DOVISH CENTRAL BANKS DROVE ASSET PRICES

With only a few exceptions, prices generally rose across asset classes all over the world in the second quarter of 2019. Higher prices were driven mainly by the shift toward easier monetary policies by global central banks. The rally began after European Central Bank (ECB) President Mario Draghi said the ECB was considering instituting new stimulus programs in July. These programs could include a cut in the ECB’s already negative short-term interest rate, additional bond-buying programs and that the central bank could leave its short-term interest rate at a negative yield even longer. The rally then picked up steam following the June Federal Reserve meeting; the Fed communicated to the markets that it too was shifting toward an easing bias and was likely to cut interest rates in the second half of 2019.

Investors cheered, believing easier monetary conditions would offset several fundamental headwinds to risk assets such as an ongoing global economic slowdown, escalating trade tensions (primarily between the U.S. and China, but also with other countries) and the diminishing impact of U.S. corporate tax cuts. Volatility returned briefly to global equity markets due to a breakdown in U.S.–China trade talks in early May. Instead of a deal, as markets were expecting, the U.S. administration raised the tariff rate on $200 billion of Chinese imports from 10 percent to 25 percent, and announced plans to enact a 25 percent tariff on the remaining $300 billion if the two countries could not come to terms on a deal. However, at the G-20 meeting in June the two countries agreed to further talks and the Trump administration held off from additional tariffs on China.

STOCKS: CONTINUED MOMENTUM IN U.S. GROWTH STOCKS

The U.S. equity market continued its momentum from the first quarter. Large company stocks represented by the Standard & Poor’s 500 index gained 4.3 percent; the Russell 2000 index of small stocks rose 2.1 percent in the second quarter. While earnings estimates continued to be lowered, sentiment improved as the Federal Reserve indicated its willingness to cut interest rates in the second half of the year. A pause in the trade war between the U.S. and China was also supportive of the equity markets.

Within U.S. equities, the financial sector was the best performing sector, rising 8.0 percent in the second quarter. Investors bid up prices...
expecting that a cut in interest rates would be supportive of the housing and mortgage markets and lead to a steeping of the yield curve: a steeper curve benefits spread lenders. Technology companies continued their strong performance from the first quarter, as investors bought growth stocks with strong business fundamentals. Energy was the worst performing sector declining 2.8 percent for the quarter. Persistently oversupply, in addition to softening global demand, remain long-term risks for the sector. Health care stocks underperformed the overall market, with a 1.4 percent gain. Political and legislative headlines including Medicare-for-All proposals, potential restructuring of the pharmacy delivery system and drug pricing pressures negatively impacted the sector.

Stocks of large companies continued to outperform small company stocks as tariffs disproportionately hurt margins of smaller companies. Investors also gravitate toward larger higher quality companies in the latter part of a business cycle. Growth continued its outperformance over value stocks. In a low growth, low interest rate, and low inflation environment, investors prefer growth over value. International stocks also rose, but continued to underperform U.S. stocks. The MSCI All-Country World Index-ex U.S. IMI returned 2.7 percent during the quarter. Developed markets gained 37 percent, outperforming emerging markets, which returned only 0.6 percent.

**BONDS: PAID TO BE LONG DURATION**
Rates fell across the Treasury yield curve as signs of slowing economic growth drove markets to anticipate the Federal Reserve would cut interest rates in future quarters. The yield on the 2-Year U.S. Treasury note dropped a little over 50 basis points, ending quarter at 1.75 percent, while the 10-Year Treasury bond dropped 40 basis points, ending at 2.0 percent. The Treasury curve steepened last quarter as the 2-10 Year spread increased from 14.5 basis points to 25 basis points by the end of June.

The Bloomberg Barclays U.S. Aggregate Bond index returned 3.1 percent, spurred by falling interest rates. Longer duration bonds are more sensitive to changes in interest rates and outperformed shorter duration bonds. Despite bouts of risk-aversion due to escalating trade conflicts and lingering late cycle fears, corporate bonds (both investment-grade and high–yield) have offered solid returns this year. Investment-grade and high-yield corporate spreads ended the quarter tighter, suggesting that investors do not appear concerned about companies defaulting on their debt obligations. Mortgage backed securities posted the lowest returns of the quarter. Lower rates raise concerns over prepayment risk. At the same time, supply-demand dynamics will be challenged by additional runoff from the Fed portfolio as the reinvestment cap is reduced to $20 billion per month this summer. Even though many European sovereign bonds were trading at negative yields in early April, they were able to generate a return of almost 5.0 percent over the last 3 months. The return was driven by the decline in underlying interest rates of benchmark German bonds into even greater negative yields. For example, the yield on Germany’s 5-Year bund declined 21 basis points and ended the quarter at a negative yield of -0.66 percent, while the yield on Germany’s benchmark 10-Year bund declined 26 basis points, ending the quarter at a negative yield of -0.33 percent. Almost $13 trillion of government debt outside the U.S. now has negative yields.

**OUTLOOK 2019: WILL MONETARY EASING EXTEND THE BUSINESS CYCLE?**
Economic growth is expected to slow in the second half of 2019 from the combined impact of the Fed hiking rates 250 basis points, fading impact of corporate tax cuts, and simmering trade tensions. Fed officials downgraded their assessment of economic activity, further signaling that downside risks to the economy are rising. Notably, the New York Fed’s recession risk model forecasts the chance of a recession during the next 12 months at 30 percent, up from 12 percent this time last year. 30 percent marks the highest reading since the last recession. To prevent a recession and extend the business cycle, the Fed officially opened the door for rate cuts this year, completing a dovish turnabout that started in January. At quarter-end, the market implied probability of a 25 basis point rate cut was 100 percent for the July 31 FOMC meeting. The market expects an additional two cuts by January 2020.
In this macro environment, we expect bonds, particularly longer duration U.S. Treasurys, to do well since they are most sensitive to falling rates. We maintain a neutral position to long U.S. Treasury bonds and portfolio durations. End-of-cycle risks are starting to build in credit, and valuations are stretched. We remain cautious of lower rated credits and will remain underweight to high yield. Rising leverage, weakening underwriting standards, and diminishing investor protections indicate growing risks, while credit spreads at the tight end of the historical range provide scant compensation for these risks, even with Fed support. We will look to trim our credit exposure if spreads tighten further. Securitized sectors continue to provide attractive risk-adjusted opportunities for high-quality, liquid returns with less potential downside than corporate credit. Non-agency residential mortgage-remains compelling amid a shrinking market.

Equities continue to benefit from the accommodative shift taken by the U.S. Federal Reserve. However, it remains unclear if deeper harm to corporate operations has resulted from ongoing trade disagreements, or whether the expected slowdown in the second half will result in an economic and hence a severe earnings recession. Notably, unlike Europe and China, the U.S. economy has shown few signs of a material slowdown, despite contrary indications from interest rates and small cap equities. Consumer demand remains healthy, the job market is strong, and inflation remains subdued. Thus far, equity valuations have been nearly immune to either macro or micro concerns as bullish sentiment prevails. In fact, current market valuations are a reflection that our long-standing economic resiliency will overcome any trade war setbacks. Given the lack of clarity, we believe it is prudent to wait until the full scope of forced supply-chain changes, technology sales restrictions, and tariffs are better understood. As such we are taking a neutral stance toward risk in client portfolios. In the interim, we continue to prefer domestic over international equities and large capitalization stocks over small capitalization stocks. We are also fairly neutral to sector weightings and prefer individual companies with idiosyncratic catalysts or inflections.

We expect oil prices to be supported by OPEC production cuts, outages, and geopolitical risks. However, we are unlikely to see prices close to $100 per barrel due to increases in U.S. shale production, which tend to put a cap on prices. We have no position in commodities, but maintain positions in material and energy stocks, and energy pipelines.

KEY RISKS:
- Brexit - no agreement with the E.U.
- Rising recession risks in the U.S.
- Corporate earnings recession.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs, Northern Trust, Bloomberg, Factset, Morningstar

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