HAVERFORD

2019 SUMMER OUTLOOK

After posting a better than expected 3.1% annualized rate in the first quarter, U.S. Gross Domestic Product (GDP) is expected to moderate to a growth rate under 2% in the second quarter and possibly stay in that range for the remainder of the year. The biggest factor hampering the economy is the uncertainty around trade and tariffs, which are negatively affecting business confidence, resulting in a slowdown in capital spending and business investment. CEOs are expected to delay large-scale projects while trade policy and tariffs are in flux.

Fortunately, the consumer continues to buoy the economic expansion that is now entering its 11th year, the longest in modern history. Consumer confidence is near a cycle high, while unemployment is near a record low. Weekly jobless claims, a leading indicator of employment, remain at a 50-year low. Wage growth, at over 3%, exceeds the rate of inflation for the first time in over a decade. After several quarters of softness, the housing market is showing signs of improvement aided by the decline in interest rates. The U.S. economy may have slowed, but it remains healthy and strong.

Trade policy is likely to dictate the path forward.

We continue to believe the Trump administration will come to terms with China on a trade deal. The result will ideally be a reduction in, or an elimination of, tariffs. Business confidence should then improve, capital spending would likely pick up, and GDP growth would receive a positive boost heading into 2020. However, while we are optimistic, we cannot rule out the possibility that the administration might not reach a deal with China this year and may expand the use of tariffs as a negotiating tool. Tariffs are a form of taxation that offsets the positive benefits from tax reform and deregulation. More importantly, the use of tariffs to extract non-economic political concessions, as used with Mexico, could do irreparable harm to business sentiment.

Even in this negative scenario, we believe the likelihood of recession materializing over the next 12 months is quite low. Various recessionary indicators show little signs of recession risk. Inflation is tame; unemployment is low; confidence is elevated; and credit spreads remain relatively tight. Several members of the Federal Open Market Committee (FOMC) have also signaled the possibility of an "insurance" rate cut during the second half of 2019. Although the federal funds futures market is now predicting four rate cuts by mid-year 2020, we do not believe that is likely. We believe any cuts will be meant to renew and revive the cycle and act as insurance against a slowdown in global economic activity. Under a more ominous scenario, a rate cut would be used to prevent a recession. If the economy truly needs four rate cuts, the signs are far more foreboding. We believe that two cuts in the renew/revive category are far more likely than four cuts.

A cut in the federal funds rate could help to alleviate the one indicator flashing red—the yield curve, which has been inverted for several weeks. An inverted, or downward-sloping, yield curve is a classic recessionary indicator.

Trade Tariffs Have Dominated the Narrative for 18 Months

Source: FactSet Research Systems, *The Wall Street Journal*

Historically, to have predictive value, the curve needs to stay inverted for at least a quarter or two, and we are clearly not there yet. Typically, an economic recession lags an inverted yield curve by one to two years; hence, our conviction of a low probability of recession occurring over the next 12 months.

The U.S. economy continues to outperform much of the globe.

Trump's trade war has created uncertainty, compounding issues that were already brewing in Europe and China in particular.

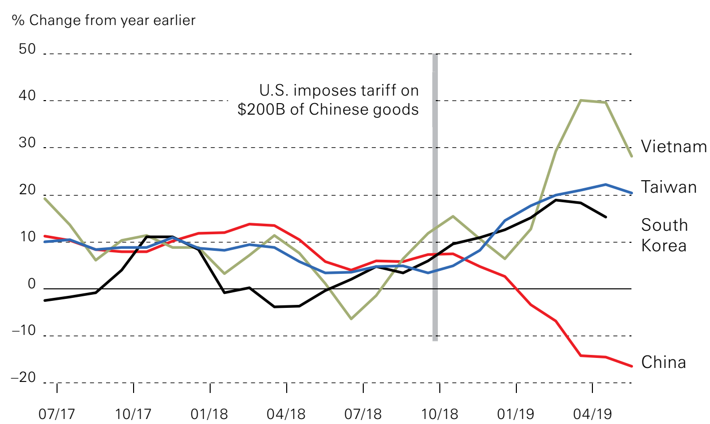
Several events are affecting the European Union, where growth in 2019 is now expected to slow to just 1.1%, a significant cut from the outlook a year ago. Given the collapse in German auto manufacturing, the rising popularity of Italy's far-right nationalist party, the failure of the United Kingdom to secure a Brexit Deal, and the violent antigovernment protests in France, it is unsurprising that manufacturing surveys and trade data have weakened across the European Union. However, other data has been more resilient, helping to cushion the blow. The labor market remains strong, with unemployment at 10-year lows, and wages are trending higher. Monetary policy will remain ultra-accommodative, with the European Central Bank pledging to cut rates and resume bond purchases if necessary. We expect any progress on the U.S./China trade deal to simultaneously boost European business confidence.

In China, manufacturing has weakened sharply as American importers look to avoid tariffs. Many companies have shifted their sourcing to alternative suppliers in Asia, such as Vietnam and South Korea. Other companies have successfully passed the tariff cost onto Chinese manufacturers. Accordingly, U.S. consumers might not bear the full cost of tariffs. This may be little consolation if the Chinese economy turns negative. China has been the single largest contributor to global growth, and a slowing Chinese economy is bad news for everyone. Even before the latest round of trade tensions, China was struggling to boost demand. Retail sales and fixed asset investment have grown at their slowest pace in at least a decade. Chinese authorities are now moving aggressively to stimulate growth through cuts to income taxes and Value Added Tax rates, lower bank reserve requirements, and a push to increase lending to small- and medium-sized businesses. While the Chinese wait for these measures to gain traction, pressure is building on both sides to reach an agreement and avert a wider downturn.

Despite this less than ideal backdrop, the bull market marched resiliently into its 11th year.

The market appears to believe that a trade agreement is within reach, and, failing that, the Fed will be able to orchestrate a soft landing of the U.S. economy through multiple rate cuts. The S&P 500 has soared 15% year-to-date

U.S. Imports from Asia



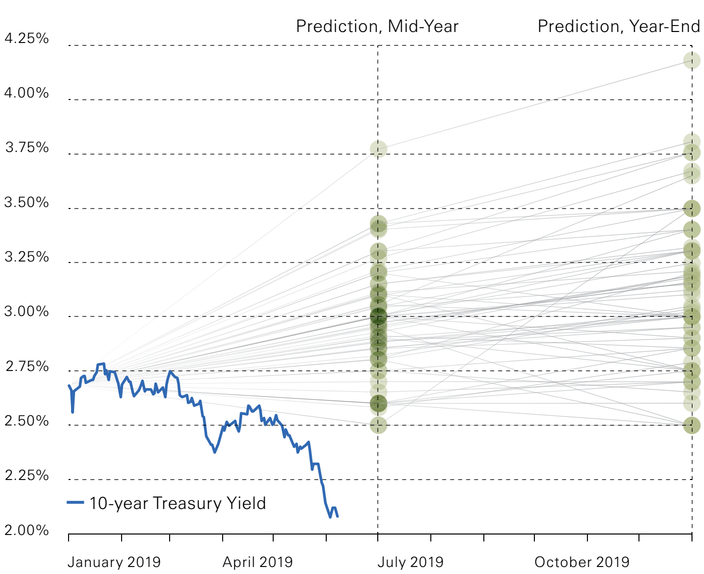
Source: FactSet Research Systems

(as of June 18, 2019) and sits just 2% from all-time highs. Valuations have also bounced back with the S&P 500 Price to Earnings ratio of 16.7x, in line with long-term historical averages and inexpensive relative to bonds. Job market strength and higher wages should translate into continued consumer spending. Lower interest rates are already boosting mortgage applications and the housing sector. Mid-single digit corporate profit growth should be sustainable in this environment. Looking into 2020, earnings growth expectations stand at 10% year-over-year. We have yet to make any significant portfolio changes in response to changing economic forecasts or the on-again, off-again nature of trade policy negotiations. Neither market forecasts nor pricing are at such an extreme that would warrant a shift in portfolio strategy. If opportunities arise to buy strong businesses at lower prices, or if franchises we currently own begin to look vulnerable, we will act quickly to make the proper adjustments.

This year's drop in rates was wholly unanticipated.

When 2019 began, the Federal Reserve had just increased the federal funds rate for the fourth time in 2018 to a range of 2.25–2.50%. Despite that trend, the benchmark 10-year Treasury note rallied from a high yield of 3.23% in early November to 2.68% at year-end 2018. Just six months later, the current 10-year yield stands at 2.09%. It is an understatement to say that the market did not anticipate the drop in rates. *The Wall Street Journal* notes that not a single respondent in their January survey predicted the yield on the 10-year note would fall below 2.5% this year. In fact, only one analyst even predicted a 2.5% yield by mid-year.

Yield on the 10-Year Treasury Note



Source: FactSet Research Systems, *The Wall Street Journal* Survey of Economists (predictions)

With hindsight, it is clear that two factors helped drive rates lower—the economic slowdown and a "flight to quality" amidst the turmoil of trade and tariffs.

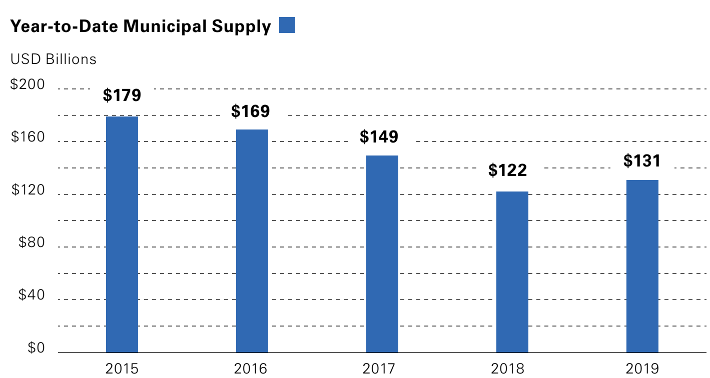
Client portfolios have benefitted as credit spreads on corporate bonds have tightened since year-end. This is consistent with the positive returns on equities during the same time. Short-term volatility is similarly consistent with equities, as spreads are tighter on mornings when stocks open with a positive tone and wider when headlines result in a weaker day for stocks. We believe that corporate bonds will maintain their historical correlation to the equity market and continue to have a positive response as the volatility eventually calms down.

State and local government finances are in the best shape since the financial crisis.

The tax-exempt municipal bond market has continued to benefit from both strong fundamentals and positive supply/demand technical factors. California collected $18.2 billion in personal income taxes in April, 20% above their own budget projections. Texas collected over $3 billion in sales tax during May, which was a record for any single month. Most states have rebuilt their "rainy day" fund reserves back to levels they had before the recession.

Positive tailwinds for the muni market are likely to persist well into 2020, but there are longer-term concerns to consider. First, technology spending by state and local governments has woefully lagged that of private businesses. Cyber-attacks against cities that include Baltimore, Atlanta, Newark, and Sarasota are reminders of weaknesses that are expensive to remedy. Local governments' technology gap is virtually ignored when infrastructure spending is discussed. On the other hand, pension obligations are a well-publicized concern. Longer-living pension beneficiaries and low interest rates have offset the increased value of financial assets. We are encouraged to see many states using the current good financial situation to increase funding.

Demand for Muni Bonds Is Outstripping Falling Supply



Source: Bloomberg, data for five months through end of May for each year

Summer Reading Recommendations

Thank you for your trust and partnership with Haverford. We hope you enjoy your summer and are optimistic the bulk of the bad weather is behind us. For those who enjoy reading in their free time, below are three books that Haverford's Research Team has enjoyed reading recently and highly recommend.

Factfulness: Ten Reasons We're Wrong about the World—and Why Things Are Better than You Think, by Hans Rosling, Ola Rosling, and Anna Rönnlund, forces the reader to confront ten instincts that distort our perspective. The authors rely on global statistics and facts to present a world, despite all its imperfections, that is in much better shape today than ever before in human history. Progress happens daily in tiny increments, but setbacks occur in dramatic fashion and are widely covered by news outlets. The world can be both bad and getting better, and, by almost any metric, life on this planet is improving. In the book, Rosling provides tools to improve our ability to formulate opinions based on facts. Read this book to better understand our world and improve your ability to consume information.

I Love Capitalism: An American Story is the autobiography of Ken Langone. The child of a plumber and cafeteria worker from Long Island, Langone turned hard work and tenacity into a job on Wall Street in the late 1950s. After an unglamorous start, he joined the firm of R.W. Pressprich, eventually rising to lead partner. Langone made a name for himself when he convinced Ross Perot to hire him as the lead banker in the initial public offering of Electronic Data Systems. He later teamed up with Bernie Marcus and Arthur Blank to found Home Depot. Langone's love of God, country, and family, along with his personal style, is fully on display in this American success story.

Magpie Murders provides a unique twist on the classic whodunit. Author Anthony Horowitz has ingeniously structured a novel within a novel. The story revolves around a book publisher's quest to find the missing chapters of a famed—now dead—author's final book. We get to read along with the publisher as she delves into the Agatha Christie-style manuscript, set in 1950s England, and attempts to simultaneously solve three mysteries. The story is a thoroughly entertaining mystery worthy of any beach vacation.

All data as of June 18, 2019, unless otherwise noted.

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