The U.S. equity and bond markets continued their strong performance in the second quarter. The S&P 500 is now sitting near record highs, while Treasury yields are close to two year lows.

In the attached commentaries, we review the second quarter and discuss the dilemma investors now face given the market rally.

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Second Quarter 2019 Market Commentary

Equities

After Rate Cuts

James P. O'Mealia – Head of Equity Portfolio Management

July 5, 2019

After rate cuts, we're gonna let it all hang down
After rate cuts, we're gonna cheer along and shout
The Fed's gonna stimulate some action
We're gonna get some satisfaction
We're gonna find out what it is all about
After rate cuts, we hope stocks don't come tumbling' down

-Apologies to Eric Clapton, After Midnight

Worries about trade wars with China, a marked slowdown in economic conditions in Europe and signs of subdued manufacturing and industrial activity in the U.S. might not sound like the recipe for higher stock prices, but it sure was in the second quarter of 2019! Indeed, after a slump in May, stocks sprinted higher in June as investors reacted with glee to the Federal Reserve's suggestion that worldwide economic uncertainty might cause it to lower short-term interest rates. Furthermore, signs that the threats of increased tariffs with China might be resolved fueled further end-of-quarter gains, with stocks surging over 7% in June. While the S&P 500's gain of 4.3% for the quarter isn't extraordinary, when added to a sparkling first quarter it combined to generate the strongest first half return since 1997. I am pleased to report that our equity accounts generally outperformed the broad market indices and the relevant value benchmarks.

With the equity market soaring to record highs, you might be surprised to learn that eleven of the 30 mighty Dow Industrials fell during the second quarter, or by more than a third for all of you math whizzes! 3M Company's shares came unglued (-16.6%) after it Post-it'd a note about weaker sales to China and the Asian region, Walgreens (-13.6%) hasn't found the right prescription for growth as reimbursement pressure in the pharmacy space continues, and Intel (-10.9%) shares crashed as chip sales and margins dipped below expectations. In a quarter when the market hit

record highs, we should mention that six of the Dow Industrials rose by more than 10% (i.e. Walt Disney, Microsoft, Walmart, American Express, Visa and JPMorgan Chase). Thankfully, we own four of the six in most client accounts, which helped us generate extremely competitive returns for the period. Value stocks held their own for the period, nearly matching the broad market advance. However, small- and mid-cap issues lagged the major market averages.

Trade wars and tariff tensions have contributed to increased economic uncertainty and a marked slowdown in Europe, slower growth in Asia and China, and softer domestic manufacturing activity. Although the Federal Reserve kept short-term interest rates unchanged at its June meeting, Chairman Powell said, “The case for somewhat more accommodative policy has strengthened.” In layman’s terms, the Fed Chairman is signaling that the next interest rate move is more likely a cut in rates. While the initial market reaction was one of cheer, we wouldn’t be popping the champagne and singing “Happy Days are Here Again” just yet. After all, the signs of weakness are going to cause softer corporate earnings in upcoming quarterly earnings reports and most likely a more cautious and subdued outlook by companies.

That caution is already showing up in weaker trade data and slowing manufacturing activity. In May, wholesale recreational vehicle shipments sank 14%, motorhome shipments dropped 9% (source: Robert W. Baird) and automakers are increasingly turned to incentives to maintain sales activity, which has stalled at a 17 million annualized rate. Ford is trying to stay ahead of tougher conditions by announcing last week that it will cut over 20% of its workforce in Europe, Deere is cutting production in the second half of 2019 to correct an overabundance of inventory and 3M is closing or selling divisions that are negatively impacting margins. The Empire State Manufacturing index plunged in May by the most in its history, underscoring the impact of recent trade issues, weather and weaker demand. Anecdotally, the weather in Texas was so bad in May that cement sales dropped 12%! Weather wasn’t an issue in China, but that country, thought to be the world’s growth engine, reported that May auto sales dropped for an eleventh straight month. As a result of these cross currents and headwinds, we have made a conscious decision to reduce our clients’ exposure to industrial stocks in recent months.

Before you call your broker and yell, “sell, sell, sell!”, I would like to point out that the situation is not dire and there is much to feel good about. While the pace of home price gains has decelerated for 13 months, lower rates have already caused a surge in refinancing activity and should help stabilize home values. We think the homebuilders will benefit and could prove to be one of the first beneficiaries of lower rates. The conventional 30-year mortgage interest rate has fallen below 4% for the first time since 2017 and Black Knight Inc. has calculated that 6.8 million borrowers could save more than 0.75% by refinancing. Time to look up the terms on that mortgage and see what your savings could be and if it’s worth the paperwork to refinance! Even though manufacturing has softened of late, the economy continues to create new jobs (224,000 jobs were created in June), labor force participation is a solid 62.9% and unemployment is

3.7%. Not surprisingly, wage gains have accelerated (3.1% on an annualized basis through June) and employees feel positive about their ability to get a raise or a new higher-paying job. As a result, consumer spending has continued to advance (+0.9% for the first quarter of 2019) and according to the University of Michigan, consumer sentiment of U.S. households reached a 15-year high in May.

Lower interest rates create a conundrum for investors. While lower rates are good in that borrowing costs for businesses and consumers decrease, if those lower rates are due to softer economic activity, you need to determine the impact of weaker demand. A key component of interest rates is inflation expectations, and again the picture is mixed. Reported inflation has been running at a 1.5% annual rate. Contributing to this low current reading is weaker economic activity which has caused certain commodity prices to fall. But weather has also played a part causing disruptions in economic activity, offset by great volatility in corn, soybean and pork bellies. Finally, oil prices have had huge swings as unseasonable weather in the U.S. and weaker demand from overseas have combined with strong domestic shale oil production to cause bulging crude oil product inventories.

To counter these factors and stabilize prices, OPEC and Russia agreed last weekend to extend crude oil production cuts for six to nine months. Those actions should help put a floor on prices for the near term, while continued tensions over Iran's nuclear ambitions and the recent spate of attacks in the Strait of Hormuz could cause oil prices to trend higher in coming months. The investment implications of all this energy discourse is the conclusion that the major international oil companies' dividends are safe and provide attractive total return potential. Oil prices jumped 27% in the first half of 2019, and Bloomberg estimated a broad basket of raw materials rose 7% for the same period. States like New Jersey are in the process of raising the minimum wage which will also cause inflationary pressures to build. New Jersey's minimum wage jumped from $8.85 per hour on July 1 to $10.00 per hour and will increase $1.00 per hour annually to $15.00 by 2024. Finally, on July 1 states across the country implemented new or higher taxes for gasoline, tobacco, vaping and electric scooters. Inflation is not dead, just lurking and growing below the surface.

Softer manufacturing activity coupled with strong services growth have combined to present a mixed near-term economic outlook. This mixture has caused the Conference Board's Index of Leading Economic Indicators (LEI) to generate mixed readings over the past six months, with May's reading unchanged. The Board noted that "positive contributions from financial conditions and consumers' outlook offset the weakness in stock prices and the manufacturing sector." The Board also noted that with the recovery entering its eleventh year, "the longest in U.S. history, the LEI clearly points to a moderation in growth toward 2% by year end." That pretty much sums up our view of the economy: strong services growth and a confident consumer will be offset by the lingering effects of horrific weather, the ongoing threat of trade wars, tweets and an increasingly uncertain outlook for the Mid-East region due to Iran's nuclear ambitions, causing slower overall growth. Throw in a dash of IPO euphoria and feeding frenzies over

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new age disruptors like Slack (+39.4% since its IPO), Zoom Video (+150.8%) and Beyond Meat (+551.6%) and you have the makings of a more volatile period for equities in the months ahead. In June alone, ten IPO's had gains of over 50% on their first day of trading, suggesting that alarm bells should be ringing that we are near a peak in excitement and demand for new issues.

Now is not the time to be complacent and we strongly suggest reviewing your asset allocation. The bond market seems to be forecasting a recession, while the stock market's recent action suggests the Federal Reserve has acted in time to re-stimulate the economy. Only time will tell, but it is encouraging that amidst this uncertainty and the mania surrounding certain stocks and sectors, our disciplined approach has enabled us to provide strong relative and absolute performance results. We are not convinced that inflation is dead and in fact, feel that Consumer Price Index inflation readings are masking burgeoning inflation in wages and services. We believe there are still attractive investment opportunities available in the equity markets, just not in the places being chased by the masses. Therefore, we believe that it will be critical in coming months to be positioned in the right sectors, industries and individual stocks. That's also why our balanced and fixed income accounts will remain defensively positioned in their bond investments.

James P. O'Mealia manages separately managed equity and balanced accounts for institutions, foundations, and high-net-worth individuals, as well as five pooled investment funds.

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High Yield Bonds

Be Careful What You Wish For

Randy Masel – Portfolio Manager, Corporate High Yield Bond Strategy

July 8, 2019

After an absolutely stellar 2019 first quarter in the high yield market, it would not have been surprising to see some backpedaling in high yield bond prices in the second quarter. Instead, a cease fire in the China trade war and an increasingly dovish Federal Reserve Bank propelled high yield and U.S. equities to nose bleed levels. The ICE Bank of America High Yield Master II index (BAML HY II index) posted a 2.56% total return in this year's second quarter, bringing the six month return to 10.16%. As a point of reference, the BAML HY II index has averaged an annual return of just under 7.5% over the last 20 years.

There is no doubt that high yield has benefited from the precipitous drop in Treasury rates: five-year U.S. Treasury yields fell from 2.51% to 1.77% over the first six months of the year. At the same time, high yield risk premiums, in the form of spreads over Treasuries fell 1.17% from the elevated levels of 2018 year-end. The combination of falling Treasuries and compressing spreads left the BAML HY II index with a paltry 6.06% yield-to-worst call on June 30th, transforming high yield to "mediocre yield".

While I am not looking a gift horse in the mouth, the frothy levels in high yield (and many other financial assets for that matter) present a conundrum for money managers. Financial assets have been propped up by the belief that the Federal Reserve's tightening cycle has ended and that the Fed will soon start cutting its Federal Funds Target Rate. Fed funds futures are currently implying a bit more than two 25 basis point rate cuts by the end of the year. The Federal Reserve has said that it will "closely monitor" economic data and "will act as appropriate to sustain the expansion". Clearly, the Fed has implied that weak economic data will be met by rate cuts.

As an owner of stocks and high yield bonds, one of the things I am not rooting for is weak economic data. But it appears that the stock market (and by implication, high yield) is rooting for weak economic numbers, or at the very least, the absence of strong economic numbers that could jeopardize a Fed rate cut. As evidence, the strong June non-farm payrolls data that was released on July 5th was met initially with a sell-off in stocks.

Quite frankly, I don't get the "good news is bad news and bad news is good news" logic of the markets currently. It would be one thing if incoming data showed the economy was getting ready to roll over and it was evident that the

Fed was clearly behind the curve. But that is not the case here: economic data shows that growth is slowing from elevated levels. At this point, though, I am not sure that any incoming data will impact the Fed's disposition to cut rates at its July meeting unless the data is exceptionally strong. By bidding up Treasury bonds to the point that long end bond yields have plunged and the interest rate curve has inverted, the financial markets have backed the Fed into a corner where it will have to cut at least once to prevent a market freak-out. Fed Chairman Jerome Powell is scheduled to speak before Congress in two days from this writing and he could attempt to moderate market expectations at that time but I doubt it.

So, where does all this leave us in terms of high yield? Frustrated and cautious. As I mentioned last quarter, it has been hard to find bonds that represent value given current market pricing and yields. These conditions may persist for a while if the Fed cuts rates in July as expected. But if the Fed cuts more than once this year, it will be on the heels of weak economic data, and if cuts just once, the rate cut junkies will be disappointed. Although it hurt our performance last quarter, for the most part I would still rather own near-cash substitutes at 2.5%-3% yields than "mediocre yield" at 6%.

Randy Masel manages a high yield corporate bond strategy that he created and launched upon joining Seelaus Asset Management in January 2014 He is also a Senior Portfolio Manager on the firm's long-only private credit fund.

Intermediate Municipal Bonds

Being Cute About Cash Could Be Tough When Strong Fundamentals Persist

Tom Dalpiaz – Portfolio Manager, Intermediate Municipal Bond Strategy

July 9, 2019

The municipal bond market's strength early this year continued into the second quarter, although at somewhat reduced intensity. The total return of the Merrill Lynch 3-7 Year Muni Index was up 1.61% in the second quarter. For all of 2019 through June, it was up 3.73%. After underperforming munis in the first quarter, Treasury bonds had a better go of it in the second (up 2.77% as measured by the Barclays 3-7 Year Treasury Bond Index). The first half total return for that same Treasury bond index was up 4.64%.

Given the difference in relative strength between Munis and Treasuries so far this year, the ratio of ten-year high grade muni bond yields to ten-year Treasury bond yields rose to 81% at the end of June from a mid-May low of 71%. This ratio had trended steadily in the 82% to 88% range for most of 2018. While interest rates have fallen quite a bit this year and ratios remain somewhat below historical averages, the ten-year muni to Treasury ratio now suggests a somewhat more attractive entry point than was available in the past four months.

Total return numbers and muni/Treasury ratios nicely outline the journey muni yields and Treasury yields have taken in any time period. They explain where we've been and perhaps offer clues for where we might be headed. These interim markers along the way are important to examine. Whether interest rates are relatively low or relatively high, the practical daily grind for all bond investors persists: what is the market presently giving us and what makes sense for each of our situations? We can wish for better markets but can only work with the ones we have. Here is where the simple mantra "Do the math" comes into play.

Seven-year municipal bond yields in the single A and Baa rating categories can be garnered right now in the 2.10% to 2.30% range. For top Federal tax bracket investors, those yields equate to a range of 3.33% to 3.65% on taxable basis. For investors in the 24% bracket, those taxable equivalent yields would be 2.76% and 3.03%. The seven-year Treasury bond yield is currently 1.95%.

Ten-year municipal bond yields in the single A and Baa rating categories can be garnered right now in the 2.32% to 2.52% range. For top Federal tax bracket investors, those yields equate to a range of 3.68% to 4.00% on taxable

basis. For investors in the 24% bracket, those taxable equivalent yields would be 3.05% and 3.32%. The ten-year Treasury bond yield is currently 2.06%.

While the "Do the math" mantra should always be a part of muni bond investing, I believe it is a particularly crucial exercise to go through when interest rates have fallen in a meaningful way and the bond "merchandise" looks relatively expensive. I understand the frustration investors may feel with the muni market yields presently available. One is not inspired to throw a parade for the sub 2% yields routinely found in the five-year and under muni bond space currently. And yet, there is something to be said for staying in the game throughout the interest rate cycle and making portfolios work harder than cash in a prudent way. We have done the math *and* the research and have selectively found value in the single A and Baa rated, six- to 12-year maturity muni space.

After Treasury and Municipal bond yields fall in a meaningful way, market participants often wrestle with questions of whether or not there will be a period of digestion or reversal. The usual culprits causing yields to rise on the muni side include a substantial increase in muni bond supply, a meaningful drop in muni bond demand, an unexpected credit scare, tax reform that includes lower tax rates, or an exceptionally frothy stock market that causes re-allocations away from fixed income. None of these, I believe, have high probabilities in the near future. Muni supply has been somewhat above last year levels but not dramatically so. Demand for munis remains strong; there has not been a net negative month in muni bond and ETF flows since last November. Are tax rates at Federal and State levels more likely to head up or down? While vigilance is always required, the long economic expansion has generally improved tax collections and credit quality as a whole for the muni sector. The forecast for the munis in 2019 remains one of a slightly shrinking market (supply is expected to be less than bond maturities and reinvestment of interest).

On the non-muni side, a sizable reassessment of the recent declines in Treasury bond yields could drag muni bond yields along. The Fed has clearly signaled its openness to reducing its Fed Funds rate target in the second half of this year (perhaps as early as this month and perhaps more than once). Much of the market appears to have embraced the multiple rate cut scenario and has worked those expectations into current bond yields. A Fed surprise seems the most likely basis for a reversal of the recent Treasury market strength.

In my previous commentaries, I expressed caution about being a little too cute with the decision to be in or out of the muni bond market. I certainly get the uneasiness with yields at current levels and the seemingly rich nature of a recently strong muni bond market. I also get the uncertainty regarding a possible reassessment in the Treasury bond market. Timing is always a tough game to play, however, and muni bond fundamentals remain undoubtedly strong. It is my judgment that a sizable reversal to those fundamentals appears unlikely in the near future. I believe the modest

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maturity, value-oriented focus of our approach to munis including the use of spread product and defensive bond structures should work together to soften, in some degree, any unexpected and abrupt reversal of recent muni bond market strength, should it occur.

Tom Dalpiaz has managed the Intermediate Municipal Bond Strategy since January 2014.

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