CAPSTONE
FINANCIAL ADVISORS

Quarterly Investment Perspective

Aldo S. Vultaggio, CFA®, CPA, AIF®, Director of Investments

Third Quarter 2019

Key Points:

- *Halfway through 2019, stocks in aggregate have erased their losses from last year, buoyed by optimism on a potential U.S.-China trade resolution and the Federal Reserve's openess to cutting interest rates. Meanwhile, bond returns have so far exceeded expectations due to significant declines in interest rates around the world. The outlook for both stocks and bonds remains positive.*
- *The U.S. economy has shown continued strength overall. Most of the major economies abroad have slowed down, particularly with business investment and international trade; however, domestic activity tied to consumers has generally held up quite well. It is still expected that overall global economic growth, albeit lower, will likely stay positive, avoiding a global recession this year.*
- *With the 2020 U.S. election campaigns now gearing up and the U.S. stock market near "all-time highs" once again, many investors are asking whether now is a good time to reduce risk or get out of the market altogether. We highlight reasons why now is the time for investors to have broadly diversified portfolios and to stick to their long-term investments plans.*

Market Review & Outlook

Stocks rallied further on the prospect of rate cuts

Unlike the first quarter when stocks moved up sharply in almost a straight line, the second quarter was choppier. Stocks, however, still finished with modest gains. Investor optimism from better-than-expected first-quarter earnings reports turned into pessimism amid escalating U.S.-China trade tensions. Investor pessimism eventually reverted after the Federal Reserve (the Fed) indicated that they could cut rates if the economic outlook deteriorated. Nonetheless, halfway through 2019, stocks in aggregate have erased their losses from 2018. (See **Figure 1**.) While this year's sharp recovery did not come as a surprise, especially after stocks fell so much at the end of 2018, it has exceeded expectations.

Bonds extended gains amid worries about a slowdown

Similar to stocks, bond returns have exceeded expectations this year. Lower economic growth and inflation expectations contributed to significant declines in long-term interest rates around the world. (Bonds rise as interest rates fall.) Meanwhile, the Fed's more cautious stance on short-term interest rates (i.e., potential policy rate cuts) combined with the European Central Bank's and the Bank of Japan's willingness to inject money into their economies (to keep interest rates low) has resulted in a nearly ideal environment for bonds.

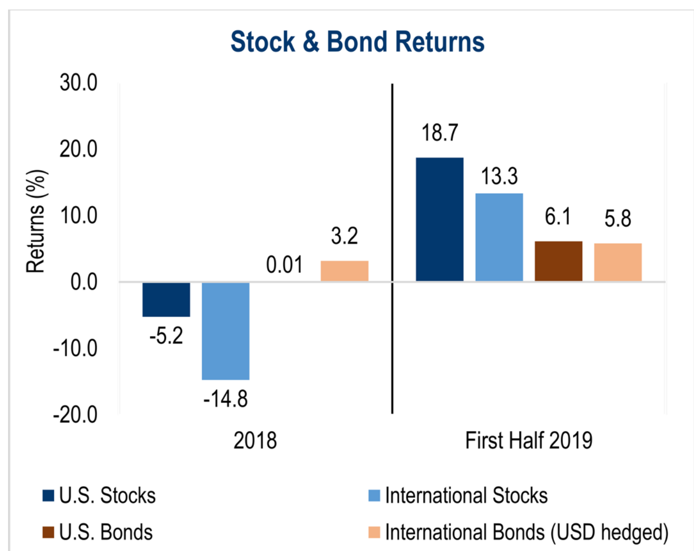

Figure 1. After a down year in 2018, stock markets around the world soared in the first half of 2019. Concerns about global trade and slowing economic growth have been offset by more accommodative monetary policy stances from the Fed and other central banks abroad to sustain economic expansions. Similarly, global bond returns have been strong amid declining interest rates.

U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Barclays Aggregate Bond Index. International bond returns are represented by the Barclays Global Aggregate Ex USA Hedged Index. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Source: Morningstar, Russell, MSCI, Barclays. Data as of 06/30/2019.

Outlook for markets remains positive yet volatile

The recovery in stocks this year is likely to continue given easier financial conditions (i.e., lower interest rates), reasonable stock valuations in most areas, and positive—albeit slower—forecasted earnings growth. A completed U.S.-China trade deal, even if it isn't as comprehensive as anticipated, could boost markets. However, regardless of the outcome on trade, stocks will likely experience increased volatility later this year as economic growth scares and geopolitical uncertainty will likely continue to unnerve markets. Bond returns may not have much more upside this year if economic conditions improve and rates start to rise again. On the other hand, bonds could extend their gains further if stock market volatility returns.

Economic Review & Outlook

The U.S. economy showed continued resilience

Last year's 3% growth rate continued into the first quarter as the U.S. economy grew by an annualized 3.1%.[1] (See **Figure 2.**) Despite ongoing concerns about trade tensions between the U.S. and both China and Mexico, second quarter economic data didn't weaken dramatically. There were some signs of a slowdown in housing sales, manufacturing activity, consumer spending, and exports. However, the collapse of trade talks and the fresh round of tariffs did not hit U.S. business investment, hiring, or consumer confidence in a significant way. The U.S. economy has been resiliant.

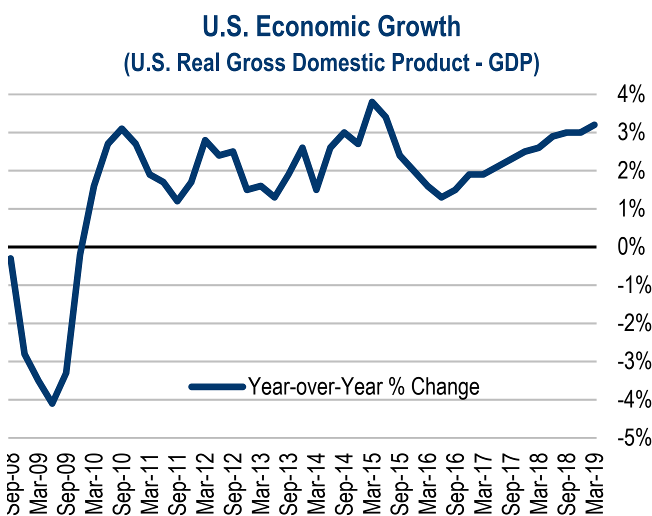

Figure 2. Despite ongoing concerns about global trade talks, the U.S. economy has been stronger than expected, growing 3.1% in Q1 and showing no signs of material weakness since.

Sources: Bureau of Economic Analysis, YCharts. Data as of 03/31/2019.

International slowdown has been tied to global trade

Outside the U.S., trade tensions and other geopolitical events such as Brexit have continued to hinder growth, with recent data from many major economies—such as China, Japan, the U.K., and the Eurozone—showing weakness mainly tied to business confidence, manufacturing, and exports. Nevertheless, domestic activity within most major economies has held up quite well. Consumer confidence remains high thanks to job creation and wage increases; service sectors, supported by consumer spending, are generally strong; and housing markets are being powered by low interest rates. Meanwhile, central banks around the world have responded swiftly with new stimulus measures that keep rates low for longer to support and stimulate their economies.

Global economy to slow but recovery imminent

It is still expected that overall global economic growth-albeit lower-will likely stay positive, avoiding a global recession this year. Trade uncertainty is likely to linger like a dark cloud for the foreseeable future, continuing to dampen business confidence and investment, as well as global economic growth altogether. While the International Monetary Fund expects growth to slow in 2019, it also expects growth to accelerate again in 2020. (See **Figure 3.**) This year's moderate global growth and inflation are two main reasons why low interest rates may persist. Further, the Fed's openess to cut rates and other central banks' willingness to employ other stimulus measures will likely result in a pick-up in global activity.

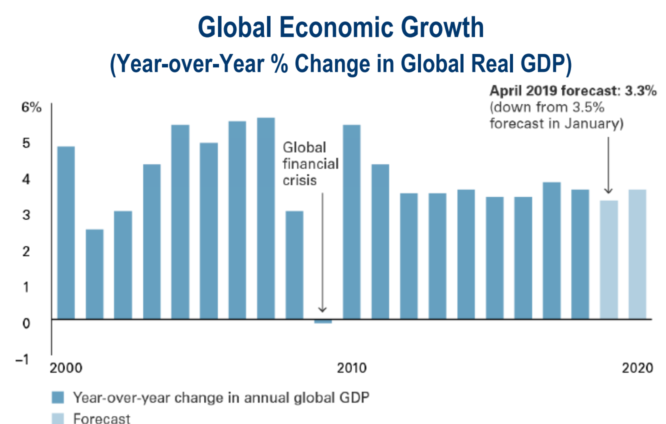

Figure 3. The International Monetary Fund (IMF) recently lowered its global growth forecast to 3.3% for 2019. However, the IMF expects global economic growth to pick up during the second half of the year and reach 3.6% again in 2020.

Source: International Monetary Fund, Vanguard Data as of 04/2019.

On the Minds of Investors

Should I change my portfolio ahead of the election?

With 2020 U.S. election campaigns now gearing up and the U.S. stock market near "all-time highs" once again, many investors are asking whether now is a good time to reduce risk or get out of the market altogether. Because stock markets eventually decline sometimeafter reaching high points and market volatility usually picks up during election years, these are valid questions

Market volatility and uncertainty are the reasons why stock market investors typically earn a higher rate of return over safer assets like bonds. However, bonds also play an important strategic role in portfolios by lowering risk and giving a disciplined investor the ability to rebalance into stocks at discounts when they go down considerably. A portfolio's allocation between stocks and bonds should be determined by the investor's long-term goals, time horizon, and risk tolerance. We believe that one's portfolio allocation should change based on those elements, and not according to short-term market conditions, political events, or speculation about markets direction.

While stock markets eventually decline sometime after reaching high points, they have also always recovered and moved even higher afterward. History shows that stock markets have regularly reached new all-time highs, and today, there is nothing that suggests this trend will not continue in the years ahead. Another thing to consider is that today, there is only one major market at an all-time high level: the U.S. stock market. In other words, there are other markets and asset classes, like international stocks and real estate that are not at all-time highs.

There will undoubtedly be a great deal of uncertainty surrounding the upcoming election; uncertainty (regardless of its source) is typically a headwind for the economy and can contribute to market volatility. However, stock and bond market returns are ultimately the results of many different factors, including interest rates, inflation rates, points in the economic cycle, corporate earnings, and others. Because of this, investors should have broadly diversified portfolios and should stick to their long-term investment plans rather than make changes based on elections, or for that matter, the current level of the U.S. stock market.

Portfolio Management

A case for infrastructure investments

An asset class that has performed well as of late – and one that may continue to perform well given the backdrop of potentially slowing growth – is infrastructure. These types of companies provide essential transportation (e.g., airports, roads, ports), energy (e.g., electricity transition, oil and gas storage), water (e.g., treatment facilities) and communication structures (e.g., satellites and cell towers) that allow our society to operate. Infrastructure assets typically generate relatively high and consistent cash flow, supported by steady demand and long-term contracts, many of which have periodic escalators linked to inflation. As a result, infrastructure companies tend to pay out relatively higher dividends; can have defensive characteristics; and can provide a hedge against unexpected inflation.

Adding "pure play" infrastructure to portfolios

We have been in the process of adding "pure play" infrastructure investments to our clients' portfolios; these are investments in companies whose primary business is owning and operating infrastructure assets. Investing in companies around the world that own high-quality, stable, essential service assets is a long-term, strategic theme. We believe these types of investments should add value to portfolios regardless of what happens politically as it relates to infrastructure spending in the U.S.; the precise level of economic growth we experience this year and next; or the ultimate outcome on matters of trade.

The tie to our investment philosophy

One of the principles of Capstone's investment philosophy is to maintain a long-term perspective and investment discipline. Investing in infrastructure (and the reasons for doing so) is just one example of how this investment principle comes into play. We design and manage portfolios strategically by incorporating asset classes and fund strategies that can fundamentally provide diversification, while maintaining or enhancing risk-adjusted market rates of return over the long-term. We do not manage portfolios tactically based on short-term market conditions. Rather, portfolio changes and decisions are made to help improve expected long-term investment outcomes.

Sources

[1] Bureau of Economic Analysis

Important Disclosure Information

Please remember that different types of investments involve varying degrees of risk, including the loss of money invested. Past performance may not be indicative of future results. Therefore, it should not be assumed that future performance of any specific investment or investment strategy, including the investments or investment strategies recommended or undertaken by Capstone Financial Advisors, Inc. ("Capstone") will be profitable. Definitions of any indices listed herein are available upon request. Please contact Capstone if there are any changes in your personal or financial situation or investment objectives for the purpose of reviewing our previous recommendations and services, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. This article is not a substitute for personalized advice from Capstone and nothing contained in this presentation is intended to constitute legal, tax, accounting, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. Investment decisions should always be based on the investor's specific financial needs, objectives, goals, time horizon, and risk tolerance. This article is current only as of the date on which it was sent. The statements and opinions expressed are, however, subject to change without notice based on market and other conditions and may differ from opinions expressed by other businesses and activities of Capstone. Descriptions of Capstone's process and strategies are based on general practice, and we may make exceptions in specific cases. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request.

Capstone Financial Advisors, Inc.
2001 Butterfield Road, Suite 1750
Downers Grove, IL 60515
Phone (630)241-0833
Fax (630)241-0834