



Investment Strategy Outlook

Summer 2019

Early this year former Federal Reserve Chairman Ben Bernanke and past Chairwoman Janet Yellen spoke to a group of economists in Atlanta. At one point the following exchange occurred between them: Dr. Yellen said, “I don’t think expansions just die of old age,” to which Dr. Bernanke replied, “I like to say they get murdered.”

Strategas Research Partners has a simple framework in their attempt to explain what causes recessions to occur: (i) Exogenous shocks, (ii) policy errors whether fiscal, regulatory or trade, and/or (iii) the Federal Reserve goes too far with their tightening cycle in order to curb inflation and adhere to their price stability mandate. The Federal Reserve is by far the most common offender of the three reasons listed and also the “murderer” to which Dr. Bernanke was referring.

We believe that downside risks to the economy and the markets have modestly increased as the risk of a policy error has intensified, both in regard to U.S. – China trade negotiations and overly tight monetary policy.

It is difficult to believe that a few short weeks ago the investment landscape was being referred to as “goldilocks.” In late April and the first week of May, broad U.S. large cap equity indices briefly achieved an all-time high, and U.S. economic data releases were close to perfect. The initial reading on Q1 GDP was 3.2%, the unemployment rate dropped to a 50 year low of 3.6%, and wage growth (which was sluggish until late 2017) continued to show a positive trend. And despite all this good news, inflation readings remained tame and below the Fed’s stated target (i.e. the market knew the Fed was not going to raise rates anytime soon).

We do not believe it was a coincidence that the White House chose to (again) escalate the

trade tensions with China just after we received this near perfect package of economic data. To take this thought process one step further, one might also speculate that President Trump had at least a couple of advisors reminding him that the economy could be peaking too early in relation to the next election. Spring / summer 2020 would be the optimal time for his reelection campaign to have the economy operating on all cylinders rather than 18 months ahead of the next election.

Most of our long-time clients have heard us mention the phrase “markets hate uncertainty more than bad news itself.” Regardless of their accuracy, economists can do some quick theoretical math to project the effect tariffs could have on economic growth. But as non-tariff barriers have entered the conversations (Huawei / restrictions on U.S. companies doing business with certain Chinese companies, China possibly banning exports on rare earth minerals, addressing IP theft, etc.) uncertainty has risen considerably. This has left investors the difficult task of trying to incorporate a plethora of unknowns, including corporate earnings forecasts against the backdrop of an already decelerating global economy.

Economic & Market Viewpoints

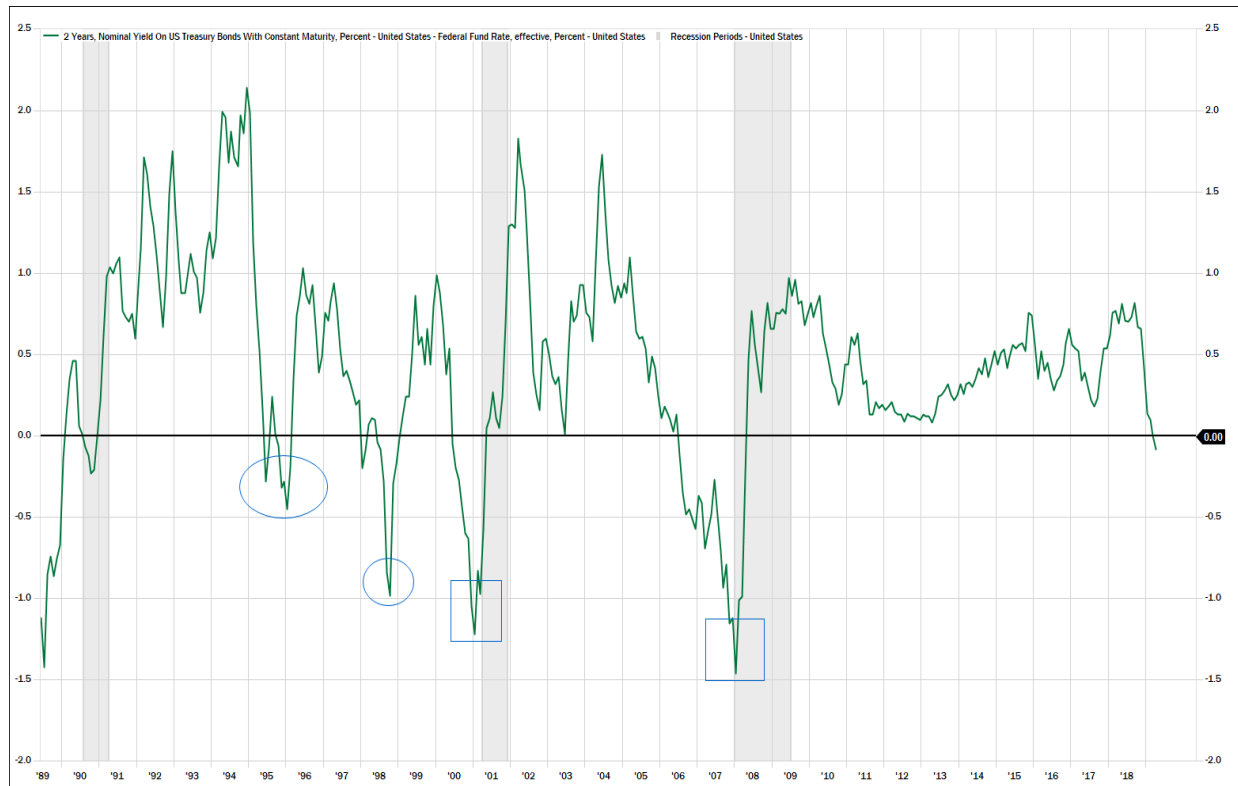
MBL Advisors employs Strategas Research Partners as our primary source for economic and investment research. We also use multiple other resources to build out our independent assessment of macro-economic and financial conditions.

- Several Wall Street firms have downgraded their economic growth forecasts and S&P 500 earnings estimates over the last week. 2019 year end S&P 500 targets could be next to follow.
- On Monday 6/3/19, Strategas lowered its 2019 S&P 500 EPS forecast to \$167.75 / share from \$171.75 / share. It also adjusted odds of a “downside economic shock” from 20% to 30%. As we already mentioned, MBL Advisors agrees with the general view that downside risks to the U.S. and global economy have increased over the last month. Nonetheless, a 30% probability is not significant enough for it to become the “base case” forecast.
- Strategas has also lowered its U.S. economic growth forecasts by roughly 0.5% to reflect “muddle through” growth of 2% +/- for the remainder of 2019 and 2020.

- European bond yields and European bank stocks look as hopeless as they have at any point since the financial crisis. As of 6/3/19 Fundstrat Global noted that 21% of global bonds have negative yields (Europe and Japan), which has only been briefly surpassed in early 2016. Deutsche Bank's stock price similarly reflects a troubled economic picture in Europe. DB stock went from an all-time high of around \$110 +/- to below \$20 per share before bottoming in early 2009. DB stock was above \$50 per share by mid-2009. DB trades below \$7 per share today. In contrast, virtually all U.S. bank stocks are vastly higher than they were at their 2008 / 2009 lows.
- U.S. yields have meaningfully declined along with global yields over the last month. U.S. yields were one of the few market-based indicators that never confirmed the rally that the stock market experienced in January through April. In other words, the stock market was pricing in better growth expectations for the remainder of 2019, but the bond market was not.
- The 10 year minus 3 month yield curve is now inverted. We have five primary thoughts on this current yield curve inversion:
 1. The bond market is signaling to the Fed that they need to cut the Federal Funds rate. A large portion of the yield curve has inverted with the stated Fed Funds rate at 2.25% to 2.50%, while real GDP growth and inflation are both likely to be below 2% for the foreseeable future.
 2. We believe the current inversion is a signal for the Fed to cut rates and not yet a strong recessionary signal. Strategas Research Partners believes that an inversion of at least -0.25% for three months would be a strong recessionary signal.
 3. The 10 year minus 2 year curve is not inverted and has actually steepened over the last week. Economists are somewhat split regarding which measure has a higher predictably of forecasting recessions. (10 year – 2 year vs. 10 year – 3 months).
 4. The 2 year Treasury minus Fed Funds curve is also inverted. This has happened four times in the last 25 plus years. In 1995 and 1998, the Fed was proactive and the economic expansion continued with equity markets resuming higher. In 2000 and 2006, the Fed remained complacent with

their policy outlook and did not cut rates until several months after the curve inverted. Economic and equity market performance following the latter two instances is unfortunately self-explainable.

Chart 1: 2 year Treasury – Fed Funds Rate



Source: FactSet & MBL Advisors 06/03/2019

- History shows that yield curve inversions almost always lead recessions and peaks in equity markets. In other words, a yield curve inversion “starts the shot clock” but doesn’t usually signal the “end of the game.” On average the yield curve inversion would occur 12 to 18 months ahead of a recession. If the current inversion is a legitimate signal, it could align the beginning of the next recession with 2020 elections.

It should be noted that credit spreads remain relatively well-behaved which is almost never the case during a recession or even stressed market environment such as 2011, Q1 2016 or Q4 2018.

- The Federal Reserve will likely be conflicted with the current setup. The Fed has a dual mandate of (i) price stability and (ii) full employment. On one hand it will be difficult for them to cut rates with unemployment low and wages growing. Most current economic data points would not usually be supportive of a rate cut. Conversely, the Fed has consistently undershot their inflation target and if anything, this should be the point in the economic cycle where they are overshooting their inflation target. Intermediate and long-term bond yields are not controlled by the Fed, and they are usually a good read on future growth and inflation expectations. As we have mentioned they are giving a strong signal of slowing growth.

So, despite economic data being okay right now, the bond market and most economists believe that global growth will be lower moving forward, and the U.S. – China trade situation only adds to this thesis. This could be the cover that the Fed needs in order to cut rates. We believe rate cuts will be more impactful the more proactive the Fed is with their actions. Unfortunately, history shows that the Fed is often a lagging indicator.

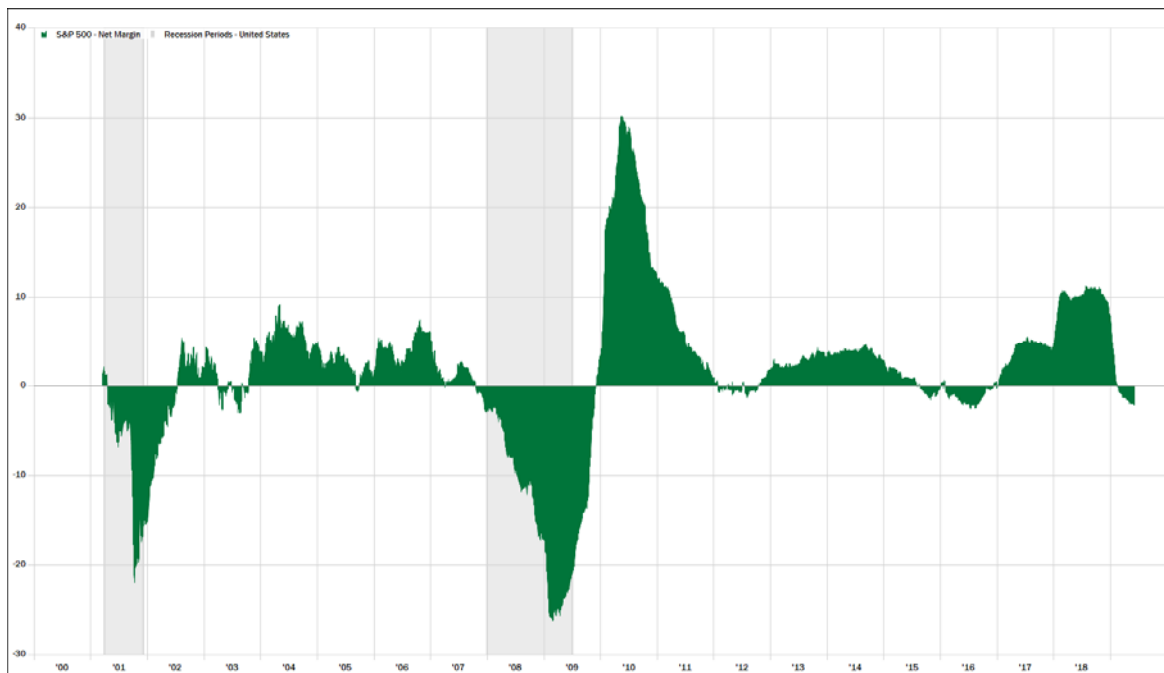
MBL Advisors' forecast is for the Fed to cut rates one or two times in 2019. Having said this, the trinity scenario which the equity markets desire (i) rate cuts (ii) and a China trade deal (iii) and okay economic growth will be very difficult to persist as one of these things will likely have to give out.

- It seems that President Trump and China both have a lot to lose if trade tensions do too much damage to the global economy or capital markets. Even so, the “pressure point” in global equity markets is likely lower than current prices to force either side to compromise. At this point both the U.S. and China are deliberately trying to inflict economic pain on one another – with the goal of gaining the upper hand in future trade negotiations. However, we should remember that President Trump himself declared the U.S. stock market to be a large portion of his “scorecard.” Keeping this in mind, it would be easier for us to see a longer-term trade war after the November 2020 election if President Trump were to be reelected.

- Decelerating profit growth could be the largest single headwind that the capital markets face over the next several quarters regardless of the news cycle surrounding the Fed and China.

Earnings growth has outpaced revenue growth and economic growth over the last ten years thanks to expanding profit margins. Profit margins are now starting to erode as wages are increasing along with re-financing costs. Increased input costs due to tariffs are not even reflected in this data yet. If corporations stop hiring or worse yet, begin to lay off employees in attempt to preserve profit margins, economic conditions could deteriorate more rapidly.

Chart 2: S&P 500 Net Margin

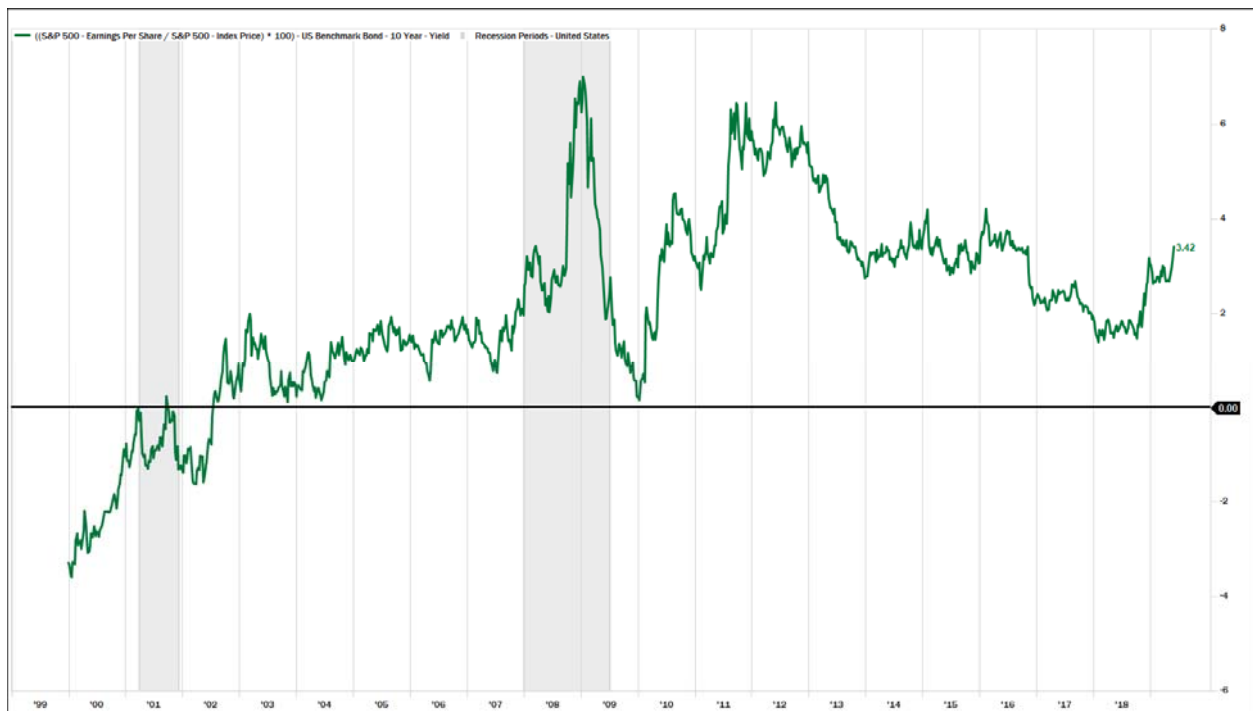


Source: FactSet & MBL Advisors 06/03/2019

- On a more positive note, equity risk premiums again look attractive for long term investors in U.S. stocks. The equity risk premium is a relative valuation metric we follow to help measure the attractiveness of U.S. stocks vs. U.S. Treasury bonds. Having said this, it is important to remember that valuations are useful to forecast long term expected returns but are less useful in forecasting shorter term returns. Nevertheless, it may be appropriate to view current U.S. equity market conditions from a different perspective as the 10 year Treasury is around 2.10% and possibly

heading below 2% if the Fed begins an easing cycle. This is a different (more positive) setup versus when the 10 year Treasury was approximately 3% last fall, and with many market participants thinking there was a distinct possibility of the ten year going to 4% in 2019.

Chart 3: S&P 500 Equity Risk Premium



Source: FactSet & MBL Advisors 06/03/2019

- The period since 2012 notwithstanding, volatility is a very normal part of equity market investing. The most positive possible spin on the -6.5% S&P 500 return in May is that markets were overbought and due for a pullback after four straight up months.

Despite the possibility of a short term overbought situation in late April, various surveys show that positioning within markets is far more conservative (high cash balances) today than it was in January 2018 or October 2018. This should help support equity prices, all else equal.

A market exhibiting strong price momentum is not normally a coincidence and can signal above average forward returns over the next 6 and 12 months. Ryan Detrick and LPL Research conducted some great work and found that there have been 15

calendar years since 1950 when all four months from January – April have had positive returns in the S&P 500. During these 15 years the S&P 500 ended the calendar year with positive total returns every single time. In addition, the S&P 500 had positive returns from May through December 14 out of 15 instances. All of this is despite an average pullback of -8.1% during the May through December timeframe. 2019 is the 16th year since 1950 when all four months from January through April had positive returns for the S&P 500.

Chart 4: Calendar Years with positive monthly returns in January - April

A STRONG START TO A YEAR HAS BULLS SMILING						
What Happens If The S&P 500 Index Is Green The First Four Months? (1950 - 2018)						
Year	January Return	February Return	March Return	April Return	Rest of Year Return	Max Pullback (Final 8 Months)
1950	1.5%	1.0%	0.4%	3.9%	13.8%	-14.0%
1954	5.1%	0.3%	3.0%	4.9%	27.3%	-4.4%
1961	6.3%	2.7%	2.6%	0.4%	9.6%	-4.4%
1964	2.7%	1.0%	1.5%	0.6%	6.7%	-3.5%
1967	7.8%	0.2%	3.9%	4.2%	2.6%	-6.6%
1971	4.2%	0.9%	3.7%	3.5%	-1.8%	-13.1%
1972	2.0%	2.5%	0.6%	0.4%	9.6%	-5.1%
1975	12.3%	6.0%	2.2%	4.7%	3.3%	-14.1%
1983	3.3%	1.9%	3.3%	7.5%	0.3%	-6.9%
1991	4.2%	6.7%	2.2%	0.0%	11.1%	-5.6%
1995	2.4%	3.6%	2.7%	2.8%	19.7%	-2.5%
1996	3.3%	0.7%	0.8%	1.3%	13.2%	-7.6%
1998	1.0%	7.0%	5.0%	0.9%	10.6%	-19.3%
2006	2.5%	0.0%	1.1%	1.2%	8.2%	-7.7%
2013	5.0%	1.1%	3.6%	1.8%	15.7%	-5.8%
2019	7.9%	3.0%	1.8%	3.9%	?	
Average					10.0%	-8.1%
Median					9.6%	-6.6%
Higher					14	
Count					15	
Average Year (1950 - 2018)						
					Rest Of Year Return	Max Pullback (Final 8 Months)
Average					4.7%	-11.8%
Median					6.0%	-9.4%
Higher					48	
Count					69	

Source: LPL Research, FactSet 05/21/19
 All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.
 The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

Source: LPL Research & FactSet 05/21/2019

Conclusion

Economic and market signals are becoming more conflicting, which is normal for a late cycle economic environment. As is usually the case, Wall Street market forecasting accuracy over the last year is a reminder to investors to stay humble when trying to predict the future. We mentioned in our 2019 year ahead outlook ([January 2019 ISO](#)) that the single most consensus market forecast that we could find was for yields to move higher throughout 2019. All major investments houses were forecasting somewhere between 2 to 4 Fed rate hikes for 2019 as of December 2018. Strategas cited a Bloomberg survey which showed that 1 of 58 economists had a 10-year yield forecast below 2.75% for 6/30/19 (most forecasts were for 3% ++). As of 6/3/19 the 10-year treasury is below 2.10% and Fed Funds futures have priced in 2 rate cuts during the remainder of 2019. We don't mention this because we had a more accurate forecast around interest rates or some other market data point (we didn't). We highlight this example to remind us how difficult and humbling trying to predict the future can be.

Having said this, we maintain our forecast from last December, which was that 2800 is a reasonable "fair value" midpoint for the S&P 500 as long as China trade tensions exist. Until additional market catalysts appear, we sense a "Trump collar" exists on the market. Thus, we foresee a broad trading range (possibly as wide as 2600 to 3000 for the S&P 500) prevailing until we get more definitive information and / or a catalyst that does not exist yet. Economic growth and corporate earnings comparisons will be very difficult until we get to the fourth quarter of this year, at which point we believe U.S. economic growth will remain sluggish but will no longer be "decelerating."

Despite multiple market headwinds that could make for a difficult investing environment this summer, we believe recession is too much of an extreme call for the U.S. economy right now. Labor markets, the U.S. consumer and the services-based part of our economy continue to act as a solid foundation. Confidence channels will be important to watch moving forward, especially if negative headlines persist at a high rate. Investors should also recall that if rebounds occur in equity markets they can be equally as violent as the preceding sell off.

In general, we continue to recommend maintaining a neutral equity weighting within portfolios. While we have maintained a fairly consistent allocation to equities over the last

nine months, we have increasingly implemented a more defensive posturing within our equity exposure. We have achieved this goal using various techniques including the following:

- o Overweighting U.S. Large Cap equities vs. all other equity asset classes.
- o Rotating some exposure from market cap weighted index ETF's to "high quality" equity ETF's and some select active managers.
- o Marginally increasing dividend yield within our equity holdings.
- o Using technical analysis to help manage downside risks within portfolios.

Although May was not a pleasant month for most investors, it was another example of how useful diversification is within portfolios. Bonds had a terrific month as yields went lower, and gold finally came to life as well.

As long-term investors, we are going to experience an endless change in market environments over the next several years. No investor has ever been able to accurately predict capital market conditions on a repeatable basis. We have very high conviction that we will be pleased with our long-term results if we build durable portfolios, stay prepared for a wide range of market outcomes, remain disciplined and execute our investment plan.

Sincerely,

A handwritten signature in black ink, appearing to read "B. Gift", with a stylized flourish at the end.

Brian J. Gift, CFA
Chief Investment Officer
MBL Advisors

Investment Wisdom

“Markets change minute by minute. Human nature barely changes millennium by millennium. There’s your edge.”

- Jim O’Shaughnessey

“The thing about goals is that living without them is a lot more fun, in the short run. It seems to me, though, that the people who get things done, who lead, who grow and who make an impact... those people have goals.”

- Seth Godin

“Investing, after all, is an operation that transfers wealth to those who have a process and can execute it from those who do not and cannot; from what I’ve seen, the average investor’s strategy consists of pride when prices rise and panic when they fall.”

– Bill Bernstein

“Life, like poker, is one long game, and there are going to be a lot of losses, even after making the best possible bets. We are going to do better and be happier, if we start by recognizing that we’ll never be sure of the future. That changes our task from trying to be right every time, an impossible job, to navigating our way through the uncertainty by calibrating our beliefs to move toward, little by little, a more accurate and objective representation of the world. With strategic foresight and perspective, that’s manageable work. If we keep learning and calibrating, we might even get good at it.”

– Annie Duke

Disclosures:

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The Standard & Poor’s 500 Index (S&P 500 TR) is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

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