STOKES CAPITAL ADVISORS, LLC

Market Commentary
June 30, 2019

Quarterly Market Review

U.S. equities reached record highs during the quarter with the S&P 500 posting an 18.5% gain for the six months ending June 30, the best first half for the S&P 500 since 1997. Investors cheered the prospects of easier monetary policy from the Federal Reserve and awaited clarity on U.S./China trade relations.

Small cap equities joined the rally in risk assets adding to already impressive gains for the year but trail large cap equities on a 1-year basis by more than 1300 basis points, the widest margin in over 20 years. While large cap equities typically outperform during the later stages of a market cycle these extreme divergences between large and small cap equities are historically not sustainable.

Foreign equity markets improved during the quarter as well, recovering from the May sell off. Global investors bid up equities in anticipation of news on the U.S./China trade dispute and applauded the European Central Bank's (ECB) signal to provide additional monetary stimulus in the way of lower short-term interest rates and asset purchases. The German DAX received the most attention from global investors as evidence appeared that the German economy is gaining strength and recession fears abated. Meanwhile, uncertainty surrounding a no-deal BREXIT and damage to China's economy from U.S. imposed tariffs kept investors on sidelines in these markets for the quarter.

Commodities witnessed positive results for the quarter, however volatility returned for Brent Crude Oil as tensions increased between Iran and the U.S. over a downed military drone and alleged Iranian backed attacks on oil tankers in the Strait of Hormuz. Gold gained more than 10% in the month of June and hit a five year high at 1,431 $/oz.

Turning to the credit markets, global sovereign bond yields continued their historic decline during the quarter with German 10 Year Bund yields falling to record lows posting a -0.33% yield. Meanwhile, segments of the U.S. Treasury yield curve remain inverted effectively pricing in several Federal Reserve rate cuts for 2019 and signal caution ahead for investors as the global economic expansion shows signs of slowing.

Global Economic Outlook

United States: Growth appears set to moderate in the second quarter from Q1's strong outturn, which was flattered by inventories and net trade effects that are likely to unwind in Q2. Nevertheless, private consumption should regain steam after a weak Q1 showing, thanks largely to a rock-solid labor market which still shows healthy momentum despite a meek print in May. Low unemployment and robust wage growth are buttressing retail sales and consumer confidence, which both posted strong readings in May. On the other hand, business investment and manufacturing activity—which slowed in May according to ISM data—will likely be hit by the recent trade war escalation. On this front, Presidents' Trump and Xi met at the G20 summit on June 28-29 where a truce and resumption of bilateral talks was announced and additional tariffs on USD 300 billion Chinese imports was withdrawn.

Eurozone: Growth revived in the first quarter of the year, after slowing sharply in the second half of 2018. A solid domestic economy drove the acceleration, with household spending picking up, boosted by a falling unemployment rate and wages growing at the fastest rate in a decade. Meanwhile, exports growth slowed amid the turbulent external environment, although overall the external sector still contributed modestly to growth. Incoming data for the second quarter suggests that growth remains broadly on pace, but with diverging dynamics in the economy. The unemployment rate dropped to a fresh over decade-low in April, but data for the industrial sector continued to disappoint with production contracting again in April. Meanwhile, a summit of the European Union's leaders failed to iron out who should take over the Union's top jobs this year in June. Key positions such as the EU Commission president and ECB president are set to change hands at a critical time amid Brexit, trade tensions and weak growth.

Japan: Comprehensive GDP data for the first quarter confirmed that the relatively robust expansion was mostly propelled by a sharp decline in imports of goods and services. Underlying domestic demand, meanwhile, appeared weak as reflected by lackluster private consumption in Q1, raising concerns over Prime Minister

Shinzo Abe's plans for household demand to drive economic growth. Turning to the second quarter, consumer confidence tumbled to an over three-year low in May, which does not bode well for a recovery in consumer spending and leaves Abe at a crossroad whether to move ahead with a controversial sales tax in October. Japan's economic prospects are quickly worsening as escalating trade tensions, especially between China and the United States, could further erode global demand and, in turn, Japan's all-important external sector

China: The Chinese economy is quickly losing momentum amid the escalating trade war with the United States. Data from May revealed that industrial production growth hit a 17-year low, while investment dynamics continued to deteriorate despite solid credit growth. Moreover, the takeover of Baoshang Bank by regulators on 24 May sparked concerns about the health of China's financial system, especially small lenders, and caused primary money rates to rise. While Presidents' Xi Jinping and Donald Trump are scheduled to meet at the 28-29 June G20 summit in Osaka, any substantial progress on trade issues seems unlikely, with the U.S. delaying the implementation of new tariffs on Chinese goods seemingly the most optimistic scenario.

Investment Strategy & Outlook

One of the more perplexing developments in recent years has been the unprecedented decline in sovereign bond yields. We now have over $12 trillion of global sovereign debt at either zero or negative yields while global equities and other risk assets continue to set record highs and post double digit gains. Negative interest rates are not something you will find in a textbook or hear about in an Econ 101 lecture and try placing a negative interest rate in your mortgage calculator! Indeed, these investors are willing to accept a guaranteed loss on their investment in exchange for a return of their capital, most of it anyway. In ten years from now will we look back at this period and reflect "What were they thinking!", or will a -0.33% return for the decade be better than most?

So, who has it right? What do bond investors see on the horizon that equity investors (so far) have ignored? Bond investors are concerned the economic expansion is coming to an end and no amount of Central Bank stimulus will prevent the impending recession, so bond prices are bid up driving yields lower. Equity investors, on the other hand have confidence in the Central Bank's willingness and ability to extend the now decade long expansion by lowering short-term interest rates and thereby providing a lift to stock prices as a risk-on sentiment prevails. But have investors placed too much faith in monetary policy?

Japan is a painful example of monetary and fiscal policy failure. Japan has been flirting with negative yields, stagnant economic growth, massive deficit spending, a deflating currency and episodes of price deflation for decades. After the collapse in real estate and equities in the late 1980's, the Central Bank of Japan drove interest rates to zero while the Government implemented other extreme policy actions but to no avail. Decades later, Japan's debt has ballooned to over 200% of GDP, growth remains stagnant and interest rates remain at the zero bound. These policies essentially punished investors and a deflationary cloud now looms over the Japanese economy.

So, the global monetary policy experiment continues while Central Bankers seemingly ignore past failures and hold fast to the belief that this time will be different. While true there are structural challenges unique to Japan's economy that no amount of stimulus would heal, one can look upon these extreme policy actions like those implemented in the wake of the 2008 Financial Crisis and question the efficacy of such policy. Indeed, investors should remain concerned about the unintended consequences down the road and proceed with caution.

In our view, the appropriate investment prescription should include a focus on quality, liquidity and minimal use of leverage or debt. Invest in companies which are critical to the daily operation of the global economy and will increase your income every year in the form of a cash dividend.

Performance Scorecard

Benchmark Description	Q2	YTD	1 Yr.
U.S. Treasury 3 Month T-Bill	0.7%	1.3%	2.4%
Barclays Aggregate Bond Index	3.1%	6.1%	7.9%
S&P 500 Index	4.3%	18.5%	10.4%
NASDAQ Dividend Achievers Index	5.6%	18.8%	15.5%
Russell 2000 Index	2.1%	17.0%	-3.3%
Alerian MLP Index	0.1%	17.0%	3.1%
U.K. FTSE 100 Index	0.9%	13.1%	-2.1%
German DAX Index	9.1%	16.9%	-1.7%
China SCI 300 Index	-2.3%	28.4%	7.6%
Japan Nikkei 225 Index	3.3%	10.2%	0.2%
MSCI Emerging Markets USD	0.7%	10.8%	1.6%