

Global Economic and Financial Markets Summary

Inside this issue:

Financial Markets Performance	2
Global Economic Outlook	5
Investment Strategy	8
In Closing	9
Appendices	10

In June, global financial markets closed a second consecutive quarter of positive returns, though not without its fair share of noise and volatility. Ongoing trade tensions continued to generate turbulence, but the quarter ended positively thanks to accommodative rhetoric from global policymakers (see [Exhibit 1](#)). After a brief drop in May, equities and bonds rallied as the Federal Reserve hinted it would reverse course and cut interest rates. Meanwhile, the European Central Bank (ECB) assured investors that it can and will add more stimulus, should conditions warrant.

Policymakers are reacting to a global economy whose growth, while still positive, is cooling. Uncertainties surrounding tariffs and the reliability of existing trade agreements are starting to materially impact the economy. Global manufacturing activity is down, inventories are rising, and businesses are postponing investment. Consumers, who have been the main driver of growth in recent quarters, are still in a healthy position, but that may not last indefinitely. Wage inflation appears to have peaked, and input costs (which could be passed onto consumers) are slowly rising.¹

That being said, and while the current U.S. expansion is now the longest on record, recession expectations for the near term remain muted based on Fed publications and outlook from major investment houses. To paraphrase a quip made by former Fed Chairman Ben Bernanke earlier this year, expansions do not die of old age, they are murdered.² While his comments may have been in jest, he does have a point. We do not see many excesses in the aggregate economy that pose an immediate threat, meaning it is still feasible for this expansion to continue for some time. However, after taking into consideration the aging demographics of advanced economies, debt levels worldwide, current asset valuations, and the lack of investment to increase worker productivity, we think growth (while positive) could be below policymakers' goals.

In the past, expansion killers have included prohibitively high interest rates, debt defaults, asset price bubbles, and high commodity prices. We do not believe these typical suspects are a threat to this expansion, though we are keeping an eye on credit markets, after

¹ U.S. core inflation, while still below the Fed's target, exceeded expectations in June.

² Remarks of Ben Bernanke and Janet Yellen at the annual meeting of the American Economic Association; Atlanta, GA, Jan. 4, 2019.

Global Economic and Financial Markets Summary Cont.

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a prolonged period of high debt issuance at low interest rates. Exogenous factors, such as natural disasters and man-made crises (e.g. a conventional war, a global trade war, and the unintended consequences of extraordinary monetary policy) could be the eventual culprits. Nevertheless, we are cautiously optimistic that, in due course, mutually beneficial trade

deals can be reached. Also, the risk of the other factors prematurely ending this expansion is more remote, though never negligible. For this reason, we once again stress the importance of staying diversified, and ensuring your portfolio’s asset allocation is consistent with your financial goals, time horizon, liquidity needs, and overall risk tolerance.

Financial Markets Performance

Exhibit 1

Total Return* for Selected Equity, Fixed Income, and Hedge Fund Indices		
	2nd Quarter (3/31/2019 to 6/30/2019)	Year to Date (12/31/18 to 6/30/2019)
Major Equity Indices	%	%
S&P 500 Index	4.3	18.5
Russell 3000 Index (Total U.S. market)	4.1	18.7
Russell 2000 Index	2.1	17.0
MSCI All Country World Ex-U.S. Index (Net)	3.0	13.6
MSCI EAFE International Index (Net)	3.7	14.0
MSCI Emerging Markets Index (Net)	0.6	10.6
MSCI ACWI Commodity Producers (Net)	0.2	13.5
<i>Source: Bloomberg, MSCI</i>		
Major Fixed Income and Hedge Fund Indices		%
Bloomberg Barclays Capital U.S. Aggregate Bond Index	3.1	6.1
Bloomberg Barclays Capital U.S. Government/Credit	3.5	6.9
ICE BofAML 1-3 Year U.S. Broad Market	1.5	2.7
ICE BofAML U.S. High Yield BB-B Bond Index	2.8	10.3
JP Morgan Non-U.S. Global Bond Index (GBI) Hedged	3.1	6.2
JP Morgan EMBI Global Index in USD (Emerging Markets)	3.8	10.6
HFRX Equal Weighted Strategies Index (Hedge Funds)	1.2	2.2
<i>Source: Bloomberg</i>		

* Includes price appreciation plus dividends and/or interest.

Financial Markets Performance Cont.

Equities

U.S. stocks continued to advance in April but declined abruptly in May after trade negotiations between the U.S. and China broke down and new tariffs were introduced. Selling pressure accelerated at the end of May when President Trump announced a series of escalating tariffs on Mexican goods, unless Mexico took steps to stem the flow of migrants across its territory. Markets resumed their ascent in early June after the Mexican tariffs were suspended and a meeting between Trump and Chinese President Xi was expected at the G20 meeting.

Large-cap shares outperformed mid- and small-caps, while growth stocks surpassed value across all market capitalizations. Among S&P 500 companies, financials performed best during the second quarter, after lagging in the first. Despite falling long-term Treasury yields, which typically compress margins, several large banks reported stronger-than-expected first quarter earnings helped by seasonal strength in fee-based businesses. Energy stocks lagged, as crude prices softened over global growth concerns.

Equities in developed markets moved in sync with U.S. equities, but produced lower relative returns for the quarter. Within the MSCI EAFE Index, every sector except real estate advanced, led by gains in technology, consumer discretionary, and industrials. Just as in the U.S., growth stocks outperformed value over the quarter.

Stocks in export-dependent Japan rose only slightly, as trade tensions kept investors on the sidelines. U.K. shares lagged and the pound lost value against the U.S. dollar, as the prospects of a hard Brexit rose after Prime Minister Theresa May resigned and Eurosceptic Boris Johnson succeeded her. In Germany, imports, exports, and industrial production have been declining, and business optimism is also at its lowest level since 2014. Nevertheless, trade tensions and slowing growth prospects across the region did not deter investors from buying European equities. Labor markets and consumer demand continued to improve, and ECB president Draghi indicated the bank could offer more stimulus measures as early as July if growth continued to stall.

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Financial Markets Performance Cont.

“Emerging market stocks advanced during the second quarter, but exhibited significant performance dispersion across the various regions.”

Emerging market stocks advanced during the second quarter, but exhibited significant performance dispersion across the various regions. Chinese stocks weighed down broad market returns as the country's growth continued to decelerate from previous highs. Meanwhile, other Asian markets enjoyed healthy advances, despite lower economic growth. Latin American stocks gained, led by Brazil, where pension reform legislation advanced, and Mexico, which in June became the first party to ratify a revised North American free trade agreement.

Fixed Income

Signs of weakening global growth, restrained inflation, and equity market volatility around trade talks resulted in strong performance across the fixed income asset class. The 10-year U.S. Treasury rate fell back to 2% during the second quarter, its lowest level since November 2016. The front end of the curve also rallied, as the Fed signaled a more dovish stance.

Global corporate credit performance was solid by quarter-end, especially in the U.S. where investment-grade bonds benefited from declining interest rates and

positive stock market momentum. After an especially strong first quarter, high-yield credit performance slowed, but investors' risk appetite in the second quarter remained robust. European investment-grade and high-yield issues rallied as well, but the yield compression was less pronounced than in the U.S. Higher quality credits outperformed across the board.

Sovereign debt of developed countries also performed strongly. While yields on some European and Japanese government bonds were already negative, many fell deeper into negative territory. Higher yielding emerging market debt (denominated in U.S. dollars) continued to look attractive vis-à-vis developed market bonds. Local currency debt also performed well, as many emerging market currencies appreciated versus the dollar.



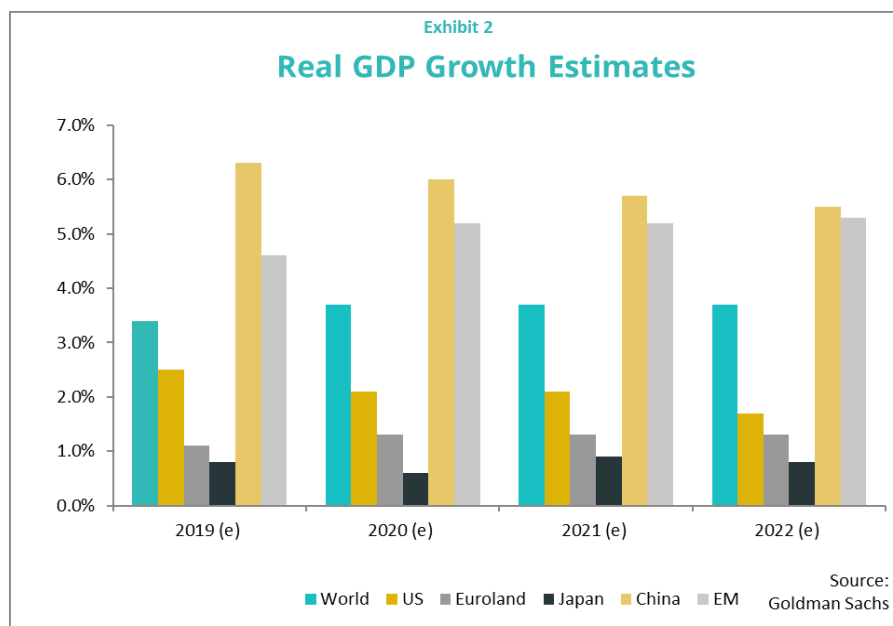
Global Economic Outlook

Forecasts of global economic growth have fallen over the past few months; the global economy is currently expected to expand 3.3% in 2019 (see Exhibit 2). Trade tensions between the U.S. and China (not to mention several other partners) are clouding confidence and investment across the globe. Trade volumes (while still positive year-over-year) are trending downward, indices of growth in the manufacturing and services sectors are showing declines, and inventories are rising in several regions (see Appendices A, B, and C). Initially, multinational corporations bore the brunt of higher tariffs, but the effects are beginning to trickle down to smaller, more locally-oriented businesses in the form of rising raw material and transportation costs.³

There has been talk of companies shifting their global supply lines to avoid tariffs, most notably out of China to neighboring countries in Southeast Asia. While those economies may benefit from the current dislocation in the long term, it often takes several years for labor and capital to move up and down the supply chain, leaving companies and investors exposed to the ongoing trade tensions for some time.

Again, we are cautiously optimistic that a U.S.-China deal can be reached, but we acknowledge that this trade conflict is more encompassing than one agricultural product or manufactured device; it is about defining the relationship

“Trade tensions between the U.S. and China (not to mention several other partners) are clouding confidence and investment across the globe.”



³A-shares are the shares of mainland China-based companies that trade on the Shanghai and Shenzhen Stock Exchanges.

Global Economic Outlook cont.

“The U.S. economy, like most developed economies, is in the late stage of the economic cycle, but the risk of recession in the near term (barring unforeseen calamities) remains low.”

between the world’s two largest strategic competitors and geopolitical rivals. These issues will not be resolved overnight. In the meantime, global growth could be constrained, and markets will likely continue to turn to policymakers (i.e. central banks) for support.

United States

The U.S. economy, like most developed economies, is in the late stage of the economic cycle, but the risk of recession in the near term (barring unforeseen calamities) remains low. A strong labor market and wage growth have supported the confidence of consumers, who are the main engine of GDP. Despite minimal slack in the workforce, wage inflation appears to be peaking (see Appendix D). With the economy at full employment, there is not much further the unemployment rate can be pushed down, and given the ambiguity about global trade, employees may be losing some negotiating power.

Lower corporate taxes and share buybacks increased profit margins last year, but the effects of the tax cuts have since worn off. Plateauing labor costs may give a short-term boost to measures of productivity, but given the lack of

substantive capital investment over the past decade, we do not believe that increase can be sustained.

Ongoing trade disputes are having a meaningful effect on U.S. business activity. Durable goods orders fell sharply in April and May, and surveys of business activity in June were at their lowest levels in three years.⁴ These developments have pressured the Fed to not only halt rate increases, but reverse course. The central bank had already announced an end to the unwinding of its balance sheet, and in the second quarter it shifted key language away from rate hikes to “sustaining the expansion.”⁵

While the market may get the rate cut (or two) it is expecting, we do not believe it is necessarily the rate cut the economy needs. We are wary of the lasting stimulative benefit of interest rate reductions this late in the economic cycle, especially given the prolonged environment of historically low rates. Instead, we believe the catalyst for a rebound in global growth will come from the resolution of trade conflicts and the restoration of confidence in the world order.

⁴T. Rowe Price

⁵Minutes of the Federal Open Market Committee, June 18-19, 2019

Global Economic Outlook Cont.

China

While the Chinese economy has been decelerating for several quarters, there are signs it has stabilized. The government has made clear it is prepared to intervene if conditions worsen, but is holding back from deploying the level of stimulus seen in previous slowdowns to avoid increasing the national debt burden. Instead, it is expanding access to its economy by opening another eight sectors (including agriculture and petroleum) to foreign investors. Domestic firms also stand to benefit from greater inclusion in global equity indices as MSCI continues to increase its exposure to onshore-listed companies (“A shares”). However, considering the muted stimulus from Beijing, and the overhang of trade tensions with the U.S., there is currently no clear catalyst to allow the economy to rapidly reaccelerate.

International

Looking elsewhere in the world, the European economy is in a more precarious position. While credit growth is still positive and unemployment continues to fall, the region is burdened by the

global slowdown, trade conflicts, and internal politics. The heavily export-oriented German economy appears to be contracting, as do the British, French, and Italian economies, which are all dealing with their own unique challenges (Brexit, “Yellow Vest” protests, and budget negotiations, respectively). Fiscal stimulus from these governments is unlikely as they must comply with European Union (EU) budget constraints. However, the ECB is stepping up the possibility of further monetary stimulus.

Beyond China, many other emerging markets are also feeling the effects of the global slowdown and trade tensions. South Korea lowered interest rates for the first time in three years in response to export concerns and a deepening political row with Japan. Weak export demand and rising real rates are restraining investment in India. New leadership in Latin America’s two largest economies (Brazil and Mexico) continue to leave markets uncertain about their new administrations’ goals and true legislative support. Growth in Russia, South Africa, and Turkey is close to zero, and the latter may face new U.S. sanctions after taking delivery of a Russian anti-aircraft system.

“Beyond China, many other emerging markets are also feeling the effects of the global slowdown and trade tensions.”

Investment Strategy

“It is important for investors to remember that missing the months prior to an equity market peak can be more painful than being invested in the months following the peak (see Appendix G).”

Equities

Despite the continued climb in equities, the U.S. stock market remains fairly-valued to slightly overvalued relative to long-term averages. Where appropriate, we continue to take advantage of the divergence in recent performance and rebalance from growth to value stocks. Within growth stocks, we continue to emphasize strategies that focus on companies’ quality and profitability, as well as those that are better able to safeguard growth against future competition.

We continue to prudently overweight international equity, within clients’ investment guidelines. Valuations outside the United States are more attractive, and international companies tend to offer a higher dividend yield (see Appendix E). Furthermore, we believe the U.S. dollar is expensive relative to its historical average; any depreciation could further enhance future returns of international investments.

While concerns about the end of the bull market abound, we still see strength in the U.S. expansion, albeit to a lesser degree than in the past. However, as most major economies have entered more mature phases of the business

cycle (when volatility tends to be higher), we expect markets to remain choppy going forward. In May, we saw a decline of 7% that was swiftly reversed. Since 1980, intra-year declines of the S&P 500 averaged 13.9%, and the index still ended the year positive in 29 of the 39 years (see Appendix F).

It is important for investors to remember that missing the months prior to an equity market peak can be more painful than being invested in the months following the peak (see Appendix G). Given the Fed’s implied dovish position going forward, one-to-two interest rate cuts paired with low inflation could be supportive of domestic equities. Therefore, we do not believe there is a compelling reason to stray drastically from the path we have laid out, and we continue to thoughtfully invest our clients’ portfolios as directed by their risk tolerances, time horizon, and liquidity needs.

Fixed Income

As we anticipate higher levels of volatility, we are taking advantage of the strong performance in equity markets to further rebalance client portfolios from equity to fixed income (where appropriate). Since our last letter, the same risks apply: trade disagreements continue unresolved,

Investment Strategy Cont.

the U.K. could still leave the EU without a deal, and tensions are now also rising in the Persian Gulf. Therefore, we want to ensure there is adequate liquidity in client portfolios to meet any near-term needs.

That said, we are being prudent about our exposures. 10-year Treasury rates have fallen by 125 basis points over the past year (a

compression of nearly 40%), much of that decline occurring just in the last quarter. With rates so low, we do not believe investors are being adequately compensated for taking increased duration risk (see Appendix H). Our focus remains on short-term and flexible, unconstrained strategies, particularly where we are assuming credit risk.

“As we anticipate higher levels of volatility, we are taking advantage of the strong performance in equity markets to further rebalance client portfolios from equity to fixed income (where appropriate).”

In Closing

Global financial markets have delivered a very solid performance year-to-date. The rise in asset prices comes as global economies are maturing and contending with an unknown future for long-standing trading and political relationships. Central banks around the globe are accommodating to offset these uncertainties, but after years of extraordinary monetary policy, their arsenals are diminished. As such, most regions are converging on a slower growth trend, which implies expected returns going forward may be lower.

While we are concerned about the possible risks, we believe all parties involved will acknowledge the benefit of finding a resolution and avoiding an all-out global trade war, but it will take time and trigger more volatility along the way. For this reason, we continue to adhere to our investment discipline of broad diversification and periodic rebalancing.

Now is an opportune time to inform us of any changes in your situation so we may ensure your portfolio is appropriately invested. As always, please call us at +1 (301) 881-3727 if you have any questions about your portfolio, or to notify us of any changes in your circumstances, including your liquidity needs.

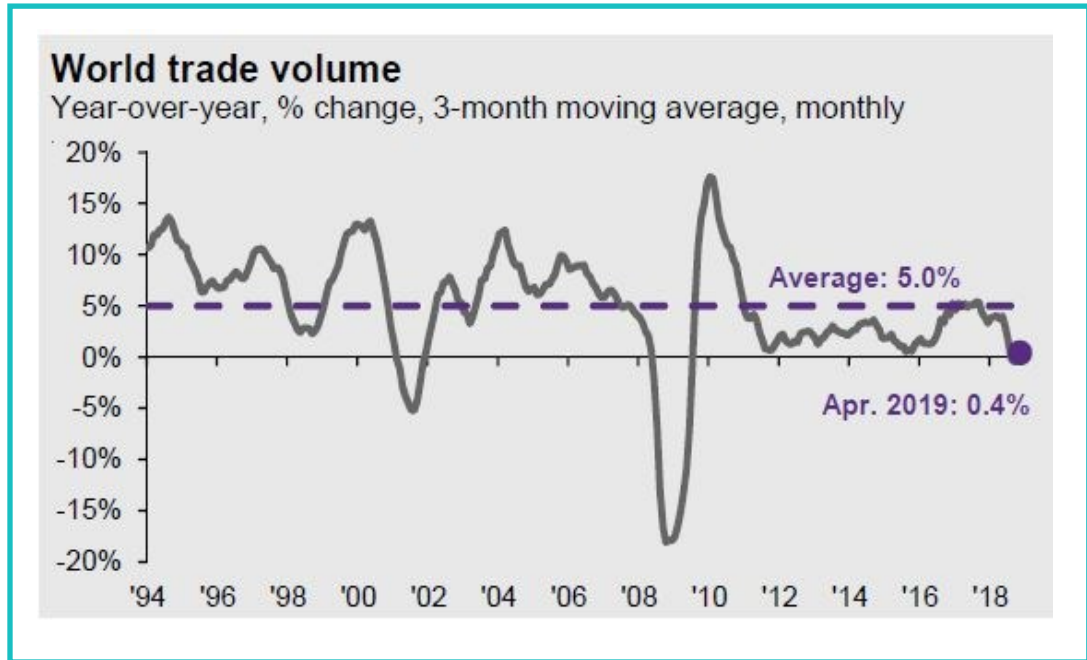
Sincerely,

The SOL Capital Management Team

Appendices

Appendix A

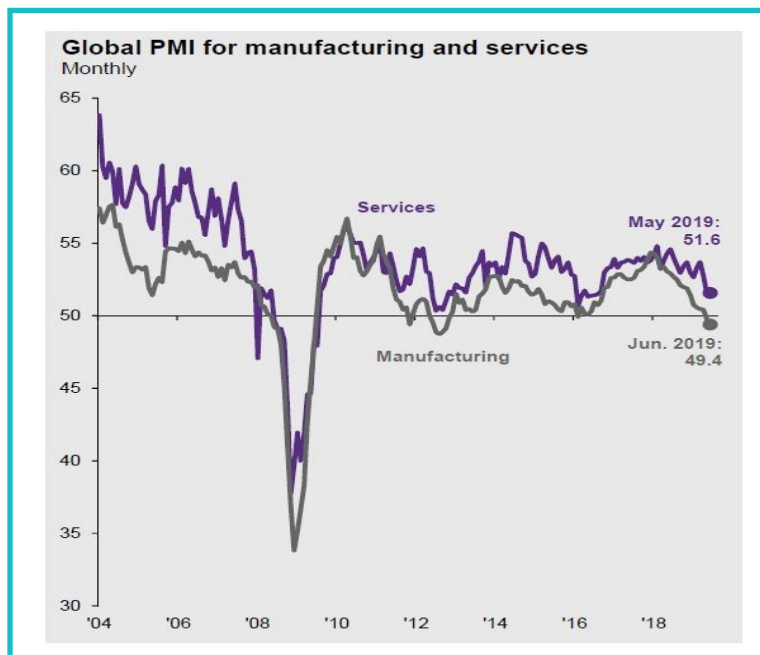
Falling Trade Volume



Source: Guide to the Markets 3Q 2019, J.P. Morgan Asset Management, page 49

Appendix B

Global Manufacturing and Services Momentum

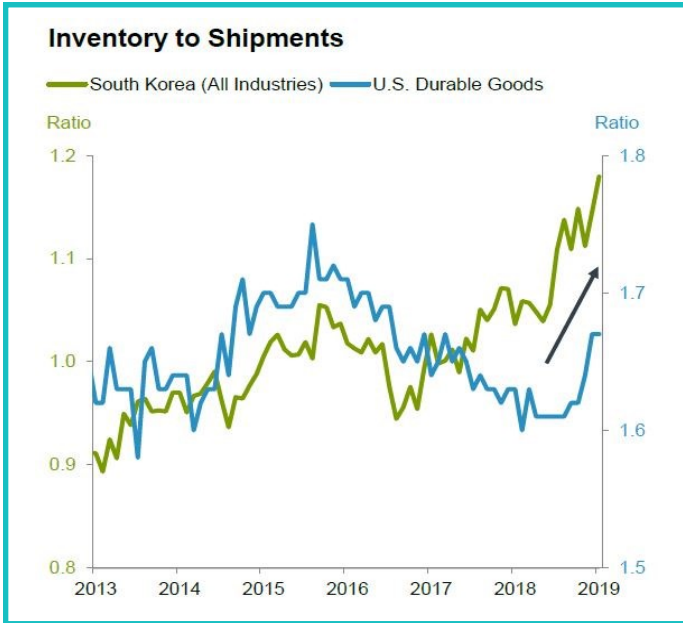


Source: Guide to the Markets 3Q 2019, J.P. Morgan Asset Management, page 46

Appendices Cont.

Appendix C

Rising Inventories



Source: Third Quarter 2019 Quarterly Market Update, *Fidelity Investments*, page 11

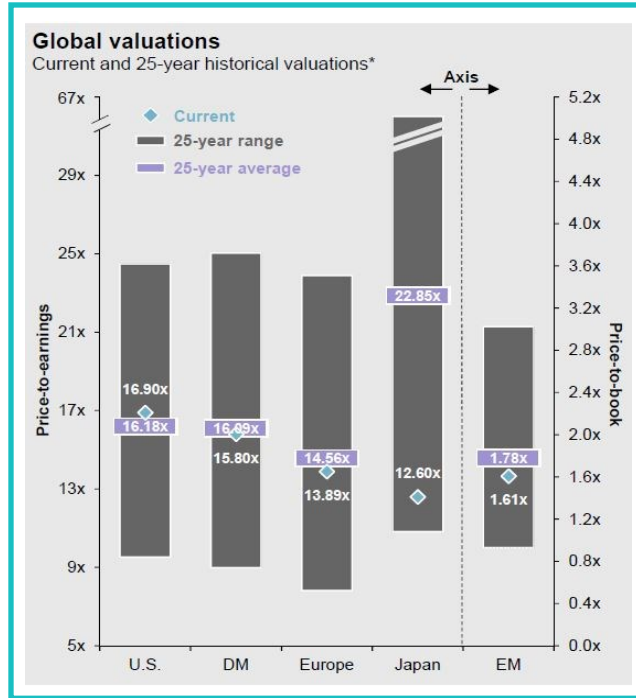
Appendix D

Peaking Wage Inflation



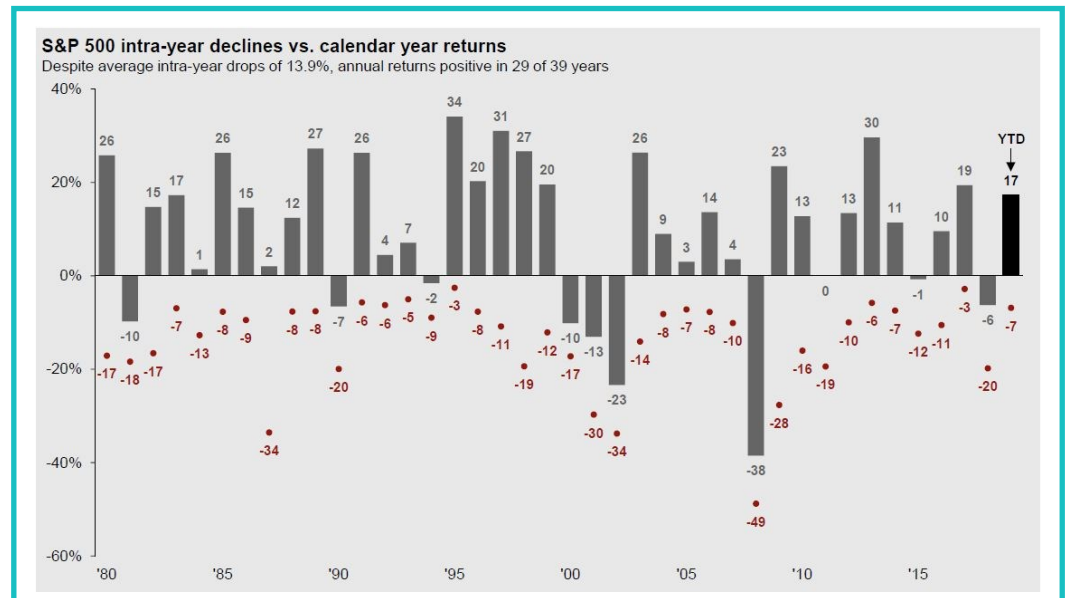
Source: Third Quarter 2019 Quarterly Market Update, *Fidelity Investments*, page 14

Appendix E Equity Market Valuations



Source: Guide to the Markets 3Q 2019, J.P. Morgan Asset Management, page 44

Appendix F Intra-Year Declines versus Year-End Returns

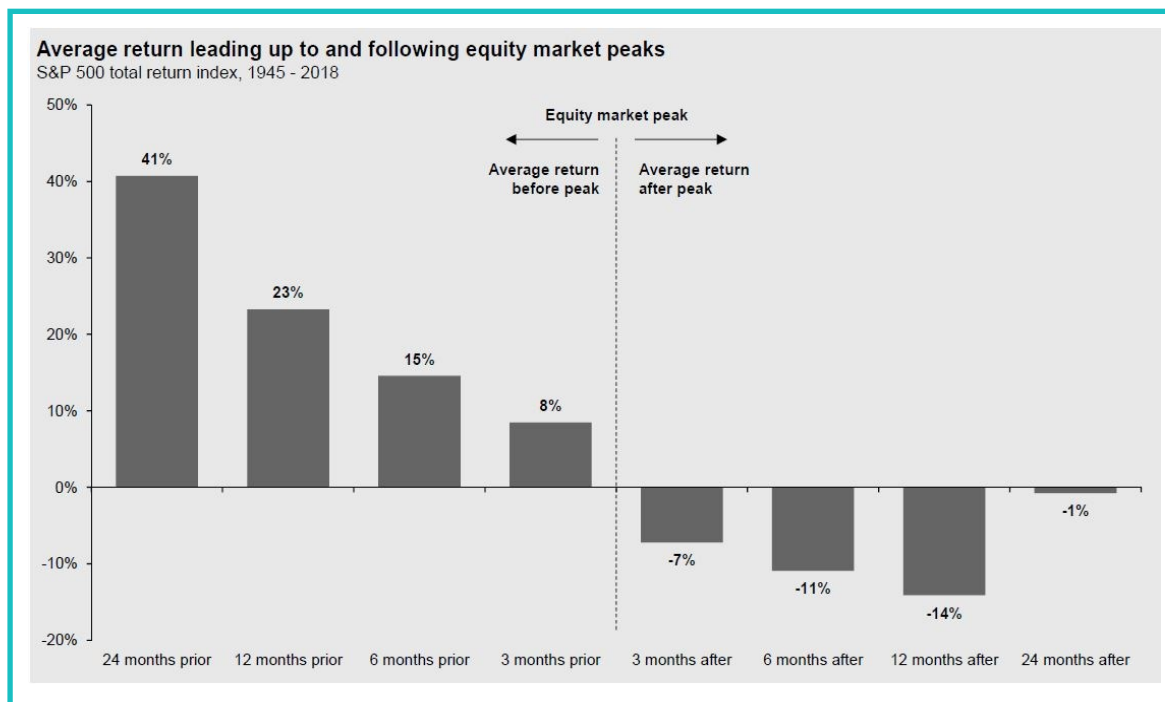


Source: Guide to the Markets 3Q 2019, J.P. Morgan Asset Management, page 14

Appendices Cont.

Appendix G

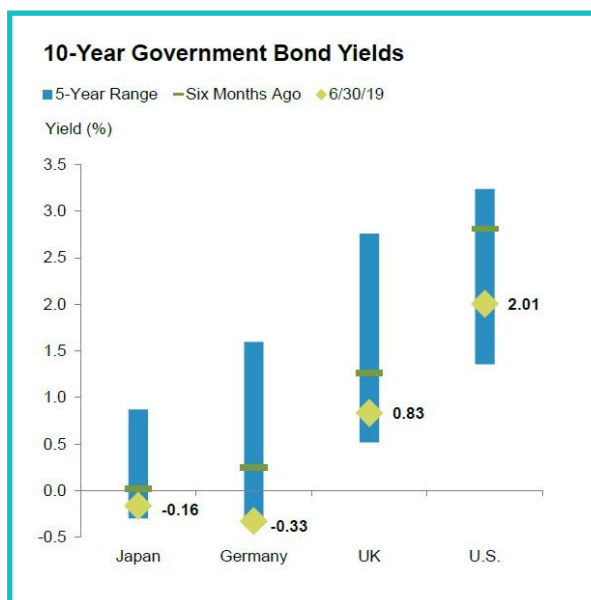
Returns Around an Equity Market Peak



Source: *Guide to the Markets 3Q 2019, J.P. Morgan Asset Management, page 14*

Appendix H

Low Interest Rates



Source: *Third Quarter 2019 Quarterly Market Update, Fidelity Investments, page 7*

Disclaimer

SOL CAPITAL MANAGEMENT
111 Rockville Pike, Suite 750
Rockville, MD 20850
Phone: 301.881.3727

3 Columbus Circle, Suite 2120
New York, NY 10019
Phone: 212.710.4698

www.sol-capital.com

E-mail: sol@sol-capital.com

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