

Stembrook Market Review — Second Quarter 2019

After a strong start to the year, both equity markets and fixed income markets continued to rally in the second quarter. Indications that the Federal Reserve intends to cut interest rates fueled the rally in both markets. Global equities were up 3.8% in the quarter and are up 16.6% on the year.¹ Global bonds were up 3.3% in the second quarter and are up 5.6% for the year.² Returns in both asset classes have exceeded long-term averages. Within the U.S., valuations have returned to elevated levels that we witnessed in the fourth quarter of 2018. Despite less attractive valuations on an aggregate level, we continue to look for pockets of value in both equity and fixed income markets.

Now entering its 121st month, the current economic expansion is on course to outlast the previous record of 120 months from 1991 to 2001. This expansion has lasted a long time, but has not been as strong as previous cycles in terms of cumulative growth (see center chart below). It is not unreasonable to assume that this expansion has further to go. The labor market in the U.S. remains tight and household balance sheets remain strong. Economists surveyed by Bloomberg expect the current expansion to continue through at least the end of the year. Despite some areas of weakness, the U.S. economy grew at a 2.1% rate in the second quarter.³ The Conference Board Leading Indicator Survey, a measure of future expected economic growth, has continued to indicate future economic growth, albeit at a slower pace over the past year.

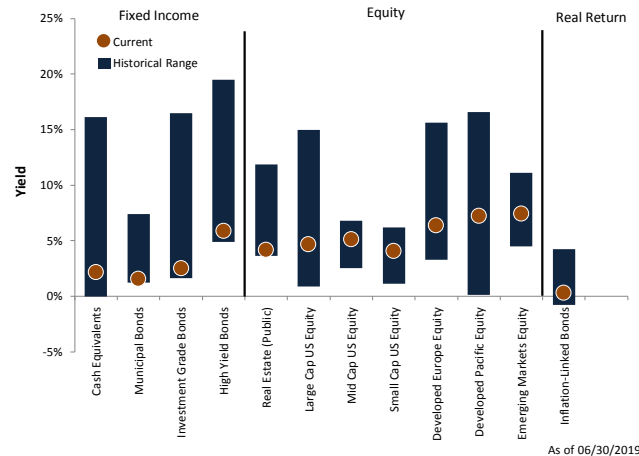
Our proprietary models forecast long-term, pre-tax returns ranging from 1% to 3% for fixed income-like asset classes and 4% to 11% for equity-like asset classes (see table to the right). Equity valuations have continued to rebound, causing us to lower our future return expectations. Bonds have also become less attractive as yields have fallen. We maintain target weight allocations for both, but are cautious as we progress into the later stages of this bull market. Our more detailed observations and current portfolio positioning are outlined in the following comments.

Expected Market Returns and Risks 7-10 Year Horizon

	Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility ¹
Fixed Income	Inflation	1.6%	3.1%
	Cash Equivalents	0.8%	0.4%
	Municipal Bonds	1.4%	1.4%
	Inflation-Linked Bonds	1.8%	1.0%
	Investment Grade Bonds	2.3%	1.3%
	High Yield Bonds	2.7%	1.3%
Equity	Real Estate (Public)	4.2%	17.5%
	Broad Market US Equity	8.9%	16.9%
	Developed Non-US Equity	8.9%	21.4%
	Emerging Markets Equity	10.8%	29.6%

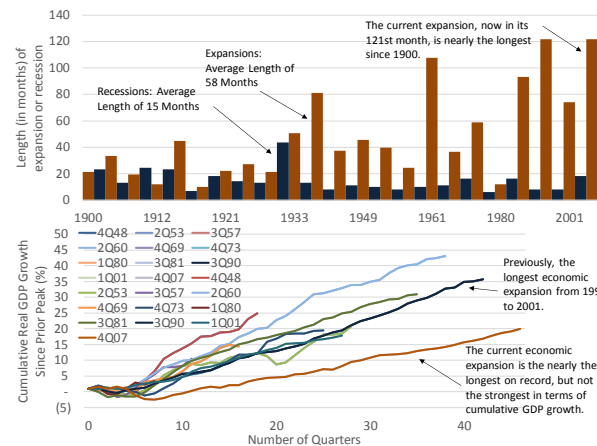
A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.

Yields Across Asset Classes



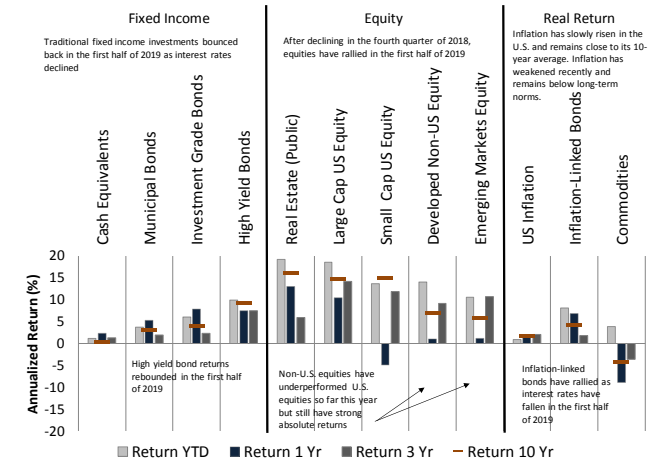
Yields are an indicator of future returns. Orange dots show current yields, blue bars show historical ranges. Yields are generally low versus their historical range.

U.S. Economic Expansions



The current economic expansion is on course to become the longest on record, but it has not been the strongest in terms of cumulative economic growth.

Historical Market Returns



Historical market returns as of June 30th, 2019. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

Global Asset Class Returns

Asset Class Name	Last 10 Years										
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Small Cap US Equity	Small Cap 11.2%	EM Eq 79.0%	Real Estate 28.6%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%	Small Cap 26.5%	EM Eq 37.3%	CPI 2.0%
	S&P 500 10.8%	HY Bnd 56.3%	Small Cap 26.3%	Real Estate 9.2%	Real Estate 17.6%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	HY Bnd 17.5%	Intl Eq 25.0%	Inv Grd Bnd 0.0%
Large Cap US Equity	Real Estate 10.5%	Intl Eq 31.8%	EM Eq 19.2%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%	S&P 500 12.0%	S&P 500 21.8%	Infl-Indx Bnd -1.8%
	HY Bnd 9.0%	Real Estate 28.6%	Commod 16.8%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%	Commod 11.4%	Small Cap 13.2%	HY Bnd -2.1%
Real Estate (Public)	EM Eq 6.7%	S&P 500 26.5%	HY Bnd 15.2%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%	EM Eq 11.3%	Real Estate 8.7%	Real Estate -4.0%
	Intl Eq 5.4%	Small Cap 25.6%	S&P 500 15.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%	Real Estate 8.6%	HY Bnd 7.5%	S&P 500 -4.4%
High Yield Bonds	Inv Grd Bnd 2.9%	Commod 18.9%	Intl Eq 7.8%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%	Infl-Indx Bnd 3.6%	Inv Grd Bnd 3.5%	Small Cap -8.5%
	Infl-Indx Bnd 2.9%	Infl-Indx Bnd 10.1%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%	Infl-Indx Bnd 3.0%	Commod -13.0%
Emerging Markets Equity	CPI 1.6%	Inv Grd Bnd 5.9%	Inv Grd Bnd 6.5%	Commod -13.3%	CPI 2.0%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%	CPI 1.8%	CPI 2.1%	Intl Eq -13.3%
	Commod -3.4%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%
Developed Non-US Equity	Commod -3.4%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%
	Inv Grd Bnd 2.9%	Commod 18.9%	Intl Eq 7.8%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%	Infl-Indx Bnd 3.6%	Inv Grd Bnd 3.5%	Small Cap -8.5%
Investment Grade Bonds	Infl-Indx Bnd 2.9%	Infl-Indx Bnd 10.1%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%	Infl-Indx Bnd 3.0%	Commod -13.0%
	Infl-Indx Bnd 2.9%	Infl-Indx Bnd 10.1%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%	Infl-Indx Bnd 3.0%	Commod -13.0%
Inflation-Linked Bonds	CPI 1.6%	Inv Grd Bnd 5.9%	Inv Grd Bnd 6.5%	Commod -13.3%	CPI 2.0%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%	CPI 1.8%	CPI 2.1%	Intl Eq -13.3%
	Commod -3.4%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%
Inflation	Commod -3.4%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%
	Commod -3.4%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%
Commodities	Commod -3.4%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%
	Commod -3.4%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

Economic Backdrop

- Overall, the global economy is facing headwinds as confidence has started to diminish and global growth has slowed in many regions.
- Consumer prices in major countries are expected to increase at a 2.5% annualized pace in the second quarter.⁴ GDP growth is also expected to increase at a moderated 2.2% pace for the same group of G-20 countries.³
- Economic growth continues to lag in Japan and the Eurozone, two regions where central banks have kept lending rates negative in recent years to help drive growth. The Japanese economy is only expected to grow at a 0.1% annualized pace, while growth in the Eurozone is expected to increase at a 1.0% annualized pace in the quarter.³
- GDP growth in emerging economies is expected to increase at nearly the same 4.2% pace as it did in the first quarter.³ This pace of growth has slowed in recent years. Most notably, China has decelerated to its slowest pace of real economic growth since the early 1990s, the economy grew at a 6.2% annualized pace in the quarter.³
- With the exception of the Federal Reserve in the United States, global central banks have kept interest rates low to negative. The Federal Reserve has kept rates stable at 2.5% since their last rate hike in December. Recently, Federal Reserve Board of Governors have been hinting at rate cuts, citing lower inflation, “soft” business fixed investment and increased economic uncertainties. Economists surveyed by Bloomberg expect the Federal Open Market Committee to cut rates by 0.25% at the end of July and again by the same amount at their December meeting.
- Sentiment has continued to fall globally. At least a portion of this pessimistic view has been attributed to trade uncertainty. Economies such as Germany and Taiwan, which are heavily dependent on exports, have seen confidence drop at a more precipitous

rate than others. The Purchasing Managers Index has fallen below a level of 50 for both the emerging market composite and developed markets. A reading of above 50 indicates expansion, while a reading below 50 indicates contraction.⁵

Equities

- Despite the global uncertainty, equity markets continue to appreciate.
- Equity markets in the U.S. outperformed international markets. Technology stocks continued to rally as the Nasdaq index finished the quarter up nearly 4.3%.⁶
- Weighed down by uncertainties over global trade, emerging markets equities trailed their developed counterparts, up 0.7%,⁷ versus a 3.9%⁸ gain in developed non-U.S. markets in U.S. dollar terms.

Fixed Income

- Fixed income investments rallied in the second quarter as the Federal Reserve signaled a cut in interest rates.
- Longer-dated Treasuries in the U.S. rallied as interest rates fell, up nearly 4.0%.⁹
- Inflation-linked bonds, up 3.7% for the quarter, also benefited from the falling interest rate environment.¹⁰

Current Positioning

- We maintain our **overweight to developed non-U.S. and emerging market equities**, where valuations and long-term growth potential remain attractive.
- We also maintain our **underweight to large cap U.S. equities**. After years of holding an overweight position in an outperforming market, valuations rose to above average levels and our models indicate that a reduced allocation to U.S. equities is prudent.
- We favor **lower priced, value-oriented equities, both in the U.S. and abroad**, which tend to outperform the broad market over time, with less volatility.
- We remain **overweight municipal bonds** for taxable investors.
- Given our significant concerns regarding a longer-term, secular rise in interest rates and the resulting negative impact on bond prices, we continue to **hold shorter maturity bonds**, while steering away from **U.S. Treasuries**.

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses time-tested return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in our continuing effort to craft and implement your customized investment solution.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.



Peter D. D'Agati, CFA



Thomas Kosinski

Endnotes and Sources:

Text:

- (1) Bloomberg: MSCI ACWI Total Return. 3/31/19-6/30/19, 12/31/18-6/30/19.
- (2) Bloomberg: Bloomberg Barclays Global Aggregate Bond Index Total Return. 3/31/19-6/30/19, 12/31/18-6/30/19.
- (3) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated into USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 6/30/19.
- (4) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 6/30/19.
- (5) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing and Service. As of 6/30/19.
- (6) Bloomberg: Nasdaq 100 Total Return. 3/31/19-6/30/19.
- (7) Bloomberg: MSCI Emerging Markets Total Return. 3/31/19-6/30/19.
- (8) Bloomberg: MSCI EAFE Total Return. 3/31/19-6/30/19.
- (9) Bloomberg: Bloomberg Barclays U.S. 7-10 Year Treasury Total Return. 3/31/19-6/30/19.
- (10) Bloomberg: S&P 10 Year U.S. TIPS Total Return. 3/31/19-6/30/19.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 6/30/19.

Source: Stembrook Research.

(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 6/30/19.

Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/InvestorTools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

U.S. Economic Expansions: As of 6/30/19.

Source: BEA, NBER, J.P. Morgan Asset Management. Data for the length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). www.nber.org/cycles

Historical Market Returns: As 6/30/19.

Source: Bloomberg, Stembrook Research.

Indices: Bloomberg Barclays U.S. Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S. Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Consumer Price Index – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns: As of 12/31/18.

Source: Thomson Reuters, Bloomberg, Stembrook Research.

Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Bloomberg Barclays U.S. Treasury Bills: 1-3 Month Index, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index, Bloomberg Barclays U.S. Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Bloomberg Barclays U.S. Corporate High Yield Index, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

Disclosures

This material is intended to inform you of products and services offered by Stembrook Asset Management, LLC (“Stembrook”). Stembrook is a New Jersey Registered Investment Advisor.

This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument.

We believe the information contained in this material to be reliable but do not warrant its accuracy or completeness. The opinions, estimates, and investment strategies and views expressed in this document constitute the judgment of Stembrook, based on current market conditions and are subject to change without notice. The investment strategies stated here may differ from those expressed for other purposes or in other context.

Past performance is not indicative of future results.

The obligations and securities sold, offered, or recommended are not deposits and are not insured by the FDIC, the Federal Reserve Bank, or any governmental agency.

The views and strategies described herein may not be suitable for all investors. This material is presented with the understanding that it is not rendering accounting, legal or tax advice. Please consult your legal or tax adviser concerning such matters.

Important note regarding Stembrook’s capital market expectations.

The capital market expectations developed by Stembrook Asset Management are estimates of both a central tendency of asset class behavior and a probable range of asset class behavior over a long-term horizon. These estimates are one of many inputs used in the portfolio construction process, and should not be used independently. These expectations should not be construed as the returns that will be achieved, but merely those that may be achieved if certain assumptions hold true. Also note that each client's portfolio may differ given specific goals and constraints applied to the portfolio construction process.

Additional information is available upon request.