Video Transcript
Economic Review & Outlook

Authors

Glenn Dorsey, CFA®, CAIA®
SVP, Head of Client Portfolio Management

Peter Eisenrich, CFA®
VP, Senior Client Portfolio Manager

Navigate Your Future. Enjoy the Journey.

Second Quarter 2019

Thanks for joining me for a recap of the latest economic and capital market developments from the second quarter of 2019. So let's begin.

As a reminder, these gauges represent the five major areas that help shape our view for the overall economic environment, which in turn drives our expectations for the stock market. Recall that 12:00 is neutral, anything to the right of 12:00 is positive for stocks, and anything to the left of 12:00 is negative. After significant movement in these gauges over the last few quarters, we made no adjustments this time around. We currently have two gauges that are positive, and three that are neutral.

U.S. Economy

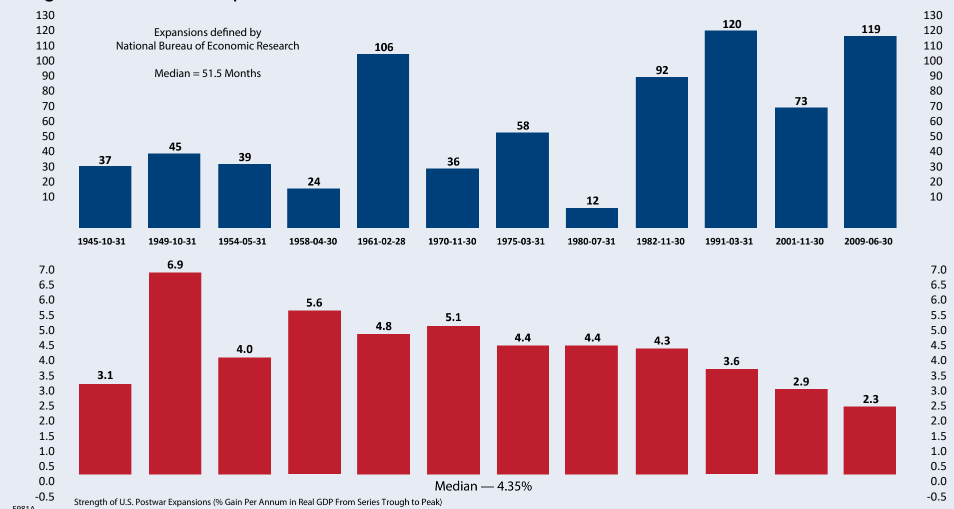
First let's discuss the U.S. economy, which we leave in a slow forward position. GDP in the first quarter of 2019 was stronger than expected at 3.1%. Second quarter GDP is expected to slow from the first quarter, but ongoing growth is anticipated. The current U.S. economic expansion has been resilient and is now the longest on record, but at the same time has been marked by the slowest pace of growth (at 2.3%), since World War II.

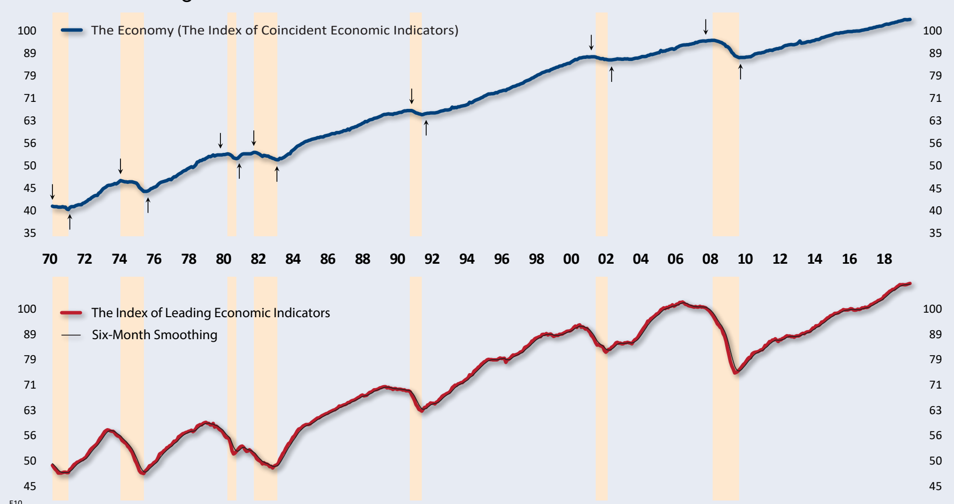
Overinvestment, which led to the internet and housing bubbles, ended the prior two expansions. In this expansion, we believe more regulation, low productivity, the lack of investment and demographics have led to this slower and more steady growth environment, and we expect growth to continue in 2019 and into 2020. The economic

Video Transcript

Economic Review & Outlook

indicators we follow that reflect the front edge of the economy continue to show more runway for this expansion.





The Conference Board's Leading Economic Indicators Index (the red line on the bottom of the chart above), has been putting in new all-time highs in recent months. Since 1960, this indicator has rolled over about 11 months prior to a recession (16 months prior to the last three recessions) and we have not seen that lower trend develop at this time.

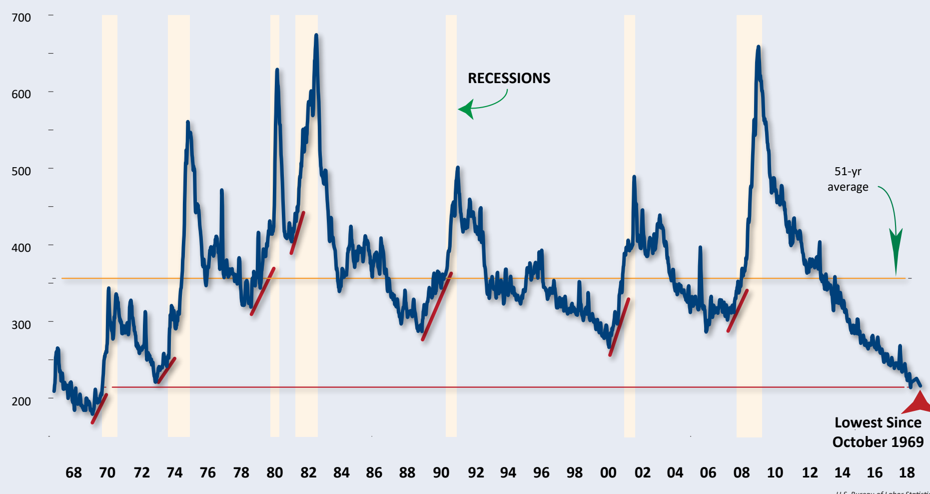
Job market data looks solid as well as the weekly initial jobless claims continue to hover near their lowest or best levels since 1969. Layoffs, which would be reflected in this reading, tend to turn up about 6 to 12 months before a recession and those indications are not present at this time.

Navigate Your Future. Enjoy the Journey.

Video Transcript

Economic Review & Outlook

Unemployment Claims (4-wk moving avg)



Furthermore, the unemployment rate sits at 3.6%, also at its lowest level since 1969, and this rate tends to move higher, on average about 0.4 percentage points, prior to a recession.

Unemployment Rate Before Recessions

Unemployment Low	Rate	Recession	Rate	Point Change	Number Days
5/31/1948	3.5	11/30/1948	3.8	0.3	183
5/31/1953	2.5	7/31/1953	2.6	0.1	61
3/31/1957	3.7	8/31/1957	4.1	0.4	153
2/29/1960	4.8	4/30/1960	5.2	0.4	61
9/30/1968	3.4	12/31/1969	3.5	0.1	457
10/31/1973	4.6	11/30/1973	4.8	0.2	30
5/31/1979	5.6	1/31/1980	6.3	0.7	245
12/31/1980	7.2	7/31/1981	7.2	0	212
3/31/1989	5	7/31/1990	5.5	0.5	487
4/30/2000	3.8	3/31/2001	4.3	0.5	335
10/31/2006	4.4	12/31/2007	5	0.6	426
Mean				0.35	241
Median				0.4	212

Source: Ned Davis Research

Navigate Your Future. Enjoy the Journey.

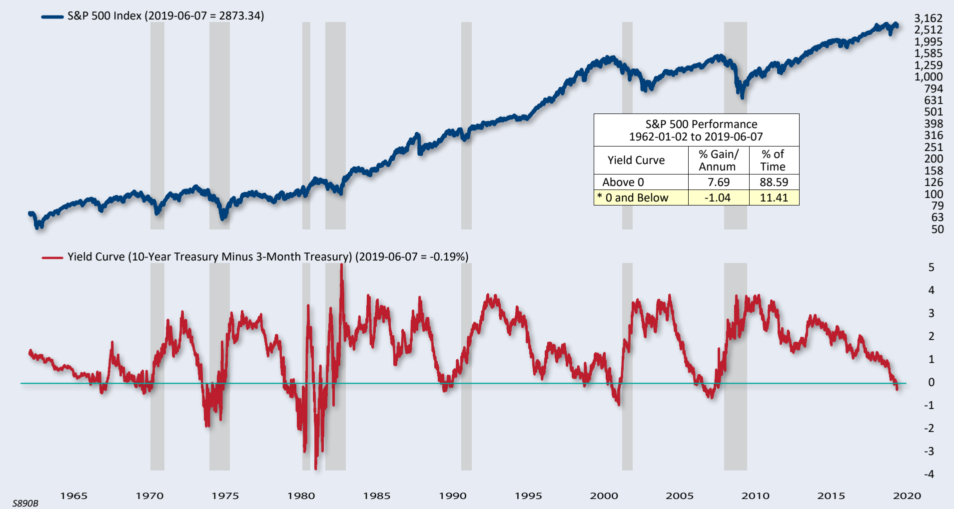
Both the leading economic indicators index and job market data suggest that the U.S. economy has more growth ahead. The yield curve has now turned decidedly inverted, which is cause for concern, as its track record of forecasting recessions has been very good. The prior 7 recessions dating back to 1962 have been preceded by an inverted yield curve.

After briefly going inverted in late March, the yield curve, as measured by the 10-year U.S. Treasury yield and the 3-month T-bill yield, turned positive before a more definitive move, which has resulted in an inverted yield curve since May 23rd. The duration

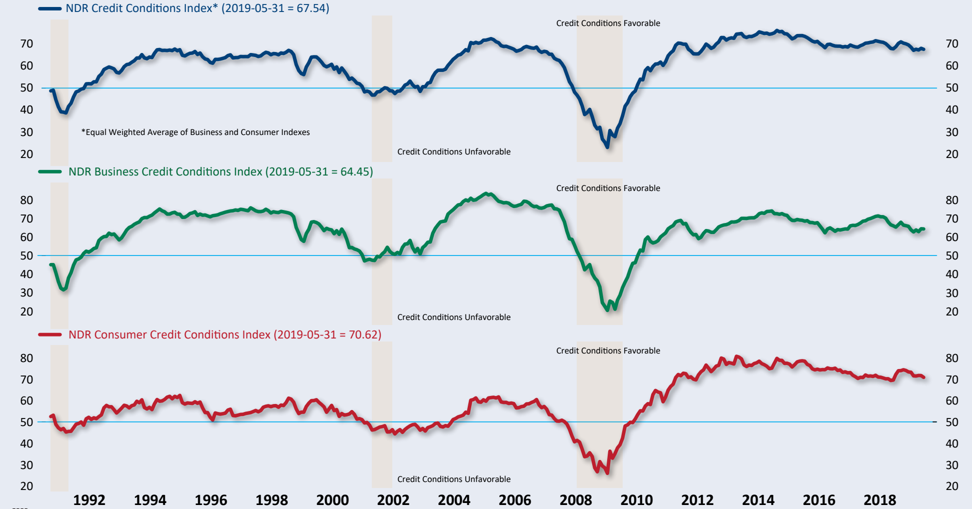
Video Transcript

Economic Review & Outlook

of the inversion seems to matter historically as the yield curve was inverted for at least 50 days prior to six of the previous seven recessions.



However, it is worth noting that there have been two false signals from the inverted yield curve when a recession did not follow. At this time, other indicators of stress in the credit market are not yet appearing, and credit conditions remain favorable.



We will continue to monitor the shape of the yield curve, but at this point, other economic measures are not confirming this signal of caution. Overall, we believe the fundamental backdrop for the economy continues to look solid and we expect growth to continue throughout 2019 and into 2020.

Furthermore, the Fed made an abrupt move to the dovish side early in 2019 and continues to indicate that they are data dependent regarding further rate activity. We believe market expectations are clearly pointing toward a pending rate cut cycle.

Navigate Your Future. Enjoy the Journey.

ClarkCapital MANAGEMENT GROUP

Video Transcript

Economic Review & Outlook

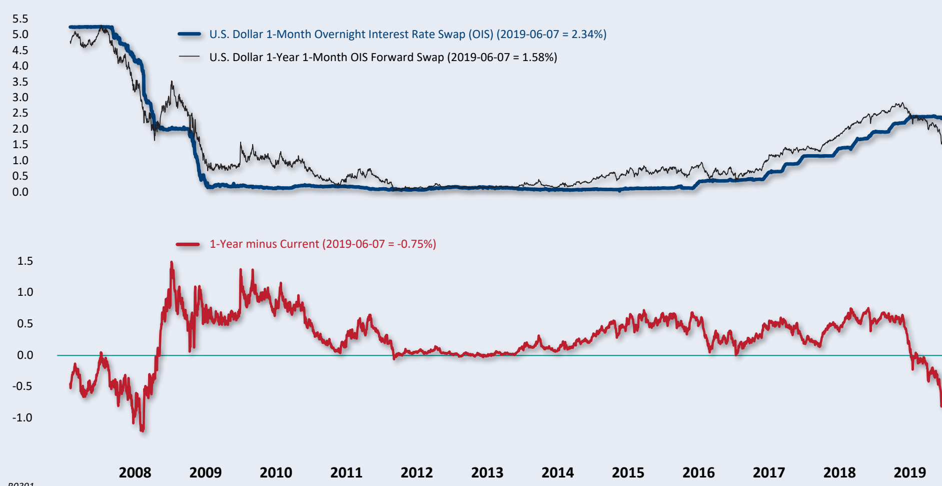
Monetary Policy

Monetary Policy

This leads us to monetary policy. The probability of a rate cut has continued to grow as the year has progressed. Believe it or not, following the June FOMC meeting, the market was anticipating a 100% chance of a rate cut at the July FOMC meeting and forecasting nearly 100 basis points in cuts over the next 12 months.

Policy Rate Expectations Using OIS Curve

Daily Data 2007-01-03 to 2019-06-07



Although we think it is likely that the Fed will cut rates in July, we believe the China trade situation will be a key factor heading into that meeting. Furthermore, we find it hard to believe that the Fed will cut as much as the market is currently expecting with GDP at 3.1% in the most recent quarter, unemployment at 3.6% and the S&P 500 near record highs.

But there are also good arguments for a rate cut with inflation remaining stubbornly low, recent weakness in manufacturing data, the inverted yield curve and increased economic uncertainty, not least of which comes from the ongoing trade strife with China.

The Fed is trying to pull off a delicate balancing act as it sets policy rates. Unfortunately, we know from history that the Fed has a hard time engineering the perfect landing. Over the last 12 rate tightening cycles, manufacturing has contracted in each case, an earnings recession resulted in all but one instance, and an overall economic recession has followed in all but 3 rate tightening cycles.

This is not the best batting average, and the Fed will remain a key focus for the market in the months ahead. Although we maintain our neutral rating for monetary policy, it is an area we will continue to monitor very closely.

Video Transcript

Economic Review & Outlook

What Usually Happens After The Fed Tightens Rates?

Tightening Cycle Began in:	U.S. Manufacturing PMI Fell Below 50	EPS Recession	GDP Recession
1954	YES	YES	YES
1958	YES	YES	YES
1961	YES	YES	NO
1967	YES	YES	YES
1972	YES	YES	YES
1977	YES	YES	YES
1980	YES	YES	YES
1983	YES	YES	NO
1988	YES	YES	YES
1994	YES	NO	NO
1999	YES	YES	YES
2004	YES	YES	YES
Hit Rates	100%	92%	75%

Source: Ned Davis Research

Economic and market forecasts presented herein reflect a series of assumptions and judgments as of the date of this presentation and are subject to change without notice. Forward-looking statements cannot be guaranteed.

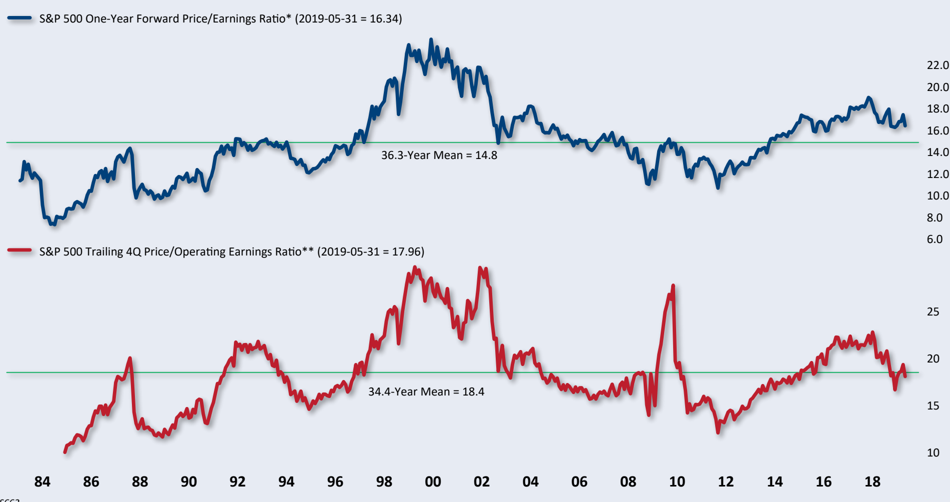
Valuations

Valuations

Next are valuations, which we maintain as modestly attractive. The 25% stock market run since the December 24th low has resulted in valuations moving higher from the depressed levels in late 2018. The forward P/E ratio of the S&P 500 is around 17 times earnings…slightly above the historical mean, but still favorable given the level of interest rates.

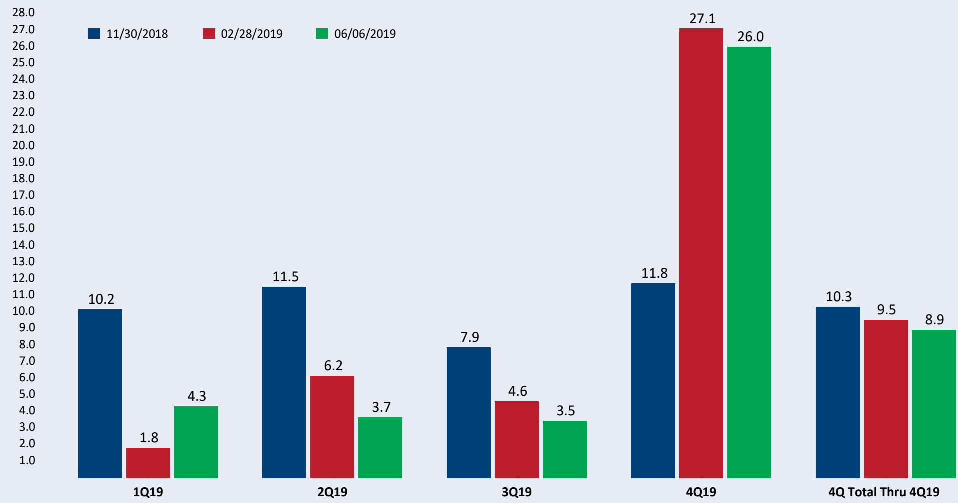
S&P 500 Forward vs. Trailing Price/Earnings Ratios

Monthly Data 1983-02-28 to 2019-05-31



We believe valuations are still modestly attractive, especially when one considers the large drop in interest rates, which tends to push up P/E ratios as bonds provide less competition to stocks. As an active manager, we believe we can find opportunities in this type of environment.

Navigate Your Future. Enjoy the Journey.



In a fairly valued market, earnings growth becomes key. As of early June, full year 2019 earnings growth was expected to be 8.9% with low single digit growth through the first three quarters of 2019 and then comparisons becoming easier in the 4th quarter with significant earnings growth expected.

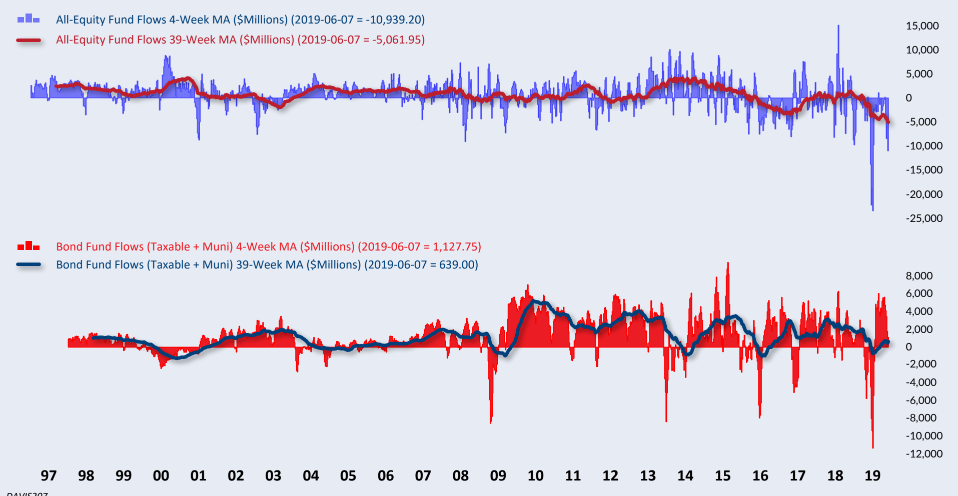
It is important to note that earnings expectations tend to drop the closer one gets to the actual earnings period. Furthermore, ongoing trade concerns and increased economic uncertainty could pressure earnings expectations, so earnings reductions would not be unexpected.

Investor Sentiment

Navigate Your Future. Enjoy the Journey.

Investor Sentiment

The next gauge is investor sentiment, which can be thought of as a measure of speculation. We are not seeing the extreme readings we saw late in 2018 when we



ClarkCapital MANAGEMENT GROUP

Video Transcript

Economic Review & Outlook

Interest Rates

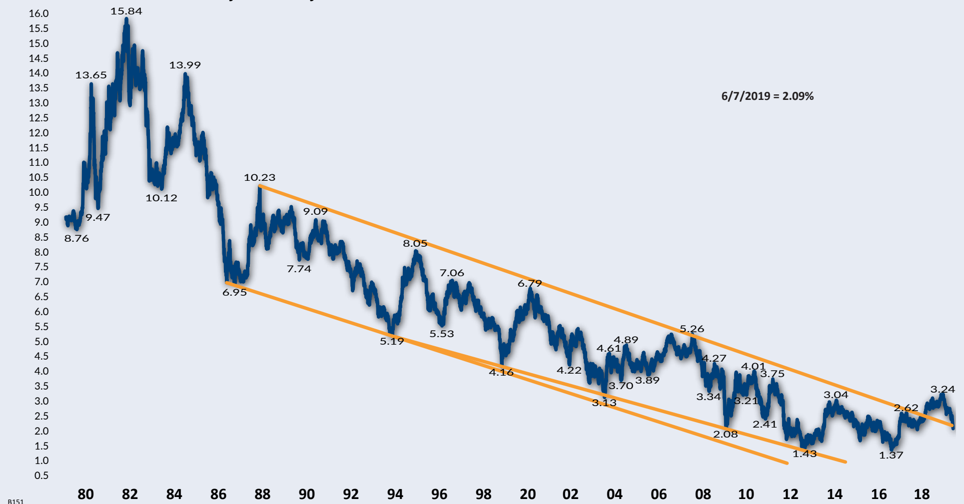
Navigate Your Future. Enjoy the Journey.

believed sentiment became too pessimistic. Recall that this reading is a contrarian indicator…when investors are too optimistic, it is often a sign that you are at or close to a near-term top and conversely, too much pessimism can mean you are closer to a bottom.

If anything, we are seeing some pessimism in the market based on significant equity fund outflows and massive bond fund inflows so far in 2019. Many of the headline uncertainties, like the trade war with China and economic concerns, seem to be driving investors out of stocks and into bonds. We maintain a neutral position for investor sentiment, but it is leaning positive with some of the pessimism building up in the market.

Interest Rates

Our final gauge is interest rates, which we leave in a neutral position. From our perspective, there were a couple of competing factors to consider for interest rates. First, yields have dropped dramatically in 2019. In fact, the yield on the 10-year U.S. Treasury spent some time below 2% late in the second quarter, which was the lowest yield level since 2016.



Building expectations of a Fed that might start cutting rates and persistent low inflation levels have contributed to this drop, as have low and in many cases, negative interest rates around the globe. From an economic perspective, lower rates are positive as it keeps the cost of capital and things like mortgage rates down.

However, the negative factor is the inversion of the yield curve and its persistence as we move into the second half of the year as we have previously discussed. Putting those two considerations together, we decided to keep the interest rate gauge in its neutral position and believe that overall, interest rates are still having a more neutral effect on the U.S. economy at this point. Monitoring the direction of interest rate moves and the shape of the yield curve will continue to be front and center issues as we move throughout the year.

Video Transcript

Economic Review & Outlook

Capital Markets

Moving to capital markets, sharp swings dominated market activity in the second quarter. Equities continued on their 1st quarter rally with more gains in April and the S&P 500 closed out the month at a new all-time high. But trade rhetoric picked up in May and the once smooth sailing trade negotiations with China turned negative, resulting in a slump for stocks. However, equities rebounded sharply in June amid growing expectations of a Fed that might cut rates and the S&P 500 achieved a new all-time high once again.

When it was all said and done, the 2nd quarter saw both stocks and bonds reach higher. The S&P 500 Index surged over 7% in June, putting the 2nd quarter gain at 4.3%, which resulted in a year-to-date advance of just above 18.5%. International equities enjoyed strong returns as well, but they have not been able to keep up with the pace of U.S. markets.

The nature of the equity market rally is worth exploring. In simple terms, this latest move higher in equities, similar to market action for much of 2018, was driven by large-cap growth stocks with significant dispersion among sectors and style. The valuation difference between value stocks and the overall market is as great as we've seen it since the late 1990s.

This has been a challenging period for investors that use value characteristics in their portfolio construction process. However, with the growth/value relationship stretched to historic extremes, any reversion back to more normal conditions should benefit those value factors. At Clark Capital, we use value measures in our portfolio construction process and believe that over a full market cycle, these characteristics will be rewarded.

Turning to bonds, as expectations have continued to build that the Fed will cut rates, yields have moved lower and lower. As a result, fixed income sectors across the board enjoyed solid gains during the quarter.

Navigate Your Future. Enjoy the Journey.

Video Transcript

Economic Review & Outlook

The Bloomberg Barclays U.S. Aggregate Bond Index rose 3.08% for the quarter and is up over 6.1% year-to-date. As would be expected in a more risk-on rally, high-yield bonds stand out year-to-date, as do long-dated rate-sensitive U.S. Treasuries.

Putting this all together, while the 2nd quarter was rockier than the 1st quarter, it has still been a very strong 1st half of the year and both stocks and bonds have enjoyed gains during this period. We expect volatility to continue in the months ahead and acknowledge that the range of outcomes for the market is rather wide over the next six months.

Uncertainty on the trade front, Fed action, and slowing economic activity lead the list of uncertainties with the largest unknown being the outcome of the trade situation with China—just one tweet either way could send stocks soaring or plunging. We entered the year with a singular price target for the S&P 500 at 2900 and have shifted this to a range of between 2800-3100.

Ultimately, however, we believe that fundamentals are what matter in the long run and the current fundamentals remain positive for the U.S. During periods of elevated volatility, we believe it is imperative for investors to stay focused on their long-term goals and not let short-term swings in the market derail them from their longer-term objectives.

Please contact your Investment Consultant to discuss how we can support your client reviews and how we can help you deliver successful outcomes to your clients.

This video was filmed in July 2019. The views expressed are those of the author(s) and do not necessarily reflect the views of Clark Capital Management Group. The opinions referenced are as of the date of publication and are subject to change without notice. This material is for informational use only and should not be considered investment advice. The information discussed herein is not a recommendation to buy or sell a particular security or to invest in any particular sector. Forward-looking statements cannot be not guaranteed. Clark Capital reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs and there is no guarantee that their assessment of investments will be accurate. The discussions, outlook and viewpoints featured are not intended to be investment advice and do not take into account specific client investment objectives. Before investing, an investor should consider his or her investment goals and risk comfort levels and consult with his or her investment adviser and tax professional. Clark Capital Management Group, Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission. Registration does not imply a certain level of skill or training. More information about Clark Capital's investment advisory services can be found in its Form ADV Part 2, which is available upon request. CCM-1046

Navigate Your Future. Enjoy the Journey.