Capital Markets Outlook | Second Quarter 2019 Review

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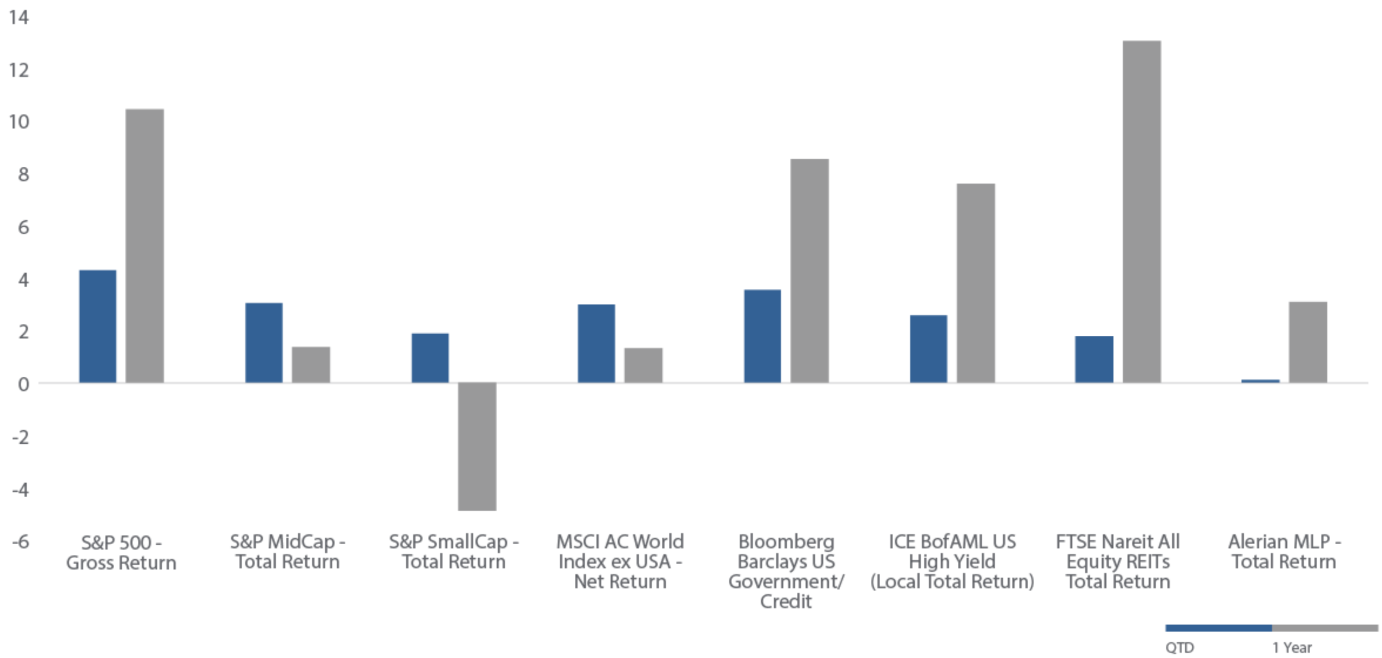
Looking back, the first half of 2019 saw a dramatic reversal as the equity markets gained nearly 20%, offsetting the sharp sell-off during the holiday season last year over macroeconomic uncertainties.

Fears over escalation in the trade dispute with China and potential moderation of economic growth, both here and abroad, began to abate, which lifted valuations back toward more recent historical levels.

The Federal Reserve (The Fed) also lent a helping hand by pivoting their forecasts for monetary policy to be marked-ly more accommodative in response to the declining indicators of global economic health. Investors shifted quickly from expecting the Fed to raise interest rates, then to maintain the current level, and now, to cut interest rates more than once before year-end. In fact, this easing of fears sent nearly every asset class higher since the start of the year.

Despite the central bankers returning and refilling the “punch bowl,” the shift back to focusing on fundamentals has remained and continues to support Westwood’s belief in high-conviction portfolios. Corporate profits remain on track to grow again, both this year and next. However, should those forecasts prove too optimistic, investors may want to consider whether active management, a hallmark of Westwood’s now over-three-decades-old philosophy, can help limit downside losses.

2019 First Quarter and One-Year Trailing Returns Across Asset Classes



Source: FactSet

In the meantime, investors will keep "dancing until the music stops" given the other supportive factors for markets remain in place. The S&P 500 has made several new all-time highs this year despite these market concerns, led by performance in Technology and Real Estate, with valuations overall remaining relatively undemanding. Labor markets are robust, fiscal stimulus remains a tailwind, and business outlooks, but for the trade fears, would be even more positive. Upcoming earnings reports will be a good barometer of the impact from these cross-currents in the global markets.

Expectations have moderated this year, on the margin, for both the real economy and corporate profits but remain solidly positive and have most recently even ticked slightly higher. Any disruptions to those outlooks would be a notable negative, though, the Fed remains at the ready to step in if conditions deteriorate.

The impacts of these potential headwinds would vary by company and may result in large differences in returns for securities and asset classes depending on the details, which could further provide a tailwind to active management.

An escalation of the tensions with China over trade resulting in a full-blown trade war would clearly pressure global growth further. Additional retaliations, whether via tariffs, export bans or other mechanisms, would further push central banks around the world to provide support for weakening growth trends. The resulting flight to safety would mark "the day the music died" for markets as risk assets, like stocks and commodities, would be sold to fund safe-haven purchases of treasuries and perhaps gold. The political rhetoric has already begun for the upcoming 2020 presidential election here in the U.S., but a further shift toward populist platforms would add another item to the list of worries and headwinds for the markets.

In contrast, the tailwinds would be meaningful from striking a deal, or even making progress to slow or lessen the impact of the next round of proposed tariffs. Adding fuel to the fire, if the Fed were to have already cut interest rates in the face of growth slowing, this could serve as even further catalyst to "party all night long" for investors. The combination would be powerful in removing the uncertainty of trade, easing monetary policy and continued fiscal stimulus to send global growth notably higher across the world. Labor pressures for businesses would likely grow, forcing wages higher at the expense of their margins, but adding incremental consumer spending to an already solidly positive economy. Global central banks would likely choose to remain dovish, despite the uptick, over fears of creating policy disruptions as inflation ticked higher but remained well-anchored around the current level.

There is no shortage of potential disruptors to the positively-biased case laid out above as fundamentals, though with some caveats, remain intact currently. Our focus, as it's been here at Westwood for over 35 years, remains unwavering on absolute risk and striving to provide strong protection for client capital should volatility rise due to the uncertainty in the markets.

Given the longevity of the current economic cycle, we continue to look for securities with solid balance sheets and strong cash flow generation that can weather any storms that may disrupt the current environment.