NOTTINGHAM ADVISORS
ASSET MANAGEMENT

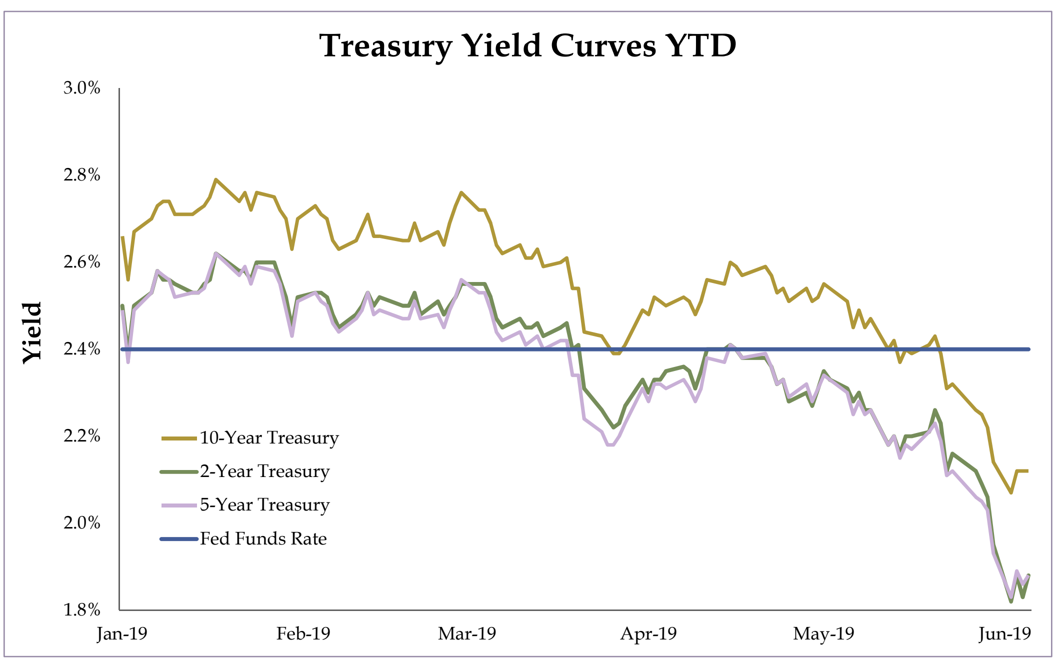
MID YEAR REVIEW

"Rain, rain go away….come again some other day…"
-Traditional nursery rhyme

As we approach the mid-point of this abnormally cool and sodden year here in Western New York, we find ourselves longing as much for sunshine, warmth and dry weather as we do for a cessation to the ongoing trade war, a halt to the persistent decline in bond yields and a softening to the political rancor which is only getting more heated ahead of the 2020 election.

Despite starting the year with what might be described as a cautiously optimistic view, we're growing a bit more concerned that the on-going trade war with China could escalate into something worse, and also that tariffs appear to be the new weapon of choice in President Trump's international diplomacy arsenal. Barring a near-term halt to the tit-for-tat tariffs, fines and levies on businesses in the US and China, we're likely to revisit our internal estimates for GDP growth in 2019 and 2020, as well as our earnings estimates for the S&P 500.

The first quarter saw strong corporate earnings here in the US, propelling the S&P 500 to a swift 18% gain through May 3rd, largely due to P/E multiple expansion. Following a -7% pullback, the Fed triggered a brief rally by suggesting they were open to interest rate cuts in 2019. The bond market was already ahead of the Fed (surprise, surprise) with the yield on the 2-year Treasury note collapsing from 2.62% in January to 1.83% as I write. This would imply the market is expecting two 25 basis point cuts from the Fed here in 2019. A failure to follow through on that could certainly disappoint both equity and bond markets.



Source: Nottingham Advisors; St. Louis FRED

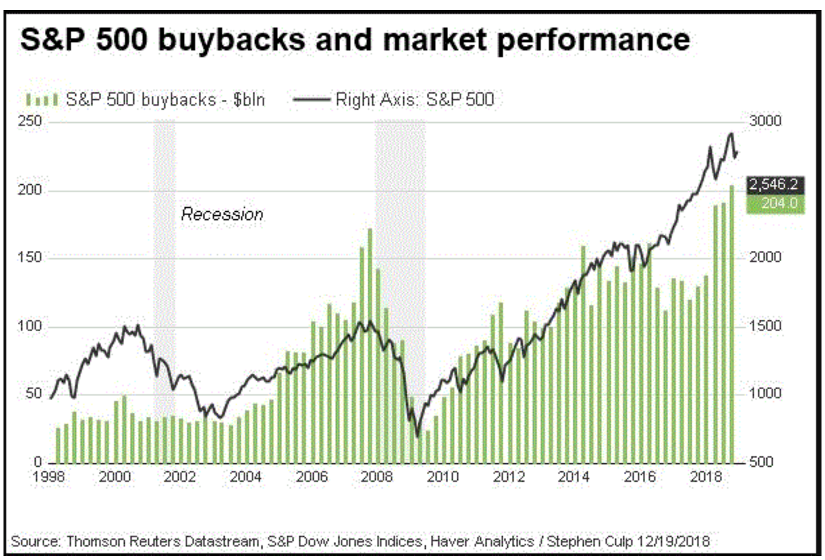
Late-Cycle Playbook
Much of our concern centers around the Trump administration's recent pivot from promoting things that are highly pro-growth, like tax cuts and deregulation, to promoting things that are more likely to stifle growth, like trade wars and antitrust attacks on tech giants like Google and Facebook. Although most of the economic data we survey remains robust – low unemployment, rising wages, strong housing, low inflation, confident consumers – we're starting to see some cracks – weak(er) PMI's, stretched corporate balance sheets, (too) high student loan burdens – that in a late-cycle economy give us pause.

A protracted trade war could easily tip the US and global economies into recession. And, while the Fed does have room to cut interest rates, current equity prices don't seem to reflect the potential for a material downturn in growth estimates. Now, this doesn't necessarily have to come to pass; but, as we always say here at Nottingham, **hope for the best, but plan for the worst**. <u>To be clear, we're not pulling the fire alarm bell here at all. However, if trade relations continue to deteriorate, the market will begin to price in lower growth, lower EPS, and the market could adjust meaningfully</u>.

The outlook for equities looks more asymmetric than at any point in the past few years. We acknowledge there is a path to continued upside in equity prices and by getting defensive early one might forgo those gains. Expensive stocks can always get more expensive. However, the probability of a meaningful move higher in stock prices over the coming year or two is highly dependent on Fed easing while the probability of a governmental policy mistake sending markets lower is rising.

US Equity Recap
Once again, domestic equities have driven the bulk of investor returns. Despite US stocks looking somewhat expensive across multiple valuation metrics, corporate America continues to churn out steady profit growth. In an era of historically low interest rates, investors are clearly placing a premium on "growth" versus "value". If it's true that price is what you pay and value is what you get, then investors seem to be paying an awful lot for an awful little. Then again the earnings yield on the S&P 500 of nearly 6% sure looks attractive relative to both risk-free Treasury securities as well as riskier corporate bonds.

It's true that a lot of the gain in US stocks has come courtesy of corporate America itself by way of share buybacks. 2018 set a record for buybacks with $1.1 trillion in stock repurchased by companies according to Barron's. In the first half of 2018, Apple alone spent over $45 billion buying back stock.



Largely thanks to the repatriation of foreign profits triggered by 2017's tax reform act, much of corporate America remains flush with cash. Given the uncertainty created by the trade war, share buybacks look to be a safer bet for corporate CFO's to goose earnings per share. There is growing concern in Washington that share buybacks are somehow wrong and should be regulated out of practice. We couldn't disagree more and consider Congressional attacks on capital markets to be one of the foremost challenges facing investors going forward.

International Equity

Despite a reasonable start to 2019 (the MSCI EAFE index has returned over 10% through mid-June), foreign stocks continue to lag behind domestic equities. There's a growing legion of investors that have never known international stocks to outperform their domestic counterparts (2017 notwithstanding). We're not sure how long this trend can continue. We've discussed at length in past missives how cyclical this can be and 10 years sure seems like a long time. Certainly valuations favor international stocks. However, the ongoing Brexit saga, slowing growth in Europe and the unintended consequences of QE appear to be limiting equity market gains. We haven't given up hope completely, but it's fair to say our patience is wearing thin.

Emerging market equities have especially struggled this year as the ongoing trade war between the US and China has taken a particular toll on this sector. The MSCI EM Index has returned only 5.6% through mid-June, trailing the broad all-country world index by a whopping 780 basis points. This has been Nottingham's favored sector for some time now given reasonable valuations, strong demographics and burgeoning growth trends. As Keynes famously remarked, however, "The market can stay irrational longer than you can stay solvent." We've pared back some exposure here in favor of large cap domestic stocks, but maintain a healthy allocation to EM in hopes of a resolution to the current trade issues, which could spark a significant rally when it comes about.

Fixed Income

After briefly establishing near-term highs in Q4 of '18, bond yields have steadily declined as the Federal Reserve has pivoted from a more hawkish stance to a dovish outlook following the fourth quarter equity meltdown. Currently, the futures market is implying a 94% chance for a rate cut as early as next month with a second cut to follow before year-end. Bond yields have collapsed in part due to the Fed's pivot but also thanks to the escalating trade war. While pursuit of a level playing field is still necessary in our view, a prolonged trade war will most certainly stifle global growth.

There currently exists over $10 trillion in international sovereign debt carrying negative yields. The German 10yr bund currently yields -0.39%. This .25% coupon bond due 2/15/29 was recently priced at $104.61. Were the yield on this security to back up to a not unreasonable level of say 2.0%, the investor would suffer a -19% loss! Of all the tail risk events (or Black Swans) that we can think of, a swift rise in interest rates would likely be the most remote yet likely the most impactful. Betting on future inflation would appear to us to be perhaps the most non-consensus bet out there right now.

Although we consider ourselves contrarians to a degree, we don't see a trigger event that would push interest rates that high over a short period of time. While hardly adherents to Modern Monetary Theory, it's clear investors of today aren't afraid of debt or massive deficits. In fact, borrowing to pay one's bills appears to be the preferred method of financing activity these days. Is there really a free lunch? Somehow, I don't think it's different this time and the fundamental relationship between risk and return will win out in the end.

What to do?

Although every cycle is different, we do think there are things investors can do this time around to protect hard-earned gains and work through what has the potential to become a messy next couple of years ("messy" is a technical term I learned while studying for the CFA exam). Periodically re-assessing one's financial position is never a bad idea (and by "periodically" I don't mean weekly…). Taking gains is never a bad idea. Nor is keeping some bets on the table that are working. All that said, we would not reach for risk right now, in either equities or bonds. There just isn't enough potential return to justify it in our view. And be careful with IPO's; this latest mania for money losing businesses will likely end badly.

We're currently favoring a neutral stance with no outsized bets in any one area. There are too many uncertainties – or as JP Morgan recently referred to it – The New Abnormal. The 2020 election circus is quickly approaching and with it the angst and absurdities that politicians like to foist on a willing electorate. Stay focused on the data and the facts while avoiding as much "fake news" as possible. You'll sleep better.

Summary

We're about half way through 2019, the 10th year of a great bull market. Despite the extraordinary run, we see a healthy dose of investor skepticism (still a large number of investors not fully invested), alongside some crazy enthusiasm (BeyondMeat anyone?). The things that have worked the past few years (US Tech) keep working; and the things that haven't worked as well (US Value and International equities) keep not working as well. We feel a growing sense among market participants that interest rates are bound to remain perennially low, supporting heightened equity valuations over the long run. Once the skeptics become enthusiastic, we'll know we're at a top. Until then, we think it pays to stay the course BUT remain flexible. If we see a material downturn in some of the forward-looking data we track, you'll begin to see adjustments in the portfolios.

Timing downturns is really hard to do. Staying diversified and fully invested shouldn't be as difficult. Nottingham maintains diversified portfolios for a reason. Sometimes it's not altogether obvious; especially when only one element of a multi-asset strategy seems to be "working". History has shown, however, that diversification pays off over the long term. A swift recalibration of market sentiment will change a lot of minds. Those low-yielding but tax efficient munis will look really good in a stock market sell-off. Stay patient and try and enjoy the summer months. For those of us in the northeast, we know the warmth and nice weather can be fleeting. So, let us do the worrying for you. Go take a long walk, play golf or go for a swim. But don't forget to take your umbrella!

Happy summer,

Larry Whistler, CFA
President/Chief Investment Officer
June 2019