally, the odds of a "No Deal" Brexit have increased, raising the risk for volatility of the UK's future trade relationship with the European Union.

According to a recent report from Wells Fargo (Exhibit 2), the industries most exposed to higher tariffs are leather, electronics, machinery, textiles and furniture. Industries with a small exposure to tariffs include mining, farming, food & beverages,

EXHIBIT 2: INPUTS EXPOSED TO U.S. TARIFFS



Source: TC Wealth Partners, Wells Fargo.

motor vehicles and aerospace. With approximately 45% of Chinese goods now subject to a 25% tariff, the complete avoidance of additional costs due to tariffs looks unfeasible for these industries.

▶ *Point of View*

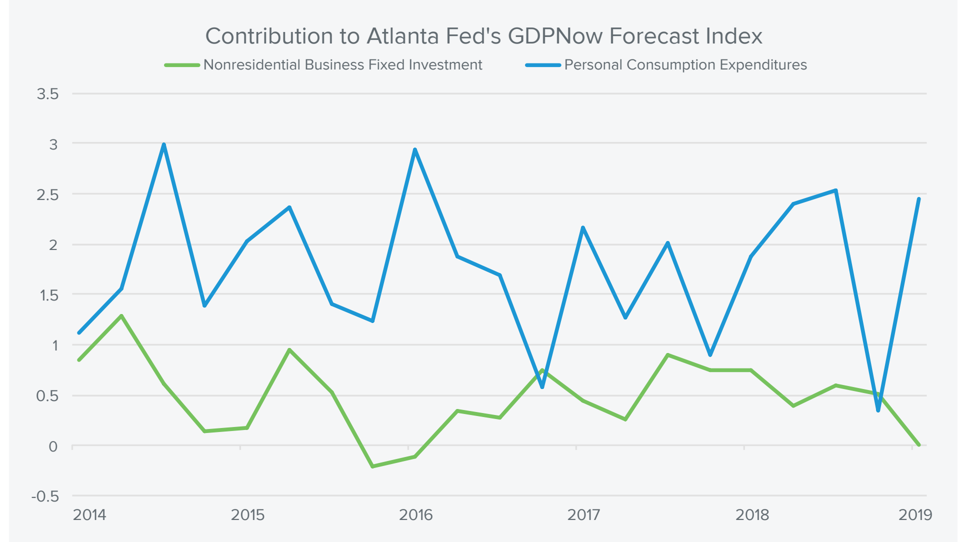
The risk of these international trade issues for the broader economy is that the slowdown in profit growth curtails businesses' willingness to invest, and any increases in consumer prices would erode real income growth and weigh on growth in consumer spending. We believe that these trade disputes are not going away anytime soon. Each side has agreed to disagree, making resolution nearly impossible in the near term.

Because of this uncertainty and the power of a Presidential tweet, we do expect trade negotiations to impact market volatility. However, going into 2020 we expect that the President would prefer to resolve the trade wars as he hits the campaign trail. We also continue to keep our eye on the Eurozone but are not optimistic that there will be a quick fix for Brexit.

BUSINESS INVESTMENT & LABOR MARKET

Manufacturing activity continued to weaken in June, with the ISM Manufacturing Index[1] slipping to 51.7, marking the third straight monthly decline and the weakest level since October 2016. The survey is still above the 50 mark, which indicates expansion. The recent upping of trade tensions, however, did weigh on new orders in June as they hit a three-and-a-half-year low.

EXHIBIT 3: CONTRIBUTION TO ATLANTA FED'S GDPNOW FORECAST INDEX



Source: TC Partners, Bloomberg. Atlanta Fed's GDPNow Forecast Index is a running estimate of real GDP growth based on data available to the Atlanta Fed for the current measured quarter.

In June, hiring rebounded from the drop in May, with employers adding 224,000 new jobs. Through the first half of the year, employers added an average of 172,000 jobs per month, down from 211,000 the prior six months. While the labor market remains tight, the pace of improvement has slowed down a bit. Wage growth on an annual basis slowed for the third straight month, the longest such streak of weakness since 2009.

Trade fears have eroded business investment in recent months. The contribution of business investment to GDP fell to its weakest level since 2016, according to the Atlanta Fed's GDPNow Forecast Index (Exhibit 3). Q2 GDP is still estimated to be around 1.9%, thanks to the recovery of consumer spending, which composes 70% of economic growth.

▶ *Point of View*

We suspect factory activity will continue to struggle in the second half of the year as companies are still trying to evaluate the impact of tariffs on their supply chains. The ongoing nature of negotiations has prolonged the uncertainty surrounding future trading relations and weighed on investment spending.

The possibility that softness in business investments will slow down hiring has us concerned, but we believe stronger consumer spending, higher incomes and elevated consumer confidence should support future economic growth.

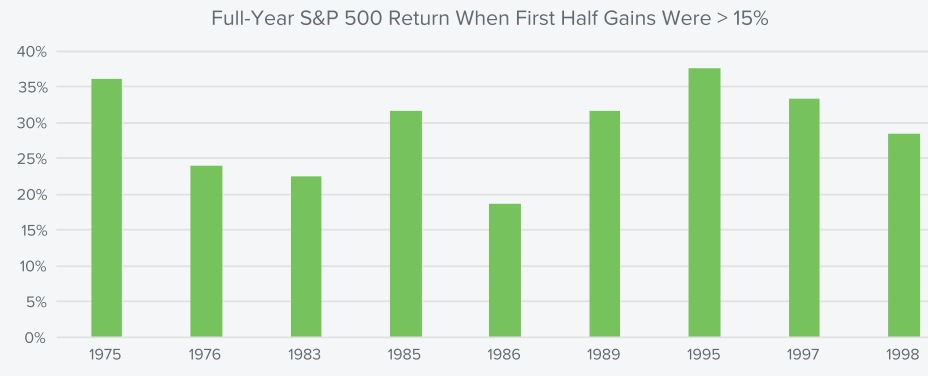
U.S. EQUITY MARKET

In the last month of the quarter, the dovish shift from the Fed drove stocks to their best month since January. The S&P 500 Index rose by more than 5% during the second quarter and is now up 18.54% for the year.

In the last 60 years, there have been nine other years in which the stock market returned more than 15% in the

[1] ISM Manufacturing Index is based on a survey of purchasing managers at more than 300 manufacturing firms by the Institute for Supply Management (ISM); the index monitors changes in production levels from month to month.

EXHIBIT 4: S&P 500 RETURNS



Source: TC Wealth Partners, Bloomberg.

first half and extended those returns into the second half of the year. The average return for those nine years was 29.34% (Exhibit 4).

The Russell 1000 Growth Index has performed the best this year, returning 21.49%. Information Technology is the best performing sector this year, returning 26.59%. Health Care has been the worst performing sector returning 6.99%. With Q2 2019 earnings season beginning, analysts are estimating a -2.6% year-over-year decline of S&P 500 earnings.

▶ *Point of View*

We believe earnings estimates have become overly pessimistic, and there should be room for upside surprises throughout 2019. In the second half of the year, we expect investor concerns tied to still-positive but slowing domestic and global growth conditions, unresolved trade tensions, persistent geopolitical uncertainty and the promise of more monetary stimulus will impact equity volatility. However, we expect positive returns to continue through the end of the year.

INTERNATIONAL MARKETS

Global equities, as measured by MSCI AC World ex US Index, returned 4.45% in Q2 as investors reacted to a dovish shift by central banks. During the quarter, 16 central banks cut rates and have indicated a willingness to cut rates further, if needed.

U.S. stocks outperformed their International developed market peers, driven by strength in the U.S. technology sector (Exhibit 5). The MSCI Asia Pacific Index remains one of the worst performers year-to-date as the strength in the Japanese yen has hampered Japan's performance. Conversely, European equities delivered solid returns despite the euro's strength and uncertainty of Brexit, as financial services companies posted strong gains.

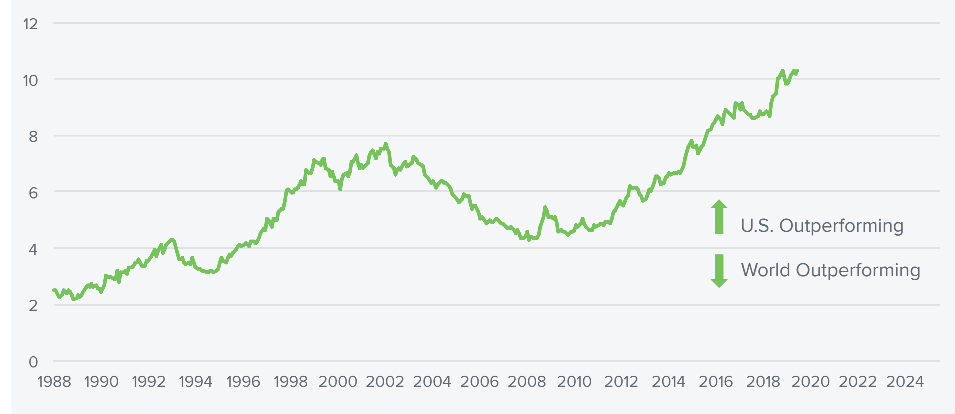
▶ *Point of View*

Developed international market valuations are cheap, but that doesn't excite us given the flawed structure and lack of growth. We are cautious because of weakening economic growth trends, subpar earnings growth and uncertainty over Brexit and German elections.

Despite the poor economic trends there are still many strong

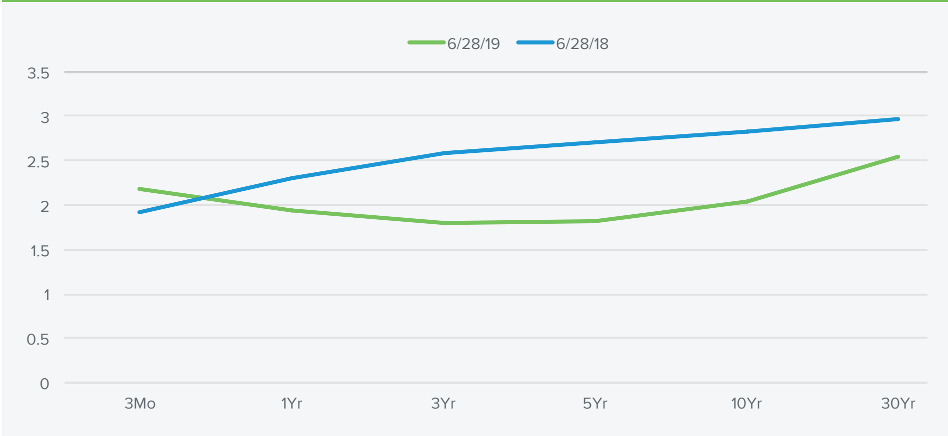
> *U.S. stocks outperformed their developed market peers, driven by strength in the US technology sector.*

EXHIBIT 5: S&P 500 RELATIVE TO MSCI AC WORLD EX U.S.



Source: TC Partners, Bloomberg.

EXHIBIT 6: U.S. 10-YEAR TREASURY YIELD CURVE



Source: TC Wealth Partners, Bloomberg.

Fixed-income markets have interpreted the recent breakdown in U.S.-China trade negotiations as a signal that growth, and therefore inflation pressures, will be slower and lower than previously expected.

multinational companies that do most of their business elsewhere, so we believe it still makes sense to have an allocation to those markets.

We are currently evaluating the possibility of increasing our Emerging Markets (EM) allocation, given that the dovish monetary policy should favor riskier EM assets. However, we continue to be cautious over the ongoing trade war and its negative impact on the global economy and global financial markets.

FIXED-INCOME MARKET

During the quarter U.S. yields declined and the yield curve flattened (Exhibit 6). The Bloomberg Barclays U.S. Aggregate Bond Index returned 5% while the 10-year U.S. Treasury yield fell to 2.0% on June 29.

Fixed-income markets have interpreted the recent breakdown in the U.S.-China trade negotiations as a signal that growth, and therefore inflation pressures, will be slower and lower than previously expected.

In May, the yield curve inverted a second time this year after the 10-year Treasury yield fell below the yield of the 3-month T-bill. Historically, an inversion of the yield curve is an indication of recession risk (Exhibit 7).

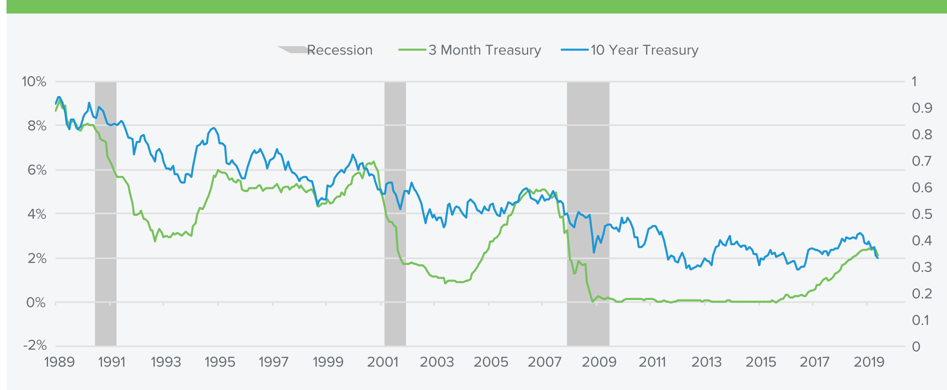
Across the globe, fixed-income yields plummeted during Q2. In the Eurozone, yields have collapsed because economic growth is slowing. At the end of June, German bonds yielded -0.38%, and negative yielding debt globally had surged back above $13 trillion.

▶ *Point of View*

Historically, the yield curve has inverted when the Federal Reserve was in a process of tightening. The Fed is not forecasted to tighten anytime soon and is likely to cut rates in the coming months. We believe that the yield curve is flattening because investors currently think growth and inflation are less likely to accelerate in the future. Therefore, the risk of holding longer maturity bonds has fallen dramatically.

We believe that the yield curve today represents a weak signal for a

EXHIBIT 7: YIELD CURVE INVERSION



Source: TC Wealth Partners, Bloomberg.

EXHIBIT 8: 10-YEAR SOVEREIGN DEBT YIELDS

COUNTRY	6/30/19	5/31/19	12/31/2018	12/31/17
U.S.	2.0	2.1	2.7	2.4
Australia	1.3	1.5	2.3	2.6
Canada	1.5	1.5	2.0	2.0
France	0.0	0.2	0.7	0.8
Germany	-0.3	-0.2	0.2	0.4
Greece	2.5	2.9	4.4	4.1
Ireland	0.2	0.4	0.9	0.7
Italy	2.1	2.7	2.8	2.0
Japan	-0.2	-0.1	0.0	0.1
Portugal	0.5	0.8	1.7	1.9
Spain	0.4	0.7	1.4	1.5
Switzerland	-0.5	-0.5	-0.2	-0.1
U.K.	0.8	0.9	1.3	1.2

Source: TC Partners, Bloomberg.

The U.S. economy remains the best house in a bad neighborhood as other developed market economies are seeing sub 1% growth.

recession, but a strong signal for slower growth and inflation. Yields and bond prices are not attractive across developed markets outside the U.S (Exhibit 8). We don't see a strong case to invest in non-U.S. developed bonds, especially since the U.S. is much healthier with deeper markets and more attractive growth prospects.

ASSET ALLOCATION OUTLOOK

Overall, we believe that a well-constructed, diversified portfolio is the best investment strategy under all market conditions, and certainly when volatility is on the rise. However, with the slowing domestic and global growth conditions, unresolved trade tensions and persistent geopolitical uncertainty, we expect volatility to return to higher levels in the second half of the year.

In early March of this year the Investment Committee made allocation changes to assets that will likely perform well in the later stages of economic cycles and lower the negative impact of volatility over the long-haul.

Within our portfolios we continue to have a higher allocation to domestic equities than developed international markets. The U.S. economy remains the best house in a bad neighborhood as other developed market economies are seeing sub 1% growth. U.S. earnings growth is comparable to other developed markets, and as a result we continue to favor domestic equities. We still have an allocation to developed international markets, because there are many strong multi-national companies that generate a significant portion of their revenue from international markets.

Within international markets we have a higher allocation to developed international markets than emerging markets. We are evaluating if an increase in our EM allocation is warranted, given that a dovish shift in monetary policy has provided a tailwind for EM equities in the past.

Within fixed income we continue to look for strategies that can adapt to the changing fixed-income landscape. We continue to have allocations to Infrastructure and MLPs. We believe that the regular cash distributions offered by MLPs continue to make them an appealing asset class. We also believe that the low correlations to traditional asset classes, inflation protection and yield with stable cash flows make infrastructure attractive.

We will continue to monitor any economic and market developments and will make the necessary changes to our clients' portfolios so that they are able to reach their goals and find comfort with their financial well-being. ■

EXHIBIT 9: MARKET PERFORMANCE

S&P 500 SECTORS	Q2-2019	YTD	1Yr	3Yr	5Yr	10Yr
Utilities	6.25%	14.70%	19.03%	8.05%	9.99%	12.17%
Real Estate	7.64%	20.42%	16.80%	6.69%	8.13%	14.45%
Materials	7.73%	17.26%	3.20%	10.38%	5.44%	11.39%
Information Technology	10.40%	27.13%	14.34%	26.20%	18.52%	18.56%
Industrials	2.30%	21.38%	10.39%	12.44%	9.25%	15.56%
Health Care	0.46%	8.07%	12.99%	10.82%	10.61%	15.51%
Financials	4.60%	17.24%	6.30%	16.39%	10.54%	13.05%
Energy	-2.55%	13.13%	-13.25%	0.20%	-5.54%	5.00%
Consumer Staples	8.14%	16.18%	16.39%	4.84%	8.39%	12.83%
Consumer Discretionary	8.60%	21.84%	10.17%	16.74%	13.96%	19.70%
Communication Services	6.20%	19.09%	13.66%	0.58%	5.34%	9.84%
DOMESTIC EQUITY INDEXES	**Q2-2019**	**YTD**	**1Yr**	**3Yr**	**5Yr**	**10Yr**
Russell 3000	4.88%	18.71%	8.98%	14.01%	10.18%	14.65%
Russell Midcap	4.37%	21.34%	7.81%	12.14%	8.61%	15.14%
Russell 1000 Growth	6.75%	21.49%	11.56%	18.07%	13.38%	16.27%
Russell 1000 Value	3.93%	16.24%	8.45%	10.17%	7.45%	13.18%
NASDAQ	5.80%	21.34%	7.81%	19.62%	14.05%	17.28%
S&P 500	5.60%	18.54%	10.41%	14.18%	10.70%	14.68%
FIXED INCOME INDEXES	**Q2-2019**	**YTD**	**1Yr**	**3Yr**	**5Yr**	**10Yr**
Global Aggregate ex. US	4.46%	4.99%	4.10%	0.97%	-0.12%	2.10%
US Aggregate	5.27%	6.11%	7.87%	2.31%	2.95%	3.89%
Treasury	5.24%	5.18%	7.24%	1.34%	2.49%	3.05%
High Yield	3.42%	9.94%	7.48%	7.52%	4.70%	9.24%
TIPs	5.01%	6.15%	4.84%	2.08%	1.75%	3.64%
Municipals	3.83%	5.09%	6.71%	2.55%	3.64%	4.72%
Asset Backed Securities	2.46%	3.17%	4.98%	1.99%	2.07%	3.35%
Mortgage Backed Securities	3.60%	4.17%	6.22%	2.06%	2.56%	3.23%
Commercial Mortgage Backed Securities	5.25%	6.60%	8.95%	2.91%	3.35%	7.16%
INTERNATIONAL EQUITY MARKETS	**Q2-2019**	**YTD**	**1Yr**	**3Yr**	**5Yr**	**10Yr**
MSCI EM	5.41%	17.30%	3.00%	10.53%	6.31%	9.12%
MSCI EAFE	4.45%	14.52%	1.70%	9.73%	2.84%	7.49%
MSCI World	5.10%	17.39%	6.97%	12.42%	7.24%	11.37%
MSCI World ex US	4.45%	15.13%	1.92%	9.65%	2.64%	7.35%
MSCI Europe	5.19%	16.83%	5.10%	8.83%	5.67%	9.84%
MSCI Asia Pacific	1.93%	10.76%	-0.62%	10.58%	4.89%	7.59%
MSCI North America	5.44%	18.93%	9.91%	13.92%	9.97%	14.09%
MSCI EM Asia	0.13%	9.74%	-2.03%	11.53%	4.81%	7.83%
MSCI EM Latin America	3.55%	12.83%	18.90%	11.17%	-0.45%	2.63%
MSCI EM Europe & ME	6.78%	13.38%	7.35%	8.98%	-0.75%	4.16%

WHAT EXACTLY IS THE FED--AND WHAT DOES IT DO?

Have you ever bowled with bumpers to prevent your ball from going in the gutters? Like those bumpers, the Federal Reserve (the Fed) – the United States' central bank – is intended to help the U.S. economy stay out of the gutter. It doesn't guarantee a strike, and certainly not a perfect 300 game, but the Fed provides the nation with a safer, more flexible, and more stable monetary and financial system.

WHAT ARE THE FEDERAL RESERVE'S RESPONSIBILITIES?

Created in 1913, the Fed is responsible for:

- Conducting the nation's monetary policy (influencing money and credit conditions) to enable full employment and stable prices;

- Supervising and regulating banks and other important financial institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers;

- Maintaining the stability of the financial system and containing systemic risk that may arise in financial markets; and,

- Providing certain financial services to the U.S. government, U.S. financial institutions, and foreign official institutions, and playing a major role in operating and overseeing the nation's payments systems.

HOW IS THE FED ORGANIZED?

The Fed is composed of three key entities: the Board of Governors (Federal Reserve Board), 12 Federal Reserve Banks, and the Federal Open Market Committee.

The Board of Governors consists of seven people, nominated by the president and approved by the Senate. Each person is appointed for a 14-year term (terms are staggered, with one beginning every two years). The Board of Governors conducts official business in Washington, D.C., and is headed by the chair (currently, Jerome Powell), who is perhaps the most visible face of U.S. economic and monetary policy.

Next are 12 regional Federal Reserve Banks that are responsible for typical day-to-day bank operations. The banks are located in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco. Each regional bank has its own president and oversees thousands of smaller member banks in its region.

The Federal Open Market Committee (FOMC) is responsible for setting U.S. monetary policy. The FOMC is made up of the Board of Governors and the 12 regional bank presidents. The FOMC typically meets eight times per year. When people wait with bated breath to see what the Fed will do next, they're usually referring to the FOMC. Upcoming FOMC meetings are scheduled for July 30-31,

September 17-18, October 29-30, and December 10-11, 2019.

HOW DOES THE FED IMPACT THE ECONOMY?

One of the most important responsibilities of the Fed is setting the federal funds target rate, which is the interest rate banks charge each other for overnight loans. The federal funds target rate serves as a benchmark for many short-term interest rates, such as rates used for savings accounts, money market accounts, and short-term bonds. The target rate also serves as a basis for the prime rate. Through the FOMC, the Fed uses the federal funds target rate as a means to influence economic growth.

To stimulate the economy, the Fed lowers the target rate. If interest rates are low, the presumption is that consumers can borrow more and, consequently, spend more. For instance, lower interest rates on car loans, home mortgages, and credit cards make them more accessible to consumers. Lower interest rates often weaken the value of the dollar compared to other currencies. A weaker dollar means some foreign goods are costlier, so consumers will tend to buy American-made goods. An increased demand for goods and services often increases employment and wages. This is essentially the course the FOMC took following the 2008 financial crisis in an attempt to spur the economy.

On the other hand, if consumer prices are rising too quickly (inflation), the Fed raises the target rate, making money more costly to borrow. Since loans are harder to get and more expensive, consumers and businesses are less likely to borrow, which slows economic growth and reels in inflation.

People often look to the Fed for clues on which way interest rates are headed and for the Fed's economic analysis and forecasting. Members of the Federal Reserve regularly conduct economic research, give speeches, and testify about inflation and unemployment, which can provide insight about where the economy might be headed. All of this information can be useful for consumers when making borrowing and investing decisions.

HOW SHOULD YOU USE THIS INFO?

When planning and investing for retirement, remember that it's a marathon, not a sprint. Paying attention to the US economy and Fed policies can help you manage your investment expectations, and at times a significant outlook change may warrant adjustments to your investments. However, we strongly encourage you to set your investment plan with the long-term in mind, an approach that will work over many years despite shorter-term shifts in the economy or policy. Our Guided Portfolios are intended to help your retirement account stay out of "the gutters" while we adjust their allocations when appropriate.

More information from the Federal Reserve is available at federalreserve.gov. ■

Source: Broadridge Investor Communication Solutions, Inc.

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Trust Company of Illinois

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