viewpointe

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> "It's not what you look at that matters. It's what you see." *- Henry David Thoreau*

Last year's combination of supply-side tax cuts and deregulation provided a powerful mix for productivity and growth here in the United States. This combination resulted in the strongest period of economic growth in more than 10 years. Not surprisingly, risk assets thrived during this period. Recent developments, however, shifted U.S. economic policy towards increased taxes (via tariffs) and more regulation. This is expected to negatively impact economic growth. Despite lower growth expectations, U.S. equities remain well within positive return territory. In addition, fixed income investments in general have appreciated in response to falling interest rates. This creates a unique environment where, despite falling growth expectations, investment returns remain solid. In this edition of *Viewpointe* we discuss our view on what lies ahead for the remainder of the year. We also discuss some recent portfolio changes. We conclude with a brief refresher on an investment vehicle that we reintroduced into our Lakepointe Classic fixed income models.

Economic Review - Still Growing, but Slowing

While U.S. economic hard data is not too bad at the moment, we are experiencing a pronounced drop in U.S. economic soft data. So, what is the difference between hard data and soft data? Hard data is based upon actual underlying measurements. For example, how many widgets were sold or how many jobs were created? Soft data, on the other hand, is based upon survey data. Two common examples of soft data include consumer confidence and consumer sentiment. Soft data focuses more on how people feel about a particular economic item at the present time or what they expect to occur in the future.

Soft data has a tendency to be more volatile as the moods of survey participants' are impacted by daily events. Longer term trends in soft data, however, can be a valuable tool in indicating the future direction of hard data. For example, if survey participants continuously project a negative outlook there is a good possibility that eventually this negative outlook will show up in the hard data. The reason being is if participants' future economic expectations continuously deteriorate, odds are there are justifiable reasons for their view. Eventually these reasons will impact the hard data. In a sense, soft data can be used as sort of a canary in the coal mine.

Soft data indicators have weakened recently as a result of negative developments on the trade front. Of primary concern is the breakdown in talks with China. At the beginning of May it appeared that significant progress was being made on a trade agreement. U.S. Trade Representative Lighthizer and Vice Premier Lie Hu appeared close to a deal after 11 rounds of talks. The deal was laid out in a 150+ page document that addressed a multitude of trade related issues. Chinese authorities were soon to take issue, however, with U.S. demands for legal changes addressing intellectual property theft and the enforcement mechanisms attached to those demands.

In response, the Chinese presented a redlined version that had been modified by Chinese leadership, which ultimately gutted what was originally discussed. Needless to say, President Trump did not care for the Chinese modifications and the situation quickly escalated. As discussed in previous editions of *Viewpointe,* President Trump's chances for reelection greatly depend on what he is able to accomplish on the trade front. In short, "no deal" is better than a "bad deal" from a reelection prospect standpoint. At the present time it is difficult to say when or if a deal will be reached.

Currently, neither side has much incentive to cut a deal anytime soon. Some pundits suggest that China may wish to drag their feet for no other reason than to see who the

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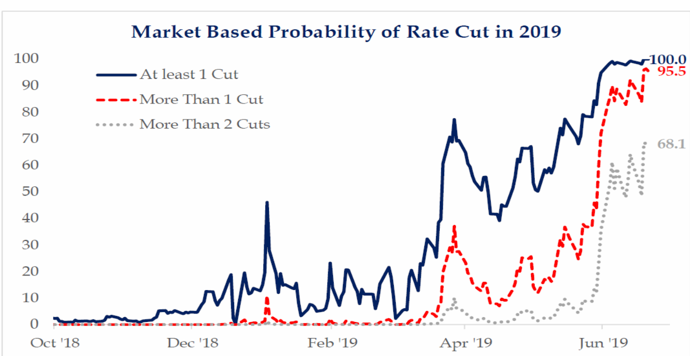
next president will be. The idea being, avoiding trade negotiations with President Trump may be in their best interest. It may also be in President Trump's best interest to drag matters out a bit longer. President Trump has been encouraging the Federal Reserve (Fed) to lower the Fed Funds Rate for several months now. Recent economic concerns, caused largely by trade related issues, seem to be opening the door for some rate cuts.

From President Trump's perspective, why not drag things out a bit longer to get a cut or two before sealing a trade deal? This scenario could provide ideal conditions to substantially boost economic growth during an election year. In addition, portraying the Chinese as the enemy on the trade front keeps the door open for Trump to criticize Joe Biden who is currently the Democratic Presidential frontrunner. Biden has been a lifetime supporter of China and Mexico trade deals. Retaining a hard stance on trade could provide Trump with some valuable ammunition to use in debates, especially at a time when taking a stand against China is receiving bipartisan support.

In conclusion, current data indicates U.S. economic growth is slowing substantially from what was experienced in 2018. Our current forecast calls for growth as measured by Gross Domestic Product to fall back to about 2% in 2019. Material positive developments on the trade front would require an upward adjustment to our forecast. Material negative developments, on the other hand, would require a downward adjustment. On a side note, it is important to mention that early estimates of second quarter economic growth indicate growth coming in just above 1%. While rather weak, it still results in positive growth, marking the longest economic expansion in U.S. history.

Fixed Income Commentary -
Rate Cuts on the Horizon

When President Trump tweeted the Fed should cut interest rates by 1% back in April, such a scenario seemed implausible to most. Recent developments nonetheless show that such a scenario could in fact play out in the not so distant future. As demonstrated in the corresponding chart, the market based probability of a rate cut in 2019 is 100%. The probability of two cuts is 95.5% and the probability of three cuts is 68.1%.



So, why the big shift? The Fed's forecast at the beginning of the year likely did not factor in an escalation of the trade war with China. As a result, they increased the Fed Fund's Rate too much for that scenario. Evidence the Fed tightened too much can be seen by simply looking at the inverted yield curve, where 3 Month Treasury yields exceed those of Treasuries ranging from 6 months to 10 years. When an inversion of this degree occurs it is a telltale sign of a policy error. Why else would investors tie up their money for a longer period of time to obtain a lower yield?

At their June meeting, the Fed started to acknowledge they had gone too far. While not implementing a cut at this meeting, they did signal possible rate cuts of as much as half a percentage point over the remainder of the year. The Fed pointed out such cuts may be necessary in response to increased economic uncertainty and a drop in inflation expectations. They specifically noted they updated their outlook based upon recent trade developments.

As a result of the Fed's shift, our base case now calls for a .25% cut at the Fed's July meeting. Another rate cut in 2019 also looks likely. We believe this second cut may occur at either the Fed's September or October meetings. In the event the trade situation continues to deteriorate, we also view an additional 3rd cut as a possibility at the Fed's December meeting. It is important to note that three cuts would be enough to solve the yield curve inversion issue. Of course, this outlook is all based on progress on the trade front. In the event a substantial deal is reached leading to increased growth projections, rate cuts may no longer be necessary. When viewed in this light it is easy to see why President Trump may wish to drag his feet on a deal until we experience a few Fed rate cuts.

Equity Commentary -
Fueled by the Fed

The Federal Reserve's shift back to a more accommodative monetary policy has thus far counterbalanced the drag from a deteriorating trade situation in the domestic equity space. U.S. equity returns remain well within positive territory despite growing economic concerns. So, why do equity returns remain strong? Once again, the Fed is setting the stage for lower interest rates with recent comments regarding the increased likelihood of rate cuts. With the Fed opening up the door for lower short term interest rates, it paves the way for lower rates across the board. In fact, that is exactly what transpired during the second quarter with the 10-year U.S. Treasury yield actually breaking below the 2% level at points.

These lower interest rates have made fixed income instruments less attractive from a valuation perspective. The median forward price earnings ratio of the S&P 500's 50 largest companies is currently about 18x. In comparison, the 10-year U.S. Treasury is yielding about 2%, resulting in a price earnings multiple of about 50x. With so many fixed income instruments being more expensive than their equity counterparts, it is no surprise that many traditional fixed income investors are seeking out alternatives. With about 47% of S&P 500 stocks offering dividend yields greater than the 10-year U.S. Treasury it becomes clear why many investors are being pushed toward equities. In addition, fiduciaries (pensions, endowments and foundations) with set return needs have little choice but to buy riskier assets that at least have a chance to meet these needs.

While we are thankful for the equity appreciation that resulted from more accommodative Fed Policy, we would prefer to see such appreciation be driven by increased corporate earnings. Unfortunately, the prospect of a growing trade war has begun to negatively impact corporate confidence. This drop in confidence in turn has led many corporations to lower their economic growth outlooks resulting in corresponding cuts to their earnings forecasts.

While accommodative Fed Policy may place a floor under equity prices, we are skeptical as to its ability to push prices much higher beyond current levels. While we view stocks as fairly valued at current levels we do not believe the current environment justifies a richer valuation. Assuming this to be the case, equity prices may take a breather until we see a shift in corporate earnings momentum. At the present time, the most obvious way to visualize this shift would be a positive resolution on the trade front. It is important to note, the more time that passes absent an agreement, the more the downside risk increases.

Asset Allocation - A Busy Quarter

We rebalanced our Lakepointe Classic portfolios in mid-May. This rebalance focused on two items. The first item had to do with replacing our large-cap international growth fund. We utilized the William Blair International Growth Fund for several years. Recently, the fund started to slip in our Bellwether Screens versus its peer group. As performance started to slip to the middle of the pack, we had several conversations with fund representatives and analyzed management commentary. Ultimately, we concluded the fund's underperformance was more than just a temporary setback. As a result, we decided to seek out an alternative fund in the large-cap growth international space.

The fund we identified is the Clearbridge International Growth Fund. This fund boasts a strong track record versus its benchmark and peers. Portfolio returns exceed benchmark consistently throughout the life of the fund. The fund's returns rank in the top quartile relative to peers across time periods and risk adjusted returns exceed benchmark and peers. When compared to the William Blair International Growth Fund the Clearbridge Fund demonstrated superior risk adjusted returns on a 1, 3 and 5 year basis. Ultimately, we believe Clearbridge offers a superior option in the large-cap international growth space going forward.

The second item we focused on in the May Classic rebalance was the reintroduction of the Vanguard Inflation Protected Securities fund into our Classic fixed income fund model. The Vanguard fund provides an opportunity to lengthen our overall fixed income portfolio duration while also providing protection against inflation in an environment where nominal yields are dropping. Nominal yields simply refer to the interest rate that is attached to a traditional fixed income instrument at the time of issue. We believe there is a strong possibility the Fed's recent accommodative shift could lead to additional quantitative easing, which will result in an extended period of low nominal yields.

At the same time, the Fed appears to be focused on increasing inflation expectations. If successful in their higher inflation pursuit, nominal yields are at risk of being eaten up by inflation, resulting in extremely low if not negative real yields. Real yields are simply nominal yields that have been adjusted for inflation. The beauty of inflation protected securities, as discussed later in the Financial Planning section, is that in such an environment an investor can protect their investment return from the forces of inflation. Furthermore, the addition of the Vanguard fund resulted in a lengthening of our overall portfolio duration, which provides the added benefit of increased market value appreciation potential in a declining nominal yield environment.

In mid-May we also rebalanced our Lakepointe Premier portfolios. In this rebalance we also replaced the William Blair International Growth Fund with the Clearbridge International Growth Fund. In addition, we replaced four individual stock holdings within the Political Activism Stock Portfolio.

Financial Planning -
Revisiting an Old Acquaintance

It's easy to see how inflation affects your daily life. Gas prices are higher. Electric bills are steeper. Wallets are thinner. But what inflation does to your investments is not always as obvious. Let's say your money is earning 4% and inflation is running between 3% and 4% (its historical average). That means your so-called "real return" – the stated return minus inflation – is only 1%, at best. What can you do to keep from losing the race against inflation? One way is to buy investments that are designed to keep pace automatically. U.S. Treasury Inflation Protected Securities (TIPS) are such an investment. While we had commonly utilized TIPS in investment portfolios prior to 2008, we have only used them in rare instances since then. Due to their reintroduction into some of our model portfolios, we thought we would take this opportunity to refresh everyone's memory regarding what TIPS are and how they work.

Since the U.S. Treasury introduced them in 1997, TIPS have become the most widely known example of what are generally referred to as "inflation-protected securities." TIPS may be attractive to long-term investors who want to preserve the purchasing power of their money over time. Investors also may like the security of knowing their investment is backed by the U.S. government as to the timely payment of principal and interest.

Like other Treasury bonds or notes, TIPS are basically loans to the U.S. government. You receive interest payments every six months based on a fixed interest rate specified in advance. With most bonds, it is easy to know the exact amount of money you will receive each year. You simply multiply the principal – the amount of your initial investment – by the interest rate.

TIPS work a little differently. Instead of guaranteeing how much you will be paid in interest, an inflation-protected security guarantees that your real return will keep up with inflation. The interest rate stays fixed; what you will not know is the exact dollar amount of the payments you will receive. If inflation goes up, your return will increase to match it. With TIPS, you are trading off the certainty of knowing exactly how much you will receive for the knowledge that, as long as you hold the bond until it matures, your investment will maintain its buying power.

How do TIPS work?

TIPS pay slightly lower interest rates than equivalent Treasury securities that do not adjust for inflation. The reason for that reduced rate? Your TIPS principal is automatically adjusted twice a year to match any increases or decreases in the Consumer Price Index (CPI), a widely used measure of inflation. If the CPI increases, the Treasury recalculates your principal to reflect the increase.

For example, let's say you buy $20,000 worth of TIPS that pay a fixed interest rate of 2.5%. Over the next six months, the CPI rises at an annual rate of 3%. Your $20,000 principal would go up by 1.5% (half of the 3% annual inflation rate) to $20,300.

This adjustment will affect the amount of your semiannual interest payments. Even though the interest rate stays the same, it is applied to the recalculated amount of your principal. In this example, the 2.5% interest rate would be applied to the new $20,300 figure. The actual dollar amount paid in interest goes up, because it is based on a higher principal. Instead of $250, your next semiannual payment would be $253.75. If the CPI figure is lower in six months, your principal will be adjusted accordingly when it is recalculated; that in turn will affect the amount of your next interest payment. If there is a period of deflation and the CPI is actually a negative number, your principal and interest payment would both drop.

The inflation adjustment feature means that if you hold a TIPS until it matures, your repaid principal will likely be higher than when you bought the bond. Even if the CPI turns negative and the economy experiences deflation, the amount you will receive when the bond matures will be the greater of the inflation-adjusted figure or the amount of your original investment.

While we have not utilized TIPS in our portfolios on a widespread basis over the last several years, we now view them as attractive. While inflation has been rather subdued for several years, we see increased inflationary pressure on the horizon. This should bode well for TIPS. In addition, we see opportunity given the current real yield level. In the event Treasury yields remain subdued and inflation heats up, TIPS are likely to outperform many of their traditional fixed income counterparts.