ACADEMY FINANCIAL, INC.
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2019 2nd Quarter Review

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"Listening to and understanding our client's financial goals allows us to provide the highest level of investment planning advice and service."

Equity Markets

The divergence of domestic vs. international equities continued year to date and only exaggerated the spread in returns through the 2nd quarter. The trade tensions with China has continued where the headlines exaggerate each nuance and possibility of a breakthrough, followed by a breakdown in talks. As talks stalled, President Trump hiked tariffs on $200 billion in Chinese goods. He also initiated sanctions against a large Chinese technology conglomerate, Huawei Technologies Inc. One example of how this affected U.S. companies is Broadcom, which announced that revenue would be reduced by $2 billion. Shortly after, Huawei announced that their revenue would be reduced by $30 billion.

Economists promotes two sides of the story. The pessimistic argument is that increased tariffs are bad. Trade wars hurt the economies on both sides and there are no winners. The optimistic view is that the trade war will be short lived, President Trump is simply positioning, and the result will be a renewed partnership which will drag China (and their influence on emerging markets) into better trade agreements that mostly benefit the U.S. economy. The comparative damage of Broadcom vs Huawei shows the power that the U.S markets have in international trade. Certainly, some U.S. companies are and will be affected, but only fractionally as compared to the Chinese companies and economy.

Short term is difficult to predict, the G20 meeting at the end of June could present opportunity to advance talks or continue the uncertainty. Our political instincts predict there will be a breakthrough in talks leading to a significant trade agreement – just in time for the 2020 election. Quite possibly this will be positive for equity markets both domestically and internationally. The probability of this not happening is still significant and one of the reasons international markets have underperformed.

Ycharts.com (SPY, EFA, IEMG)
https://www.cnbc.com/2019/05/05/trump-says-tariffs-on-200-billion-of-chinese-goods-will-increase-to-25percent-on-friday.html
https://www.cnn.com/2019/06/14/tech/broadcom-chip-stocks/index.html

Fixed Income Markets and the Federal Reserve

Through the 1st quarter, the Federal Open Market Committee stopped the increases in rates and gave indications of a continued pause. As we entered the 2nd quarter the expectations were that the Fed might lower rates. The 10-year yield has fallen from 2.7% to 2.0% year to date, while the 2-year yield has fallen similarly from 2.5% to 1.7%.

Fed funds futures are pointing to odds of a July cut since the Fed did not cut rates in June. The biggest concern we have with interest rates is that the yield curve flattened and, at points, inverted. Currently the 3-month is approximately 0.15% above the 10 year.   While this is not the case as we look at the 2-year vs 10-year we do see the inversion with the 3-month vs 10-year treasury rates. While not a certain indicator of a coming recession, recessions in the recent past have had inverted yield curves precede them.

https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/textview.aspx?data=yield
https://www.cnbc.com/2019/06/14/fed-rate-cut-could-come-sooner-than-some-expect-but-not-yet.html

Commodities, Real Estate, and Alternatives

Gold has rebounded rising from $1280 to $1400 / oz just in June. Oil (WTI) fell from a relative high of $66 to $58 per barrel both indicators of a softening economy. The ratio of Gold to Oil being 24 which is high relative to historical averages.

Bitcoin has been in recovery mode at over $12000 / BTC with an astounding return of over 180% YTD. All cryto currencies are some of the most speculative of securities as Bitcoin has ranged from a high of near $20,000 / BTC in late 2017 down to near $3200 / BTC in late 2018, a drop of over 85%! One of the drivers is the entry into crypto currency of Facebook, Paypal, and the credit card companies. Bitcoin and other currencies aren't an area we include as part of an overall wealth management allocation, but secure digital money could be a disruptor to some banking operations or foreign currencies as it becomes more stable and widespread. An interesting space well worth following.

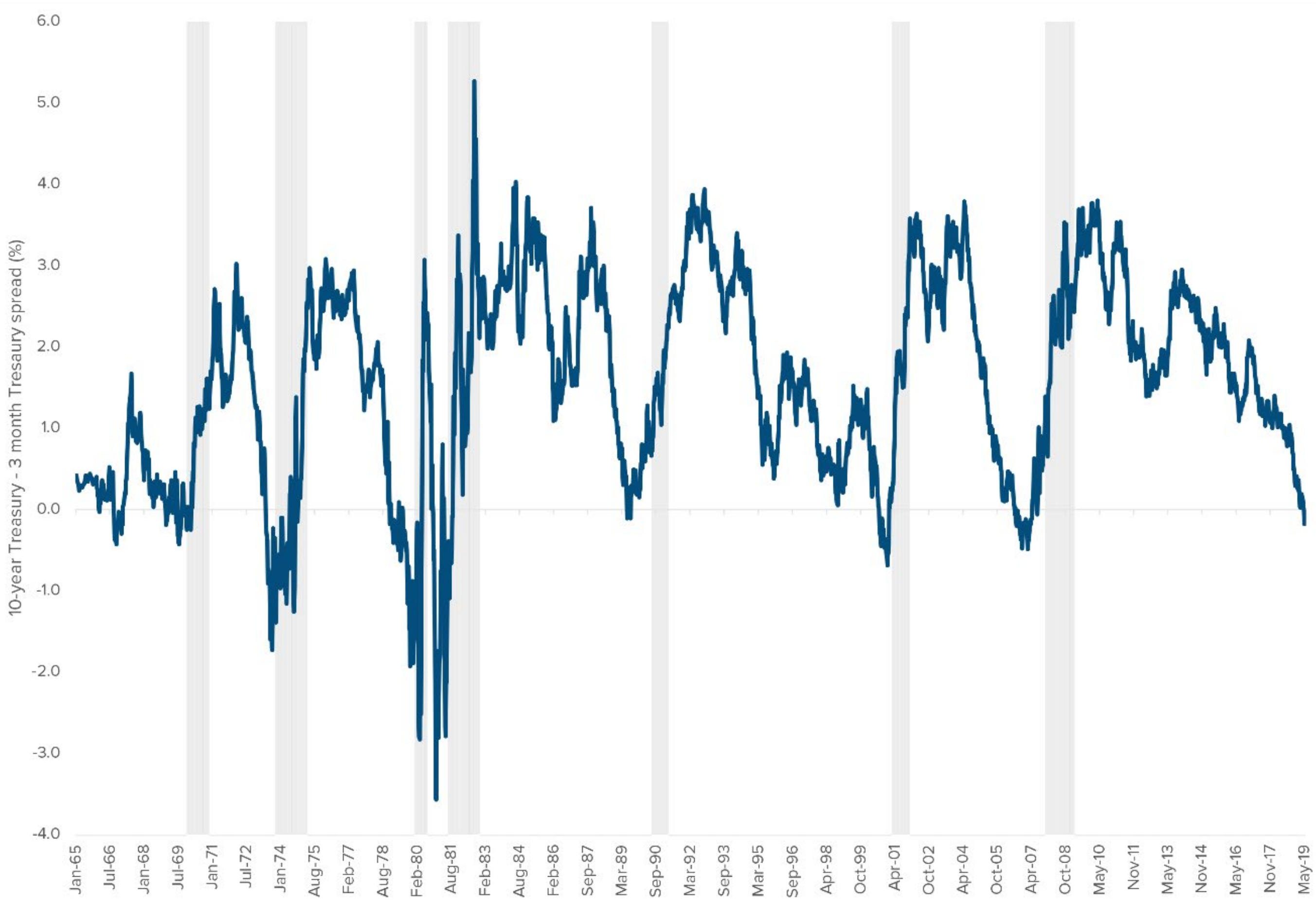
https://ycharts.com/indicators/gold_price
https://ycharts.com/indicators/crude_oil_spot_price
https://ycharts.com/indicators/bitcoin_price

U.S. Economy: Positives and Negatives

We view as a positive: Stock markets higher, interest rates down, inflation contained, unemployment low, oil and gas prices lower, strong recent initial public offerings.

While on the negative side: Earnings growth rate slowing, valuations increasing, start of an inverted yield curve.

The chart below shows the 3-Month to 10-year treasury yield spread since 1965. Not only do we have an extended period without a recession, we see that the spread is approaching zero. The relationship is compelling, but we need to consider correlation. Did the reduced yield spread cause the recession or was the U.S entering a recession and the spread flattened because of reduced business and consumer activity? Another possibility is the two act concurrently with each component affecting the other. In our view, this is the most likely scenario happening now.



*Shaded areas are recessions
Source: Federal Reserve Board of St. Louis, NBER

Forecast

The U.S. has had a solid run of economic growth in the past few years, and really since 2010. When compared to international markets there is a stunning divergence. In addition, the recent tax cuts and deregulation have arguably enhanced recent U.S. GDP as discussed in previous quarterly reviews. Some scenarios could shock us into recession – Extended trade wars, oil and commodity spikes, geo political conflict, U.S. debt default, to name a few. While those scenarios are concerning, they have occurred multiple times throughout history with usually short-term negative effects. The positives of low inflation, low unemployment, etc., would need to significantly worsen before we changed our viewpoint about the U.S. markets. Higher than average valuations still give us pause as do the slow growth international markets. Taken in total, the forecast looks solid going into the 3rd Quarter.

An important reminder with any forecast or market moves: We believe investors should not attempt to time the market and that the key to successful wealth management is to coordinate with your financial planner and establish the risk and return expectations for your unique situation.