EMSTONE ADVISERS, LLC

July 15, 2019

Numbers in the News

Indicator	6/30 Value	Versus 3/31
2-yr T-note yield	1.75%	-51bps
10-yr T-note yield	2.00%	-40bps
Yield Curve (2-10yr)	25bps	+11bps
ICE BofAML High Yield (YTW)	6.06%	-42bps
S&P 500	2941.8	+3.8%
Dow Jones Index	26,600.0	+2.6%
CB Consumer Confidence	121.5	-2.1%
Trade Deficit (May/Feb)	-$55.2B	+11.0%
Payroll Employment (000)	151,308	+512
CPI last 12 months	+1.6%	-0.3pp
Core CPI last 12 months	+2.1%	+0.1pp
Personal Consumption Deflator (PCD) last 12 months (May/Feb)	+1.5%	+0.2pp
Core PCD Last 12 months (May/Feb)	+1.6%	+0.1pp

Bloomberg Barclays Bond Index Returns

	Second Quarter	12 Months
Aggregate	+3.08%	+7.87%
Government/Credit	+3.53%	+8.52%
Intermediate G/C	+2.59%	+6.93%
Intermediate A+ G/C	+2.44%	+6.51%
1-3 Year Govt	+1.46%	+4.02%
Municipal Bond	+2.14%	+6.71%

bps = basis points (0.01%)
pp = percentage points
AR = annual rate
NC = no change

Data obtained from various market and government sources by Stoneridge PMG Advisors, LLC. For additional information , please contact our office.

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In the first quarter of 2019, the US economy grew at a robust pace of 3.1%, aided by a boost from net exports and inventory building. The increase in net exports and inventories was due to trade-war related distortions as merchants stocked up on inventories ahead of tariffs. If we look through the noise from temporary disruptions, the underlying trend in economic activity, including personal consumption, was weakening. In the second quarter, there were some signs of stabilization. Consumer spending rebounded and new home construction activity picked up. On the flipside, there were plenty of causes for concern. Despite the improvement in new home building, construction spending still declined on a year-over-year basis for four months in a row. In addition, manufacturing and private investment continued to remain tepid as the impact of the protracted trade war rippled across the globe. The overall pace of growth during the second quarter is expected to have slowed to an annualized rate of 1.5 – 2.0%.

The Escalation of Trade Wars ❖ The US increased the tariffs on $200 billion of Chinese goods from 10% to 25% in May and threatened to extend the levies to all remaining Chinese imports. Furthermore, restrictions were imposed on US technology exports to China. China responded by refusing to resume negotiations under threats and announced a halt to the purchase of US soybeans. Later, as part of a temporary truce allowing negotiations to continue, China resumed buying US soybeans. Trade conflicts were not limited to China. New tariffs were brandished against auto imports from Japan and the EU. Even as the recently concluded US-Mexico-Canada trade agreement is pending ratification, the Administration threatened sweeping tariffs against Mexico. The suddenly announced threats, though later called off, created uncertainties for US manufacturers whose supply chains span the border with Mexico.

The Fallout from the Tariffs ❖ Studies by researchers affiliated with the National Bureau of Economic Research, suggest that trade wars can lead to not only increased costs for consumers, but also reduced employment in export-oriented sectors such as manufacturing and agriculture. According to the Association of Equipment Manufacturers, tariffs could suppress job creation in the US manufacturing industry. The ongoing trade war between the world's two largest economies is a shock to the global manufacturing sector, forcing a re-alignment of global manufacturing value chains that will play out over time.

Domestically, the US farming sector is particularly reeling from the impact of China's retaliatory tariffs. The US previously enjoyed a significant trade surplus in the farming sector. As a result of the trade war, the sector's trade balance has declined to its lowest level since 2007. Soybean exports have plummeted by 80% and other agricultural exports declined by 50% since the trade war began last year. Furthermore, the US withdrawal from the previously signed Trans-Pacific Partnership has placed US farm exporters at a disadvantage in Asian markets.

Consumer Resilience ❖ Thus far the tariffs have been focused on producer goods. Nevertheless higher consumer prices resulting from the tariffs have almost completely offset the average household's lower tax bill following the Tax Cut and Jobs Act. Since finished goods have not been directly targeted yet, the consumer and service sectors of the economy have remained resilient. Despite an unexpected sharp decline in June, consumer confidence remains historically high. Small business confidence jumped in April and May before falling back a bit in June.

In the first quarter, it appeared as though lower mortgage rates could help revive the housing sector. Mortgage applications and new home sales improved, and home builder optimism rose. However, the rebound in housing activity this year has been modest. Home prices continued to appreciate, albeit at a slower pace. Investors, seeking to purchase properties and turn them into rentals, are outbidding first-time home buyers. The housing market continues to be plagued by supply shortages, particularly for families looking to buy their first home. Home builders' confidence slipped in May on rising construction cost and trade concerns.

The Near-Term Outlook ❖ The job market, though cooling off from the hectic pace of last year, keeps chugging along. The average pace of job creation was 223,000 jobs per month in 2018. This year it has cooled to a still solid rate of 172,000 jobs per month through June. This bodes well for consumer spending. Personal consumption, which rebounded in the second quarter, is likely to soften a bit. While the job market and the consumer economy remain solid, the trade war is weighing on the manufacturing sector and capital spending. Given trade uncertainties, global slowdown, and the rising geo-political tensions with Iran, market participants are expecting the Fed to cut rates later this month.

Fixed Income Commentary ❖ During the second quarter, US Treasuries outperformed corporate credit. The pivotal change in rate expectations for several rate cuts by the Federal Reserve in 2019 produced exceptional returns across the Treasury curve with longer maturities outperforming. The Bloomberg Barclays US Intermediate Treasury index returned 2.36% during the quarter and an impressive 3.99% for the year-to-date. Even short-term rates fell as market participants adjusted to projections of slower global growth. The three-month Treasury bill ended the quarter at 2.09% down from 2.32% just one month ago. Two-year Treasury notes declined 51 basis points (0.51%) to 1.75% while ten-year Treasuries declined 40 basis points (bps) to yield 2.00% at the end of the quarter. The result was a yield curve that continued its recent trend by flattening 11 bps.

Overall investment grade (IG) credit spreads were relatively flat for the second quarter, tightening just two bps; however demand for corporate bonds remained strong. Expectations for lower rates supported a continued hunt for yield and trumped concerns of recession and trade tensions. IG credit default swaps were tighter than they had been in more than a year as the quarter ended. Investment grade outperformed high yield corporate bonds underscoring the continued preference for higher quality. Although issuance this year has been plentiful, it remains 12% below last year's pace year-to-date further supporting narrower yield spreads.

Bloomberg Barclays Index Second Quarter, 2019	Total Return	Excess Return[1]
Intermediate Treasury	+2.36%	0.00%
Intermediate Agency	+1.71%	0.00%
Intermediate Credit	+2.99%	+0.53%
Intermediate High Yield Corporates	+2.40%	+0.39%
Securitized (MBS, ABS, CMBS)	+2.04%	-0.33%
Source: Bloomberg Finance L.P.		

Nearly all industries within the credit index produced positive total returns last quarter. In terms of excess return, the best performance came from food & beverage at 2.37% and wireless telecom at 2.33%. The return for food & beverage was most likely lifted by better than expected earnings from PepsiCo. That company benefited from lower taxation as well as positive return from strategic initiatives. Insurance continued its trend of strong steady performance with excess returns of 1.87% in life, and 1.24% in property and casualty.

Crude oil fell sharply during the quarter from its year-to-date high of $66 on April 23 to $51 before trending higher from mid-June to end the quarter at $58. The decline showed up in negative excess returns for oil field services (-0.35%) and refining (-0.20%). The volatility in oil is due to changing supply dynamics. The US is increasingly becoming a top producer. As of April 2019, the US had a daily production of 12.2 million barrels compared with 11.3 b/d in August 2018.

Against a backdrop of the probable change in Federal Reserve policy to a more accommodative stance, we now expect US Treasury rates to remain in a new lower trading range. Over the next few months, we expect short rates (two-year Treasury) to range between 1.50% and 2.00%, and the ten-year Treasury to range between 2.00% and 2.25%.

[1] Curve-adjusted excess return over US Treasuries