INVESTMENT OUTLOOK

A QUADRANT CAPITAL MANAGEMENT PUBLICATION

SECOND QUARTER 2019: MAKING HISTORY

History has demonstrated that the most notable winners usually encountered heartbreaking obstacles before they triumphed.
-B. C. Forbes

It was 243 years ago this month that the US declared its independence and, against long odds, began the adventure that has been labeled American exceptionalism.

But it's also a notable time for commemorating other important historical events in the history of the country, extraordinary successes overcoming extraordinary obstacles. This year marks the fiftieth anniversary of the Apollo 11 astronauts' first steps on the moon, of the Stonewall Inn riots that ignited the modern day gay rights movement, and of the rock-n-roll music festival Woodstock. And it is the centennial of the completion of the first transcontinental railroad, of the first time a woman (Elizabeth Cady Stanton) testified before the United States Congress, and of the awarding, to John Wesley Hyatt, of the first patent for plastic. It also marks the start of the Gilded Age, a period of rapid industrial growth and technological advances that led to great concentrations of wealth.

Even as we mark these historical events, we note current events too that are historically significant. We recently witnessed the first steps by a US President on North Korean soil. In Nepal, officials granted a record 381 permits to climb Mt. Everest. (A permit costs $11,000, in case you're interested.) And, not trivially, this July marks the 121st month of this economic expansion—the longest the US has ever experienced.

Not so surprisingly, then, financial markets recorded all-time highs. In the second quarter, domestic and international bourses recorded low to mid-single digit increases, as did bonds and cash, and only commodities turned in negative numbers (among them, cotton -19%, orange juice -16%, natural gas -13%, copper -8%).

Asset Class	Index	2nd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	4.3%	18.5%
US Small Cap Stocks	Russell 2000	2.1%	17.0%
International Developed Stocks	MSCI EAFE	3.7%	14.0%
Emerging Markets Stocks	MSCI EM	0.5%	10.5%
Real Estate	MSCI US Real Estate	1.3%	17.8%
Commodities	Bloomberg Commodity	-1.8%	3.8%
Bonds	Barclays US Aggregate	3.1%	6.1%
Cash	FTSE 3-month US T-Bill	0.6%	1.2%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

These modest advances built on unexpectedly strong first quarter gains, with all equity classes recording double digit year-to-date gains. Bonds have also notched good returns. These positively correlated results stem from a common driver, the extension and reiteration of dovish global central banks' policies and communications strategies.

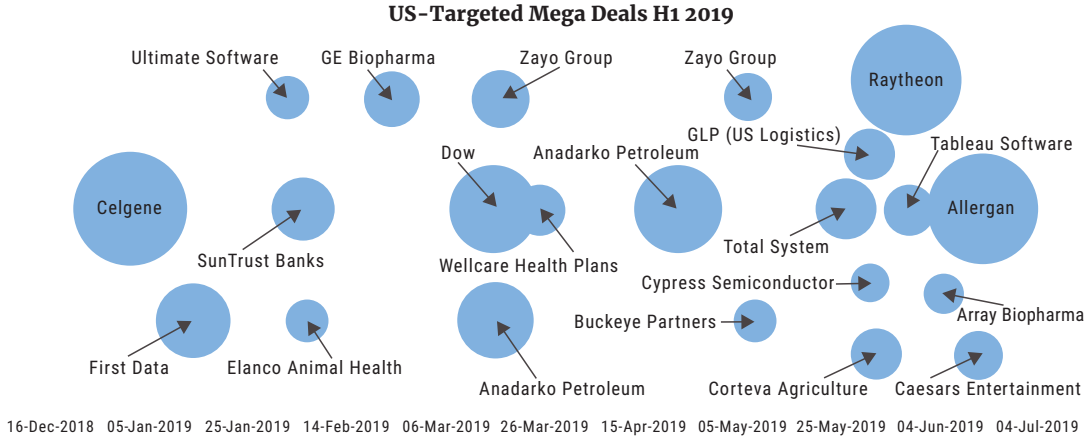
THE GOOD TIMES ROLL: FEASTING AT THE CENTRAL BANKS' BANQUET

We learn from history that we learn nothing from history.
-George Bernard Shaw

It is now more than ten years since global central banks responded to the Great Recession with policy initiatives of epic accommodation. Ultra-low interest rates and trillions of dollars of bond purchases have flooded financial markets with liquidity, pushing up asset prices in financial and real estate markets.

With so much liquidity sloshing around looking for a home, excesses are bound to pop up. Low interest costs and the search for growth are drivers of corporate mergers and acquisitions activity. According to Dealogic, first half 2019 deal volume for US-targeted transactions reached a record $1.17 trillion, a 20.5% increase over 2018. Further, "mega deals" valued at more than $10 billion are on the rise, and accounted for almost 70% of the dollar volume of transactions (even though they represent only 0.5% of all deals).

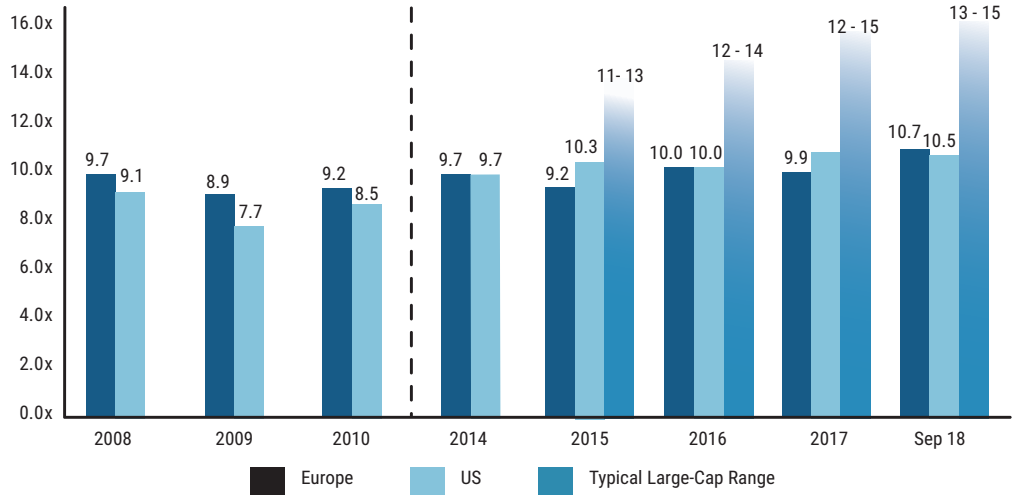
US-Targeted Mega Deals H1 2019



SOURCE: DEALOGIC

In addition, institutional investors, seeking higher returns, have poured enormous sums of money into private equity funds. Industry follower Prequin estimates that more than $3 trillion has been invested into such funds, of which $1.2 trillion is dry powder that has yet to be deployed. Further, 90% of private equity investors plan to increase or maintain their allocation to the asset class. It wouldn't be hard to imagine that this mountain of cash might pressure private equity fund managers to overpay for acquisitions of increasingly large size. As the chart below indicates, purchase prices for acquisition targets have been steadily rising over the past ten years. (After all, that's what happened the last time the industry was awash with funds, in 2007. Private equity managers overpaid for and over-leveraged acquisition targets, giving rise to the bankruptcies and restructurings of late-cycle deals like Texas Utilities and First Data.)

Average Purchase Price Multiple of Pro Forma Trailing EBITDA for LBOs



SOURCE: TRADINGECONOMICS.COM | US BUREAU OF ECONOMIC ANALYSIS

Perhaps the most visible manifestation this year of excesses of capital pressing for lofty returns is in the initial public offering (IPO) market. According to Dealogic, 120 companies completed their IPOs and raised $35.2 billion on US exchanges in the first six months of the year. This marks the highest volume since 2014 and the fourth-busiest year-to-date period since 1995. These IPOs have delivered an average gain of 29%. Many new stock issues met with tremendous enthusiasm, even exuberance—despite a lack of earnings or even the prospect of earnings

in any visible time frame. New stock offerings across a variety of industries were greeted with extraordinary returns: online pet products retailer Chewy tasted delicious, videoconferencing firm Zoom Video zoomed threefold, messaging firm Slack tautened, and plant protein maker Beyond Meat rose 541%—beyond belief. Such levitating market returns for immature companies is reminiscent, perhaps eerily so, of the late 1990's, when pets.com and drugstore.com and a host of other internet IPOs soared, then crashed and burned.

Makes a person say, hmm.

LOFTY RETURNS AMID SLOWER GROWTH

History is, strictly speaking, the study of questions;
the study of answers belongs to anthropology and sociology.
-W. H. Auden

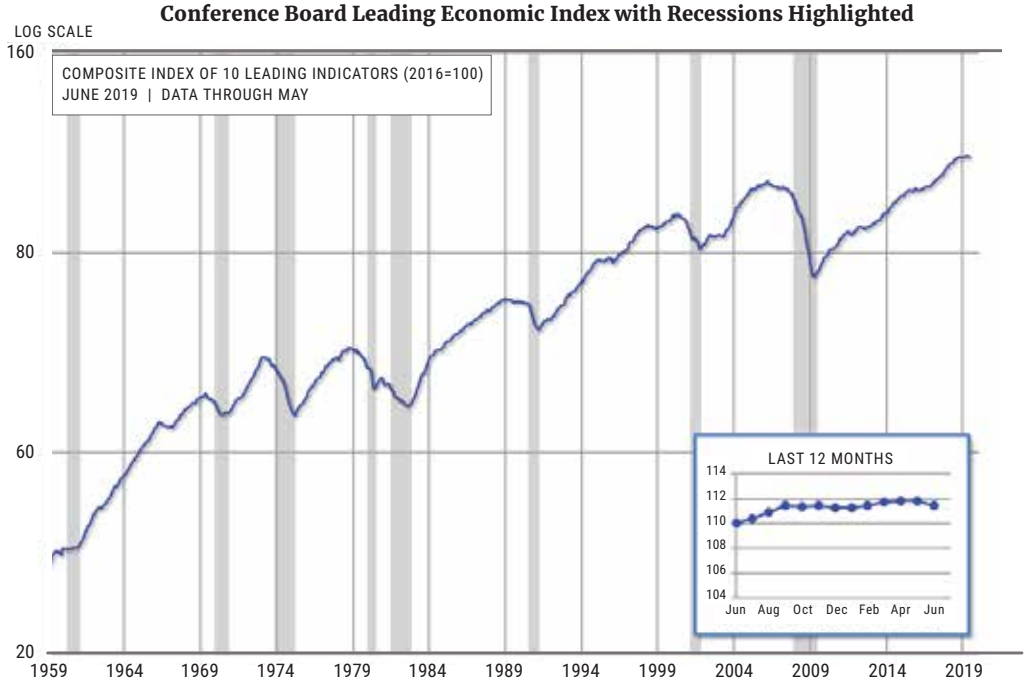
The frothiness exhibited in the IPO market and the frantic pace of deal-making are classic signs of a late stage economic cycle. Issuers of stock are eager to act while the market window remains open, and acquirers seek target companies in a (sometimes costly) effort to sustain growth. The question needs to be asked: is there a downturn on the horizon?

The US economy has surprised forecasters, growing 3.1% in the first quarter on strong exports and inventory investments, but many economists anticipate a slower pace of growth for the balance of the year. Contributing to such muted expectations are weaker global growth, waning effects of fiscal stimulus (tax cuts and government spending), trade tensions, Brexit uncertainty, and geopolitical concerns in hotspots such as Iran and Venezuela.

The World Bank recently lowered its forecast for global growth to 2.6%, the weakest since 2016. Sluggish growth is evident in most developed markets, from Europe to Japan to Australia. And in emerging markets, China's growth has decelerated to an estimated 6.2% this year as it wrestles with a trade conflict with the US.

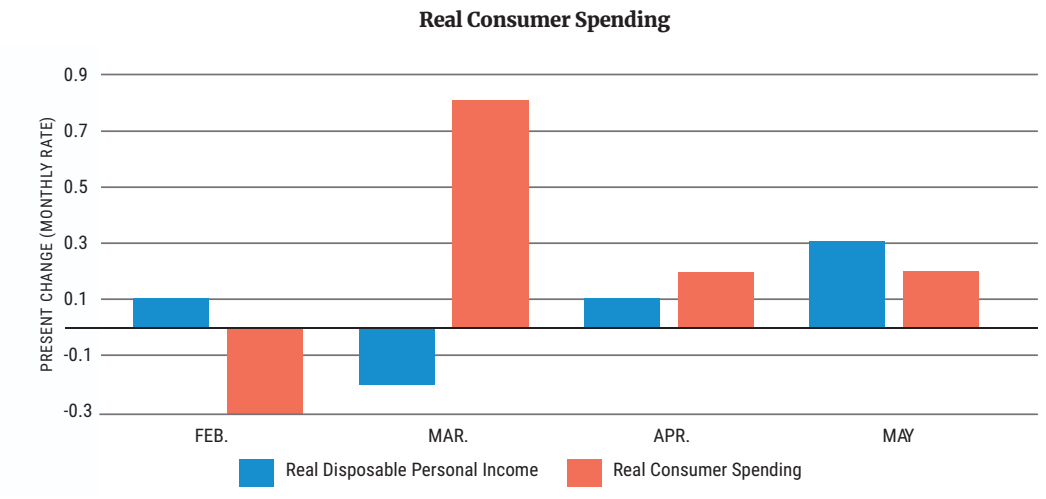
Even as domestic economic growth seems poised to slow, signs of imminent recession are few. The Conference Board's index of leading economic indicators was unchanged in May, after three consecutive monthly increases.

Conference Board Leading Economic Index with Recessions Highlighted



SOURCE: DSHORT.COM

The labor market has demonstrated considerable strength, with unemployment at a cycle low of 3.7% and healthy average monthly job gains of 164,000. Wages grew 3.1% in the past year. The Bureau of Labor Statistics reports that job openings exceed job seekers by more than 1.6 million. The US economy is consumer driven, with 2/3 of economic activity generated by consumers. And consumers are not sitting on their wallets.

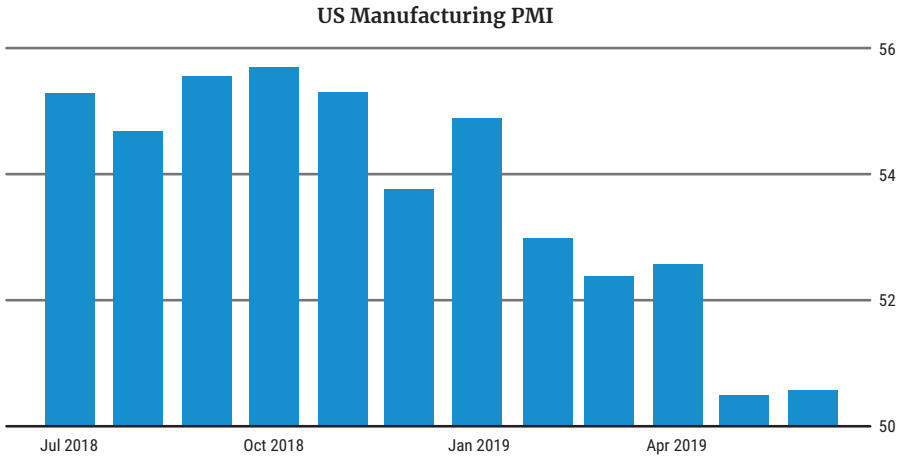


SOURCE: US BUREAU OF ECONOMIC ANALYSIS

As the chart shows, personal income and spending picked up in the second quarter, after some softness in the late winter.

Still, there are warning signs, or at a minimum, soft patches. Existing home sales have fallen for 15 consecutive months. Auto sales will fall below 17 million vehicles this year, for the first time since 2014, and have been weaker year-over-year for six consecutive months. These are surprising and concerning data points, given robust consumer employment, rising incomes, and low interest rates.

In the business sector, manufacturing is showing the strains of slower global growth and trade disputes. The ISM manufacturing index has fallen for three consecutive months, even as it remains modestly in expansion territory; factory output declined in the first four months of 2019.



SOURCE: IHS MARKIT

And capital expenditures, up 3% in the first quarter this year, nonetheless represents a sharp fall-off from a 20% rise a year ago, according to *The Wall Street Journal*.

And then there is the message of the bond market, where an inverted yield curve—wherein short-term rates are higher than long term rates—has historically signaled a coming recession.

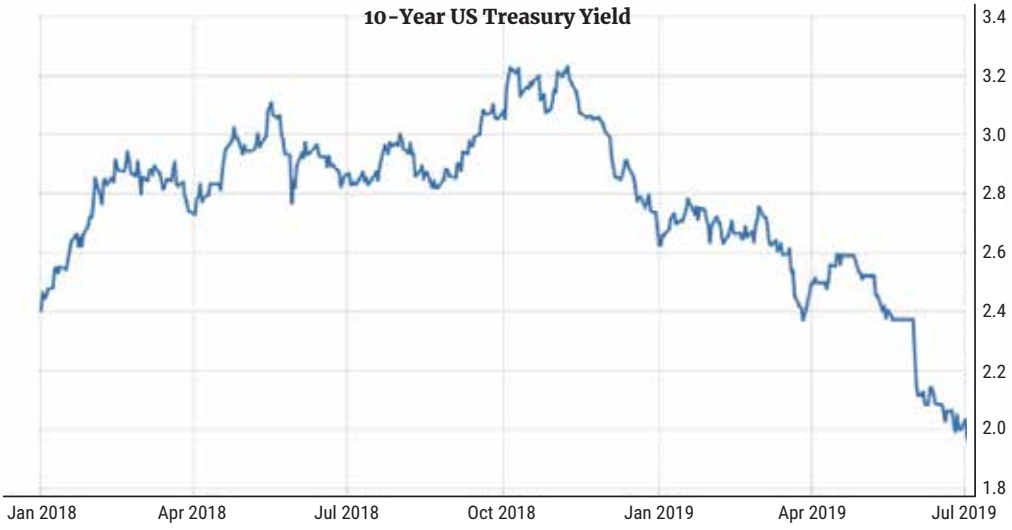
An inverted yield curve is, in fact, one of the best forecasters of an economic slowdown or downturn—an inverted yield curve has preceded every US recession in the last 50 years. Further, it's a long lead indicator—that is to say, it's forward looking rather than coincident or lagging. The yield curve has been inverted for more than a month now, and the longer it's inverted, the greater the likelihood of a recession.

Taken all together, these data points offer ample basis to question where we are in the business cycle.

PLUMMETING RATES AND THE DEATH OF INFLATION

I think all of the secrets of the universe are revealed in history.
We understand who we are by understanding where
we've been and why we are the way we are, and where we come from.
-Matt Barr

If a picture paints a thousand words, then—from the chart below—I know why I can't have yield. Last year, tax cuts juiced economic growth, enabling the Fed to implement four rate increases. Then, around the start of the year, the Fed abruptly pivoted, declaring that it could afford to be "patient." Global economic growth slowed. Trade disputes deepened. Businesses grew cautious. The Fed beige book downgraded its assessment of the economy from "strong" to "moderate." And the yield on the 10-year US Treasury bond pushed down and down, dropping under 2% by early July.

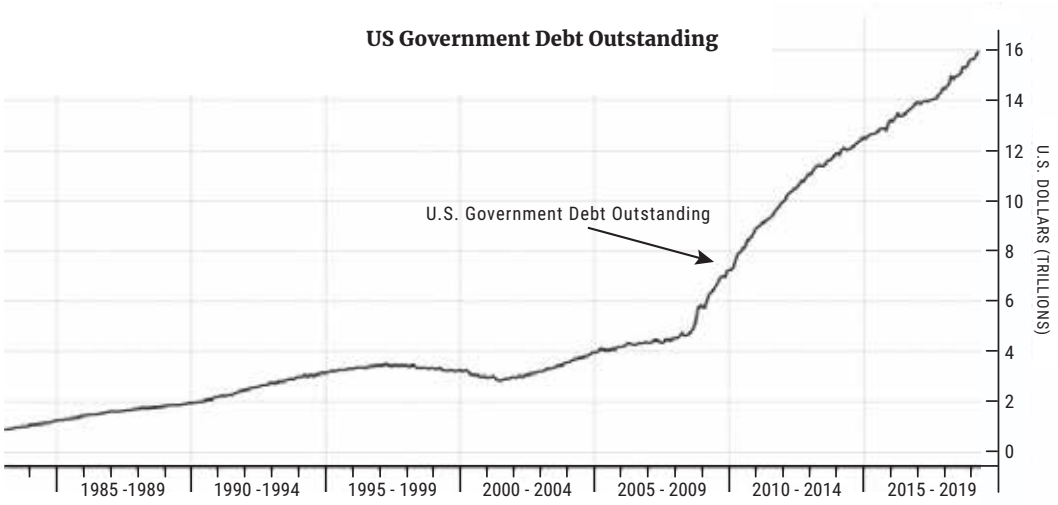


SOURCE: TRADINGECONOMICS.COM | U S DEPARTMENT OF THE TREASURY

As meager as the yield is on US government bonds, it's lofty in comparison with global rates. Recently, the 10-year German bund yielded -0.38%, the 10-year Japanese government bond yielded -0.16%, and the 10-year French government bond yielded -0.08%. Even hapless Italy's 10-year government bond now yields less than the comparable US government bond. Around the world, more than $13 trillion of bonds bear negative interest rates.

Recently, European Central Bank Chairman Mario Draghi declared that further monetary stimulus would be needed to support growth and diminish deflationary pressures—notwithstanding that the ECB's benchmark rate is lower than it has ever been, at -0.40%. The Reserve Bank of Australia lowered rates in June, and the Reserve Bank of India changed its stance to "accommodative" in the same month. The Bank of Japan expects to hold rates at -0.1% until 2020. And the Central Bank of Brazil's key interest rate sits at an all-time low.

Low rates have encouraged, or enabled, higher levels of borrowing. The widening US deficit (it's up 38.8% annually to $738.6 billion for the first eight months of the year, as the government's revenue increase of 2.3% hasn't kept pace with a 9.3% jump in spending, according to Bloomberg) has led to an explosion of additional debt.



SOURCE: US DEPARTMENT OF THE TREASURY

The US government is not the only profligate borrower. According to *The Wall Street Journal*, US business debt has increased from $9 trillion in 2006 to $15 trillion in 2018. US consumers have gorged on student loans and automobile loans. In the Middle East, the six nations of the Gulf Cooperation Council have increased their foreign currency debt nearly tenfold in the last four years.

Initially, central banks lowered rates to encourage borrowing—to stimulate economies—but success beyond their dreams now forces them to maintain low rates in order to help borrowers meet debt service and avoid defaults.

With the Fed's dovish pivot indicating a rate cut perhaps as soon as this month, it would appear that the interest rate increase cycle has ended, at dramatically lower interest rate levels than past cycles. It may be that the explanation lies in structural factors that are overwhelming cyclical factors. These structural factors include demographics, disruptive technologies, slower GDP growth potential, changing investor risk appetites, and wealth distribution. In such an environment, signs of inflation are in retreat, and it may be wishful thinking to believe subpar inflation is transitory. (If the interest rate mantra of "lower for longer" becomes "lower forever," there are important long-term implications for fixed income investors.)

Pity Chairman Powell. Apart from the attacks on Fed independence, he faces market pressures to cut rates this year; market participants clearly believe the future direction of interest rates is down, as the inverted yield curve implies. Increased trade tensions may induce businesses to defer capital spending, strengthening arguments to act pre-emptively to sustain the expansion. Weak inflation readings and slowing job growth, along with the closely followed inverted yield curve, all point to likely rate cuts in coming months. At the same time, current absolute low interest rates raise the question as to how effective any rate cuts may be to provide further stimulus. And we know that low rates punish savers, who receive less interest income. They can, perversely, decrease economic activity

as individuals are forced to save more. And low interest rates may cause further asset inflation, as investors bid up stocks, junk bonds, real estate and other risk assets in search of more yield. We are at a critical juncture for monetary policy. Alas, with record low global interest rates and global deflationary forces, there is little in the history books to guide the Chairman.

EQUITIES: WHAT RISK PREMIUM?

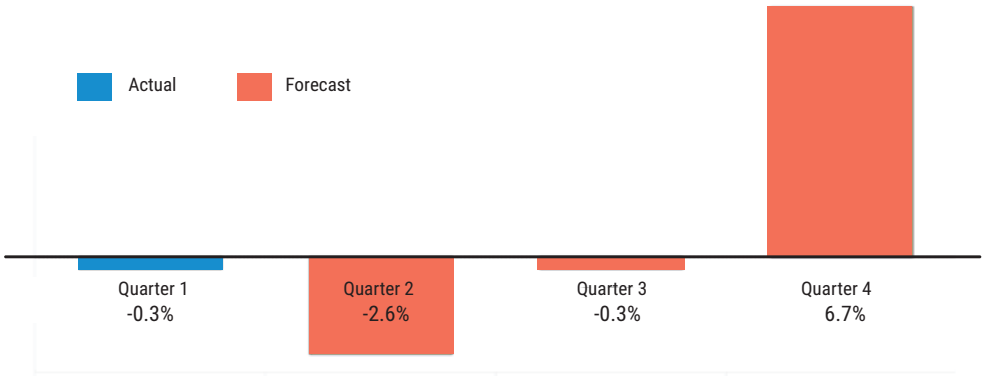
If one tries to think about history, it seems to me—it's like looking at a range of mountains. And the first time you see them, they look one way. But then time changes, the pattern of light shifts. Maybe you've moved slightly, your perspective has changed. The mountains are the same, but they look very different.
-Robert Harris

Bond buyers enjoy a contractual obligation from issuers of debt to receive scheduled interest payments and a return of capital at the instrument's maturity date. Buyers of equities lack such protections. Stock dividends, for those stocks that do pay dividends, are not guaranteed, nor is the principal. Small wonder, then, that uncertain returns lead stock investors to demand more compensation from equities—something we call a risk premium.

When the risk-free rate is low, as it is now, investors are tempted to accept a lower risk premium. Put another way, they are more tempted to bid up equity prices. (We introduced you, last quarter, to TINA—There Is No Alternative to stocks.) Ultimately, however, investors' decisions on how much to pay for stocks comes down to an assessment of the future earnings and cash flows they will generate. Of course, those assessments shift almost continuously, as new incoming data alter investors' perspectives.

Last year, corporate profits benefited from the substantial reduction in corporate tax rates. There is no such boost this year. Add to that decelerating global growth, rising input and transportation costs, and persistent US dollar strength, and the outlook for corporate profit growth this year is, at best, lackluster. FactSet reports that second quarter earnings for the S&P 500 are expected to be down 2.6% from the year-earlier period. (First quarter earnings, exceeding expectations, were up a mere 0.2% versus the prior year first quarter.) The trend of flat to negative earnings growth is expected to persist through the third quarter. For the full year, corporate earnings growth is estimated at 1.1%. Better earnings growth of 10.7% is forecast for 2020.

Earnings Expectations
Estimated Earnings Per Share, Y/Y Percent Change



SOURCE: FACTSET

At current stock market levels and current profits estimates, equities are trading at 17-18 times this year's earnings. That's a bit rich versus recent history, and especially so in light of an earnings drought; arguably, such a valuation is defensible in the context of the low interest rate environment. Still, it's not easy to warm to equities at their present levels—just as it's not easy to warm to bonds yielding 2%. With trade disputes growing (Mr. President, please don't mess with my Scotch whiskey and Parmesan cheese!) and the yield curve inversion pointing to a slowdown or recession, a focus on high quality stocks seems as right as ever.

For years, the over-abundant liquidity in financial markets has provided artificial support to lower quality companies. But we note a change in investor sentiment this year—quality is substantially out-performing the overall market. This is a favorable development for many active managers, who are demonstrating improved performance versus indices. We believe that the more challenging market conditions we observe may sustain the out-performance of quality stocks, with their superior returns on equity, wider profit margins, and greater free cash flow generation.

The outlook for international stocks is also fraught with uncertainty. Developed market growth is very sluggish, especially the manufacturing sector, and the European Central Bank's policy stance anticipates the need for further accommodation. Emerging markets are held back by actual and potential tariffs, deceleration in the growth of the Chinese economy, and the continuing strength of the US dollar.

In contrast, the backdrop of sustained low interest rates is bullish for commercial real estate. Fundamentals—high occupancy rates, rising rents, limited supply—are constructive for most property types. Demand remains particularly strong for apartments, data centers, cell towers, and medical facilities.

The Past as Prologue

"Those who don't study history are doomed to repeat it. Yet those who *do* study history are doomed to stand by helplessly while everyone else repeats it."

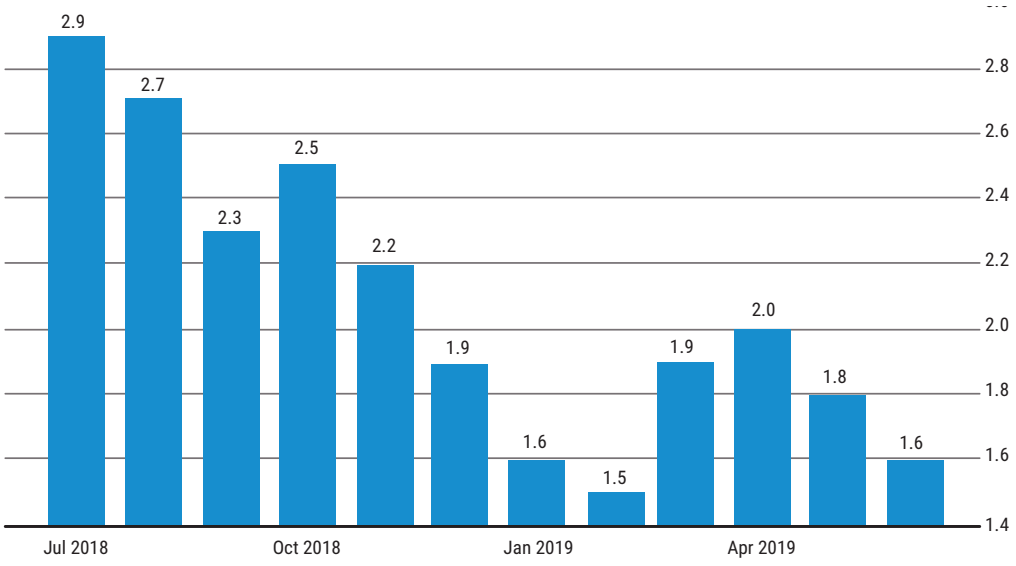
The oft-misquoted Mark Twain reminded us that history doesn't repeat, but it rhymes. That means that business and interest rate cycles remain powerful forces, but each cycle plays out differently.

The Bank for International Settlements—the central bank to the world's central banks—recently warned that central banks are bearing too much of the burden in fostering economic expansion, that other policy drivers need to kick in to ensure the global economy achieves sustainable momentum. This means better fiscal policy, structural reforms, pro-growth regulatory regimes. History—and a clear-eyed view of global nationalist impulses—suggests that politicians may not be up to the task.

How do we manage through environments that are inherently uncertain—where we are reminded by Yogi Berra that it's tough to make predictions, especially about the future? We begin with time tested principles of risk management, asset allocation, and—dare we say it—humility. At the same time, we retain a flexible stance and remain vigilant for signs of economic weakness that may affirm the message of the inverted yield curve. While we are wary of elevated valuations, sluggish earnings, and decelerating global growth, the old saw that says "Don't fight the Fed" has us reluctant to prematurely reduce equity exposures.

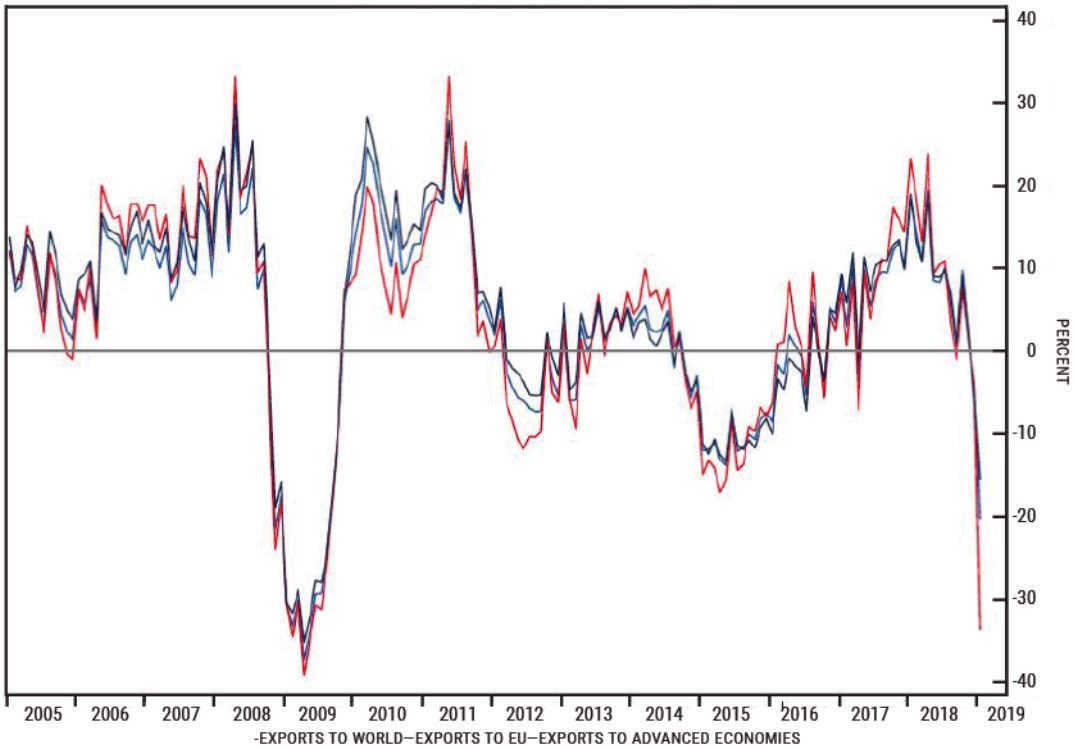
Finally, we leave you with three charts that highlight key data points we are monitoring—data points on inflation, trade, and the yield curve that may tell us that market history is, indeed, rhyming.

United States Inflation Rate

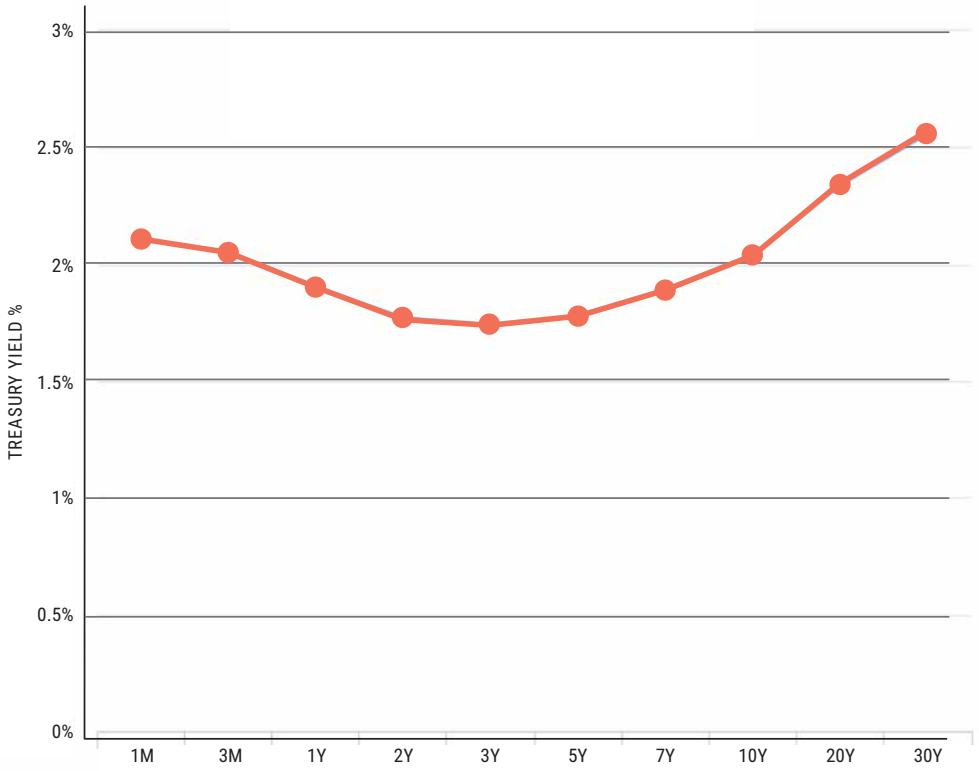


SOURCE: TRADINGECONOMICS.COM | US BUREAU OF LABOR STATISTICS

Global Trade YoY
Advanced Economic Trade Direction Statistics



SOURCE: BMO CM & MACOBOND



SOURCE: GURUFOCUS.COM

QUADRANT CAPITAL MANAGEMENT

A Subsidiary of Peapack-Gladstone Bank

100 PASSAIC AVENUE, SUITE 301, FAIRFIELD, NJ 07004
TEL (973) 276-0830 • WWW.QUADRANTCM.COM