Sterling Advisors

REVIEW & OUTLOOK – 2Q 2019

This Review & Outlook includes commentary on Sterling Advisors' three investment Strategies: Large Cap Value, Large Cap Core and Intermediate Fixed Income. As a valued client, we want you to be aware of and updated on all investment options available from Sterling Advisors.

Closing Prices 6/30/2019	
DJIA	26,599.96
S&P 500 Index	2,941.76
Barclays Intermediate U.S. Govt.	2,197.53
Russell 1000 Value	1,254.67
Russell 1000 Growth	1,586.62
NASDAQ	8,006.24
U.S. Treasury Bond	
Current Yield 10-year Bond	2.005%
Current Yield 30-year Bond	2.529%

Source: Bloomberg

The Market Environment

U.S. stocks rewarded investors with strong gains in the second quarter, as major indices closed at or near historic highs. This extends the current bull market in stocks beyond the 10-year milestone, adding to its record-breaking longevity. Interestingly, bond investors also enjoyed robust returns in the second quarter, something that's atypical of a "risk-on" market environment. Declining interest rates, increased trade and tariff tensions, Federal Reserve policy uncertainty and sluggish global economic data were all contributors to the circumstance of stocks and bonds advancing in unison. Large Cap U.S. stocks, represented by the S&P 500 Index, rose 4.30% in the second quarter, while the Barclay's U.S. Aggregate Bond Index returned 3.08%.

The persistent decline in interest rates throughout the first half of 2019 was a major macroeconomic change contrary to prior expectations. Just six months ago, equity markets plunged in reaction to a controversial rate hike, accompanied by hawkish commentary from Federal Reserve Chair Jerome Powell. Now, after a retrenchment in the level of global interest rates and a batch of lackluster domestic economic data, futures markets are implying at least one interest rate reduction in the second half, possibly as soon as July. If this materializes, it will represent a meaningful pivot in monetary policy that may be interpreted as a lack of confidence in sustainable economic growth under current conditions. A key contributor to slowing manufacturing data, business confidence and retail sales has been the effect of recently implemented tariffs on global trade. While this malaise is difficult to quantify, corporate earnings reports in the coming month will provide valuable insight on the magnitude of the slowdown, which could prove to be transitory or lasting, subject to the inking of a substantive trade deal with China. Despite this recent softness, the U.S. economy is a global standout that continues to expand, fueled by tame inflation, low unemployment and moderate GDP growth. It's our view that these supportive economic underpinnings have given asset prices the benefit of the doubt until more clarity on the trajectory of corporate earnings becomes available.

Turning to the internals of the stock market during the quarter, large caps outperformed small caps, growth stocks bested value, volatility levels were subdued, and perhaps most notable, IPO issuance skyrocketed to a pace only matched by the dot-com era nearly two decades ago. Additionally, bonds and equities with defensive characteristics such as REITs and utilities thrived despite the overall preference for growth stocks and the stampede of new issues in Q2. There is a mixed, but sensible, message being delivered by financial markets – one that shows investors' willingness to pay a premium for growth and reliable income vehicles, in a global economy with a scarcity of both.

Large Cap Value Strategy

The Large Cap Value Strategy participated in the strong advance of the equity markets in the second quarter but fell fractionally short of matching the 3.84% total-return of its benchmark, the Russell 1000 Value Index. It was the average cash position of 7.55% during the quarter that drove the slight shortfall in performance. This drag on performance from holding cash in a rising market, versus the always fully invested benchmark index, is an effect that our portfolio management team is mindful of, and it is subject to change based on our top-down macroeconomic view and availability of investments that we find to have an attractive risk vs. reward. Despite the Russell 1000 Value Index's gain in Q2, the overall trend of growth outperforming value remained intact, as the tech-heavy Nasdaq Composite Index and other more growth focused indices posted stronger gains. While the lack of traction in value stocks is frustrating the short-term, we are encouraged to see our proprietary screening process has continued to identify relative value opportunities, and after thorough analysis of each, our investment team added two new holdings during the quarter. These included an opportunistic purchase of shares in a universally known consumer electronics/services company, and a leading domestic apartment REIT. Both have the attractive relative value characteristics required to become long-term positions in the strategy. We remain optimistic that by continuing to uncover new ideas while prudently trimming or eliminating holdings that reach full valuation, the strategy will be able to provide ongoing competitive returns. Although difficult to predict when the market's appetite for value-oriented stocks will reinvigorate, we recognize these style preferences change over time, and we believe the Large Cap Value Strategy is positioned well to participate in today's market while poised to capitalize when value strategies see a resurgence.

Upon a deeper analysis of the Large Cap Value Strategy's Q2 relative performance, individual security selection accounted for roughly two thirds of the .22% underperformance vs. the benchmark. The two main detractors from a stock selection standpoint were the Materials and Industrials areas. With respect to Materials, uncertainty surrounding the planned breakup of a leading global chemical company, which is held in the strategy, was the main driver of lackluster returns. Turning to Industrials, four of five portfolio holdings posted positive absolute gains, but a global freight and package delivery company, well-known to us all, was the laggard that posted a significant negative return in Q2, dragging down the cumulative performance of the Industrials held in the strategy. From a top-down point of view, the common theme is chemicals and freight delivery/transportation are cyclical businesses. We continue to like the prospects of both holdings for company-specific fundamental reasons, but we are always mindful of where the economy may be in the business cycle, and how that may impact earnings for our most cyclical holdings. On the other hand, stock selection within Financial Services and Healthcare posted strong relative performance. This was a great help to overall results, as these are two of the larger parts of the U.S. economy, therefore heavily represented in the benchmark index. Within Financial Services, our steadfast ownership of large money-center banks proved timely despite the plunge in interest rates. All of the strategy's holdings posted positive returns in Q2, with several showing double-digit advances. Although the flat yield-curve and depressed level of interest rates are generally negative for banks and insurance companies, valuations are historically low and capital is being generously returned to shareholders through dividend increases and share buybacks. This is a function of strong balance sheets, high credit quality, and disciplined management teams. Moving to Healthcare, the strategy's holdings posted an average return of 3.61% vs. the 2.84% of the benchmark index. Q2 was a treacherous time to be a Healthcare investor given that drug pricing, opioid liability, and Medicare for All have come to the forefront as major issues to be debated and pontificated on by politicians. This type of uncertainty is typically detrimental to share prices of companies that could be impacted adversely by changes in law but can provide patient value investors opportunities to buy proven businesses at a discount. The strategy's outperformance in this area originated from holdings in the medical device and life science areas, which proved to be a safe-haven from the storm of politically driven headlines, lawsuits and potential legislation.

The aggregated impact of sector allocation decisions had a minimal effect on overall performance in Q2, with the result showing little deviation from the Russell 1000 Value Index. However, digging deeper into individual sectors, the strategy does continue to have significant over and under-weighting of market sectors based on our top-down view of the domestic economy. For example, we have continued to avoid meaningful exposure to Utilities and Consumer Staples, which we see as fully valued given the voracious demand from yield-seeking investors. In Q2, our strongest allocation decisions were an underweight positioning in Energy and an overweighting of the Communication Services area. The strategy's average Energy weighting in Q2 of 6.5% vs. the benchmark's 9.19% provided a tailwind by avoiding some of the negative return associated with being invested in most energy stocks. This sector is suffering from an oversupply of oil and gas, coupled with sluggish demand for drilling equipment and services. Within Communication Services, the strategy's 10.52% exposure vs. the benchmark's 6.55% weighting allowed the strategy to gain from the strong returns in this newly formed sector. Our standout holding in this sector was also the top-performing position in the strategy, a diversified media company well-known for its theme parks, movie studios, and recently launched streaming content offering – advancing 25.77% in Q2. On the negative side, our above-market weighting of the Real Estate sector and underweighting of the Financial Services sectors detracted from performance. The strategy's average exposure to Financials of 18.26% is significant, but well below the 23.51% of the index, leading to a shortfall from an allocation perspective, in light of the sector's strong 7.48% move higher during the period. The Real Estate sector took a breather after several quarters of impressive gains. Our 6.63% average weight vs. the benchmark's 4.21% was minor detractor. We remain confident our Real Estate holdings have unique characteristics that will provide our clients with earnings growth in addition to reliable dividend income. As always, we will continue to adjust the strategy's sector allocation in accordance with our top-down view of the global macroeconomic environment, being careful to maintain proper diversification while expressing our view on your behalf.

Large Cap Core Strategy

The stock markets continued their strong advance in 2019, with all major U.S. averages posting gains in the second quarter. The individual consumer's balance sheet is strong, unemployment is low, inflation is tame and real wages are rising. Companies continue to be more efficient, cutting costs and raising prices. The economy has been good for many American businesses. The stock market is near records with tight credit spreads signifying risk is minimal. Why would the Federal Reserve pivot from interest rate hikes to potential interest rate cuts? That the Federal Reserve might cut interest rates moving forward is a big change in monetary policy expectations. Just several months ago investors were pricing in additional Federal Reserve Rate hikes. Amazing how market expectations change so quickly as new information is released. The 10-Year Treasury yield fell dramatically during the quarter to finish at 2.0%. The bond market is doing the job for the Federal Reserve ahead of their official policy communication. With the implied signal interest rates might be cut, the Federal Reserve has taken interest rate risk off the table and signaled to companies to go to the credit markets to refinance, spend on additional projects, take on additional debt for stock buybacks, acquire companies or increase dividends.

What about all the tariffs? It's clear the U.S. wants structural trade reform. There seems to be confusion by some Americans as to whether the tariffs are a tool to force change or a permanent policy to raise revenue. Our guess is the active and proposed tariff threats will lead to a change in behavior in the other country regardless of the tariffs dollars themselves. The question our team askes is how long can Americans be taxed in attempt to force a foreign power to do something it really does not want to do? Hopefully, the U.S. and China can find middle ground soon. Although, the U.S. economy can and likely will prove resilient either way. Corporate earnings growth has been tremendous, but the rate of growth cannot continue at this pace forever. Late in the economic cycle, the market is rewarding stocks with predictable and growing earnings, exactly the kind of companies we invest in our portfolios.

From an investment standpoint, our largest sector concentrations are Healthcare, Technology and Communications. We expect with interest rates in the process of bottoming in the near term, we continue to be tactical and add companies that will do well when rates normalize while selling companies we think are fully valued with current rates. In a changing market landscape, we ask if the companies are levered to the U.S. Consumer, are company profits related to the slope of the yield curve, are companies impacted by a potential adoption of a single payer health care system in the future? Can company profits be affected by climate and weather, do consumers have an aversion to a social or environmental trend and finally is the product or service sustainable over the long-term?

We continue to use stock selection, relative strength and momentum confirmations as our measure for reward, using stop-loss levels to protect accumulated capital. Patience is always a virtue to a seasoned investor, but when navigating a mature bull market, it becomes an absolute necessity. The equity markets are at a decision point, from which they will either move sustainably to new highs accompanied by momentum, or the new highs will not confirm and lead to sideways consolidation or a retreat. We are watching the price action on stocks that break through prior resistance for follow through of additional gains and remain committed to sticking with our discipline in this inconsistent environment.

Fixed Income

Bond prices continue to project a recession-like turn for the economy. The Fed rate foresees at least a couple of rate cuts before year-end. It should be noted, however, that negative rates in many developed economies and low rates at home, by historical standards, leave less room for the Fed to cut rates in the event of an economic downturn. Nevertheless, the Fed appears to be on a path to support global liquidity and growth prospects. As a result, bond yield will probably need to see a rebound in global growth before moving significantly higher. There are, however, a few inflationary indications that suggest we may see some upward bond rate pressure in later stages of this year or next.

We continue to advocate a cautious approach as corporate bond credit spreads have narrowed to near long-term lows raising the potential that rates could increase over the next six to twelve months even if the Fed lowers rates in July and/or September. In addition to a quality orientation from a credit standpoint, we also recommend a short benchmark duration posture.

Outlook

As we shape our outlook for the second half of 2019, we are mindful of global macro economic conditions and how far along in the business cycle the U.S. economy likely sits. We also give consideration to the enormous change in investor sentiment in a short period of time. Mainly due to the Federal Reserve changing tack from its distinctly hawkish position last December, sentiment has gone from despair to optimistic, sending stock prices surging to historic highs after having flirted with a 20% bear-market decline just seven months ago. Although we find ourselves in the curious situation of seeing stocks at record levels while leading economic indicators soften, we remain cautiously optimistic for equity investors and reiterate the importance of being a long-term investor by remaining invested through volatile periods, with appropriate asset allocation. This allows us to avoid emotional decision-making and affords us the proven benefit of compounding returns over time. Additionally, financial markets are known to be reliable discounting mechanisms that tend to "climb the wall of worry", which is to say today's asset prices are a representation of expected future economic conditions, earnings, cash flows, etc. – rather than the message of current data points. That said, with the 2020 presidential election coming into focus, little clarity on trade relations with China and corporate earnings just now beginning to show the impact of recently implemented tariffs, our outlook is for greater volatility ahead. Uncertainty always exists and seasoned investors know that there is always a "reason to sell" for the skittish market participant. Although we remain selectively bullish on stocks, it is our view we are entering an environment with uncertainties that have the potential to create externalities that could challenge the discounting accuracy of financial markets in the short-term.

Our Investment Team has been focused on rotating into securities we feel will have earnings power given the low level of interest rates, flat yield-curve and trade/tariff impacts. Companies deriving most of their revenue domestically with strong balance sheets and consistent earnings have been emphasized of late. Finding fairly valued companies with good risk vs. reward scenarios has become increasingly difficult as the "safety" sectors with generous dividends have become, in some cases, exorbitantly priced. In a world of minimal interest on deposits and meager bond yields, a great deal of capital is in search of income through dividend-paying stocks that have historically had less volatility in price. While we recognize this is a logical alternative for a saver, the price one pays for an asset is the key determinant of future returns, and the majority of these low-volatility income producers appear fully priced on a historical basis. Our expectation is for increased sector rotation, with volatility increasing on trade/tariff headlines and in response to the 2020 election's hot-button issues, as they continue to emerge.

<u>Reasons to be Optimistic:</u>

- Low interest rates are supportive to GDP growth
- Data-dependent Federal Reserve
- Positive wealth-effect from rising asset prices
- Ultra-low unemployment rate
- U.S. economy stands out globally

<u>Concerns:</u>

- Record IPO issuance
- Some leading economic indicators in decline
- Flat or inverted yield-curve has persisted
- Further deterioration of trade relations with China
- Corporate debt overhang

Most major domestic stock indices have fully recovered from the late 2018 correction that left market participants wondering if the bull market in stocks had ended. While the snapback in price is impressive, we are mindful that equity indices have made modest progress from levels seen 18 months ago, and we're now seeing slowing earnings growth alongside pockets of weakness in leading economic indicators. The relative strength of equities with defensive characteristics is another potential sign the business cycle is mature, warranting an investment strategy that emphasizes protection of your capital, with upside participation. Given the relatively high valuation of the average stock, disciplined active-management and knowing what you own in a portfolio of individually selected securities should be beneficial in the second half of 2019. We remain vigilant for risk factors as we select individual equity and fixed income securities that possess the fundamental attributes necessary to generate attractive returns in a stable, but changing, economy. In the first quarter is extremely unlikely to continue uninterrupted, we remain constructive that equity markets can move modestly higher in 2019, providing us with continued opportunities to apply our patient and disciplined investment approach on your behalf.

Sources: Bloomberg and FactSet

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Dow Jones Industrial Average: The most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. **NASDAQ Composite Index:** Measures all NASDAQ domestic and international based common type stocks listed on The Nasdaq Stock Market. The NASDAQ Composite is calculated under a market capitalization weighted methodology index. **Standard and Poor's 500 Index:** Capitalization-weighted index of 500 stocks, including the reinvestment of dividends and other distributions, designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Russell 1000 Value** Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

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