The Cobblestone Advisor

Investment Brief

July 2019

COBBLESTONE
CAPITAL ADVISORS

Let the Good Times Roll

Despite a broad-based selloff in risk assets in May, June's sharp recovery led to US equities having their best six-month start to the year since 1997 as the S&P 500 (+18.5%) reached new highs. It wasn't just US equities that generated notable returns in the first half of the year; bonds rallied as well, with US fixed income markets up +6.1%. Although performing positively, international developed stocks (+14.0%) and their emerging market counterparts (+10.6%) underperformed domestic equities amid fears of moderating growth in China and subpar economic output in Europe. Real assets, likely buoyed by a tempered US Federal Reserve (Fed), have also performed strongly thus far in 2019, despite very little concern of runaway inflation.

While the year-to-date returns are certainly welcomed by investors, we must point out that the typical correlation between equities and bonds—that sees equities fall when bond yields decline—has broken down. This leads us to question if there is truly a disconnect between the two asset classes, and whether the drivers of recent market returns are likely to persist. Sentiment, as we highlighted in April's Investment Brief, looks to be the likely catalyst that continues to underpin movements in asset prices. This is not just a US phenomenon—in equity markets across the globe, price multiple expansion has been the key driver of returns this year, rather than growth in earnings.

In our view, there are two primary factors currently driving sentiment. The first is monetary policy expectations. The second is ongoing trade negotiations between the US and China. Importantly, neither should be counted on to keep the equity market rally going, and each has the potential to drive both upside and downside volatility in financial markets for the foreseeable future. With regard to monetary policy, market participants were—as recently as March—pricing in a 0% probability of a 25 basis point rate cut at the Fed's July meeting. This quickly changed and, as of the beginning of July, the probability stood at 95% (exhibit below). The increasing reliance of market participants on an easy Fed has been a notable driver of higher security prices: 45% of the year-to-date return of

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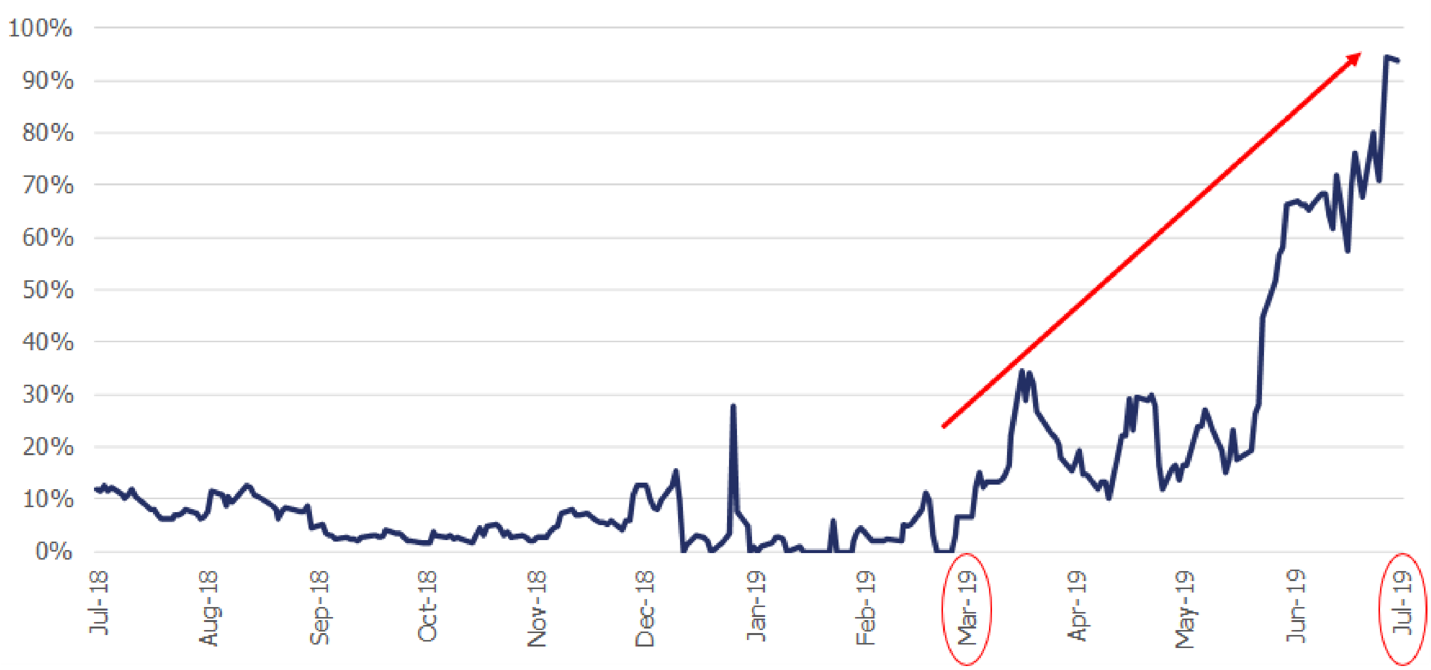
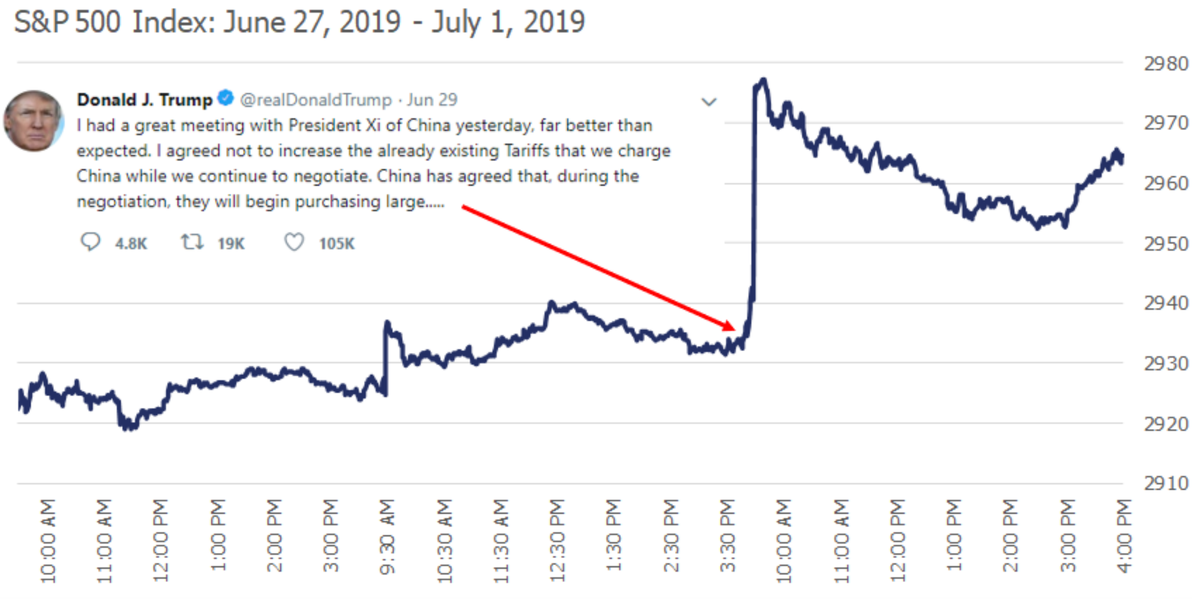
Probability of July Fed Rate Cut



Source: CME FedWatch Tool

the S&P 500 has come from gains in the two days following each of the three instances of dovish Fed news (Jan 4, June 4, and June 19).



Source: Bloomberg; Twitter

US-China trade tensions also continue to ebb and flow, with financial markets largely following suit. On May 13, after China announced new tariffs on $60 billion of US imports, the S&P 500 suffered a one-day loss of -2.4%. As relations between the two countries continued to deteriorate throughout the month, the index moved lower, ending May down -6.6% for the month. This contrasts with the tone of Presidents Trump and Xi at the end of June, which had become more conciliatory. As seen in the exhibit above, President Trump's tweet concerning a "...great meeting with President Xi of China..." drove the S&P 500 sharply higher.

Regarding whether there is a disconnect between stocks and bonds, we would argue "no." The Fed has become more dovish in recent months, telegraphing its willingness to move to a more accommodative policy stance if necessary. Thus, it makes sense that yields have moved lower. Lower yields, in turn, raise the present value of future cash flows, which support higher equity prices. The risks, however—which the market may be underappreciating—are that monetary policy easing measures fail to meet market expectations and/or the US-China trade war intensifies. Although negative developments in both policy and trade are completely plausible, financial market participants seem to be betting on a single end result and are failing to recognize a range of possible outcomes.

In this sentiment-driven environment where the prices of risk assets continue to advance, equity markets sit at all-time highs, and bond yields are moving lower, it is increasingly important for investors to remain vigilant and properly diversified. Proper diversification can be achieved via an appropriate asset allocation based on an investor's long-term objectives, current financial position, and tolerance for risk. Depending on individual circumstances, a suitable asset mix may consist of equities, bonds, real assets, and other alternative investments. Ensuring that portfolio exposures are well-balanced across various asset classes can be a powerful way for investors to achieve proper diversification, reduce overall portfolio risk, and potentially enhance returns.

Total Return (%), Ending 6/30/2019				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	4.30	18.54	10.42	14.17	10.68	14.65
Russell 2000 (Small Cap Stocks)	2.10	16.98	-3.31	12.29	7.04	13.40
MSCI EAFE (International Stocks)	3.68	14.03	1.08	9.09	2.24	6.88
MSCI EMF (Emerging Markets)	0.61	10.58	1.21	10.65	2.48	5.79
Barclays US Aggregate Index	3.08	6.11	7.87	2.31	2.94	3.88
Dow Jones US Select REIT	0.82	16.67	9.75	3.73	7.58	15.35
Consumer Price Index (% Chg over Period)	0.46	1.02	1.66	2.06	1.48	1.74