Second Quarter Outlook

As of July 1, 2019

Economy In Review

The first half of 2019 has produced one of the best six month periods for the equity markets in over 20 years. The second quarter started off in a similarly strong fashion to that of the first quarter. Volatility did increase despite the strong performance we have seen through June 30th. There were several mitigating factors that influenced the volatility throughout the second quarter. Geopolitical tensions have escalated between China and the U.S., the European Union's (EU) economy has stagnated further and trade with Mexico has become more contentious. The Brexit debate has continued and remains as an overhang for both the British and European Union's economic growth.

Escalating trade tensions were a main theme in the second quarter. The U.S. encouraged restrictions on China's leading technology company, Huawei. Huawei is considered to be the Chinese equivalent of Apple, Inc. U.S. officials have called out the Chinese firm for transferring technology illegally and also restricting companies outside of China from competing for business inside the country. As the quarter finished, we saw the U.S. and China agree to a cooling off period and rekindle trade discussions. In addition, the tension between Mexico and the U.S. was reduced as it appears as though the two countries have come to a resolution.

In spite of the trade tensions, the U.S. economy continues to advance. The economic backdrop remained solid but less robust when compared to prior quarters. Trade tensions along with slowing capital expenditures could reduce future U.S. productivity and growth. The slowing economic conditions have also put downward pressure on prices, thus limiting inflation.

The U.S. is coming off of some of the best economic conditions seen in the last 25 years. As of July 1, the current economic expansion will be the longest in over one hundred years. Unemployment is at a 50 year low and interest rates hover near 40 year lows. The economy continues to generate strong jobs, capital investment, as well as, high business and consumer confidence levels. U.S. Gross Domestic Product (GDP) has slowed but remained positive in spite of various headwinds. We would expect continued growth and the potential for renewed economic strength unless the various trade disputes continue without any compromise or resolution.

Present

Future expectations of economic growth can be gauged by the Purchasing Managers Index (PMI). This index is an index of the prevailing direction of economic trends in the manufacturing and service sectors. The PMI levels still are showing strength and point to continued growth as we move into the back half of the 2019. Because of the influence of trade tensions we've been closely following the PMI. Another strong predictor of future growth is employment which remains strong, especially with small companies which generate the majority of jobs in the U.S. In spite of current slowing but positive GDP levels all the ingredients are in place for future growth. Internationally, the ECB has moved to make further rate cuts signaling that growth is slowing and that by lowering rates and the value of its currency will help advance the economy. This is never a long term solution as negative interest rates do more harm than good, unsettling financial market conditions.

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The S&P 500 continues to report solid earnings but the second quarter will show the first negative earnings growth in since 2016. Keep in mind that this is a tough compare when tax cuts in 2018 helped growth and adjusted both revenue and earnings higher. Expectations are for continued mid-single digit revenue and earnings growth for 2019 while valuations remain neither expensive nor cheap. Lower interest rates are helping in supporting equity valuations.

Market volatility remains elevated due to political uncertainties. Inflation has been limited and is lower than expectations from only a few quarters ago. These lower expectations coupled with the reversal of the Federal Reserve rate policy has allowed bonds to increase in price and rates to move lower. The supportive economic environment and lower interest rates have spurred refinancing and helped to improve housing prices.

President Trump has provided risk to the markets due to the reworking of trade agreements and political relationships. His adversarial tone and style, on many fronts, has increased uncertainty. This has hurt equity prices in the short term. However, we believe that earnings are the ultimate arbiter of stock valuations. Over time higher earnings levels should propel markets higher. Additionally, we anticipate the growth of overseas markets to rebound once trade agreements with China and Europe are in place. This will solidify willingness to expand capital investment which has been delayed given the uncertain political environment.

Since our founding in 1995, our returns have been driven by a formulated investment process that starts with our top down analysis of economic inputs. Our equity investment focus is Growth at a Reasonable Price (GARP) while concentrating our fixed income on quality income producing investments. Of the S&P 500 groups, ten of eleven groups reported positive returns for the quarter. Returns by sector were as follows: Financials (7.43%), Materials (5.72%), Technology (5.65%), Consumer Discretionary (4.92%), Communications Services (4.15%), Industrials (3.06%), Staples (2.97%), Utilities (2.67%), REITS (1.58%), Healthcare (0.94%), and Energy (-3.71%). At quarter end we expect the economy to continue to remain solid and the Federal Reserve to remain accommodative for the remainder of 2019.

<u>Outlook</u>

U.S. GDP has faced multiple headwinds in 2019 but continues to indicate continued growth. The most accurate and up to date GDP forecast comes out of the Atlanta Federal Reserve. They most recently put GDP growth at 2.0% for the second quarter of 2019.

In the short term, we would expect a future trade agreement. This will allow companies to move forward with capital investment which plant the seeds for future productivity growth. We maintain this perspective since business confidence and capital investment will likely improve once trade negotiations with China, Europe and the U.S. government are finalized. The cooling off of U.S. and China trade tensions are beneficial but the lack of an official agreement puts domestic companies in a position that will likely limit their overseas capital investment. U.S. companies will have to consider a pivot to make investments in plant and equipment in the U.S. and other countries outside of China.

We continue to expect revenues, margins and earnings to remain solid but grow at lower levels than seen in the prior year. This scenario should put the equity markets in a trading range pattern. We expect a sense of relief if and when we get clarity on trade, Brexit and political bickering here in the U.S. The U.S. economy is experiencing tight labor markets, higher input costs and the continued disruption of supply chains. It is our stance that these headwinds will work themselves out over time. This may benefit the economy over the longer term as greater capital investment is made to improve productivity and support future growth.

After considering the economic positives and the noted risks, the S&P 500 appears to be fairly valued over the next quarter or two. As the U.S. economy continues to expand, the overall market is trading at a 16.5x forward P/E ratio. This falls between the 5 and 10 year averages. We believe that over the next 12 to 18 months that the equity markets will maintain an upward bias.

Summary

Hudson Valley Investment Advisors, Inc. favors equities over fixed income. We expect some sort of trade resolution and areas that negatively impacted our economy to become tailwinds. Our understanding of current market and political environment allows us to better position our client's portfolios and we will continue to look for long term opportunities.

The economy is now working in a more traditional manner and a differentiation among investments has begun. The Federal Reserve is on the sidelines in terms of rate increases. It is important to remember that interest rates had been close to or below 1% for an extended period of time. This allowed lesser quality companies to compete on more equal footing with their better quality competitors. Overall, even though growth in the U.S. has slowed, we feel that equities continue to be better positioned to have future appreciation over fixed income.

Our team at Hudson Valley Investment Advisors, Inc. continually strives to meet your investment goals in the forever changing market environment. We will continue to apply our process to allow your portfolio to benefit from our insight and investment strategy.