Notes from the Trading Desk

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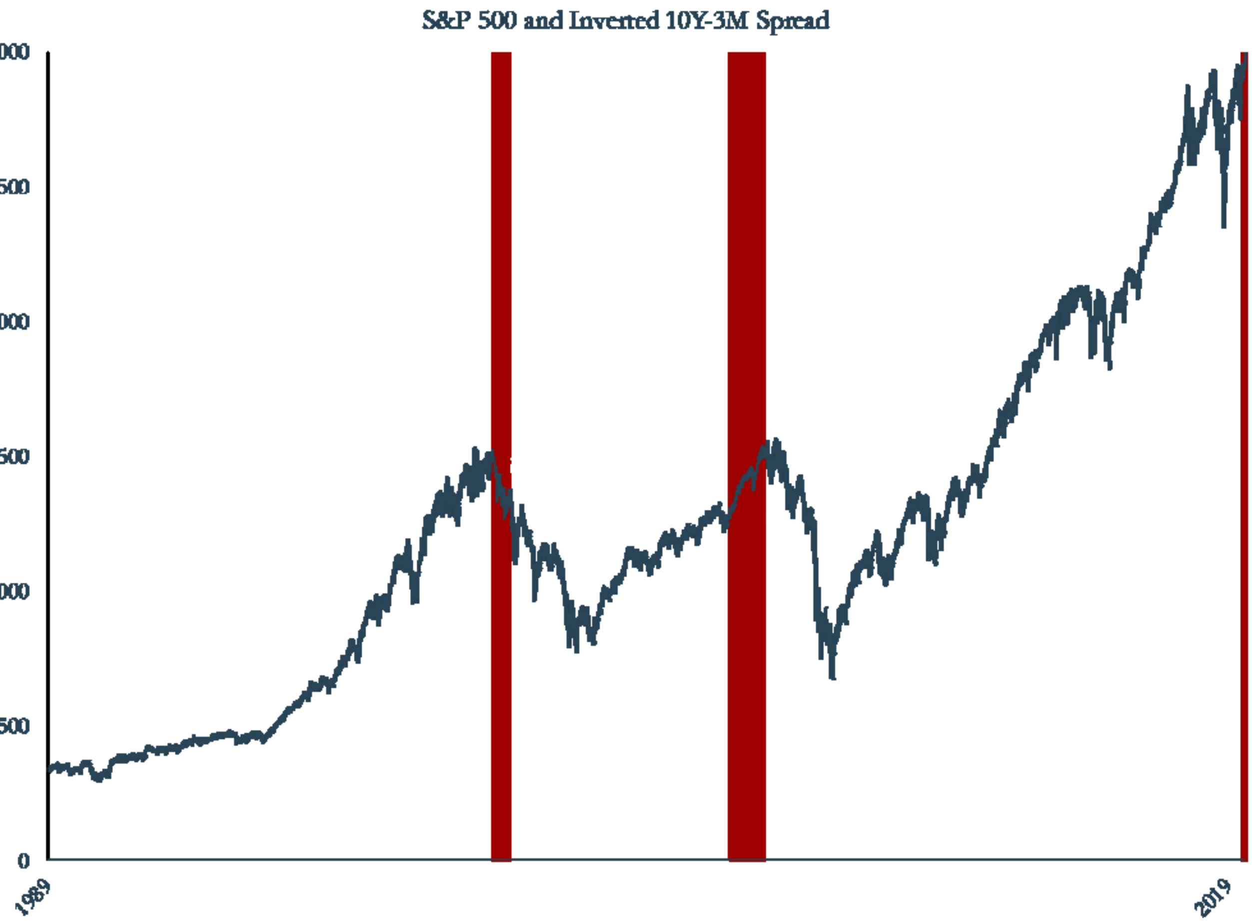
The major U.S. Indices began the third quarter on a high note. The S&P 500, Dow Jones Industrial Average and the Nasdaq spent much of the week in rally mode. As a result, they are all trading at all-time highs. For the week, the Nasdaq led the way higher as it was up 1.94%. It was followed closely by the S&P 500 — up 1.65%. The Dow was up 1.21%, while the Russell 2000 was the laggard — up only 0.58%. Communication Services and REITs were last week's best performers, though they were followed closely by Tech, Consumer Staples, and Consumer Discretionary stocks. According to FactSet, the market is now placing a 100% probability of a Fed rate cut at the July meeting. More specifically, the probability of a 25 bps cut is 97.4%, while a 50 bps cut is only 2.6%. Just one week ago, there was a 31.6% probability of a 50 bps cut. Friday's strong jobs report was clearly enough to shake the market's hope that the Fed will cut rates by 50 bps in July. As a result, yields spiked higher on Friday across the curve.

As ***Notes from the Trading Desk*** has been on a brief hiatus, let us start with a review of the current market and economic backdrop. The S&P 500 is trading at an all-time high and is up more than 19% YTD. In 2018, Cash and Fixed Income were the only major asset classes with a positive return (1.82% and 0.01%, respectively). In 2019, nearly all major asset classes are up. The Barclays US Aggregate Total Return Index — a broad-based fixed income index — is up 6% YTD. Gold is up more than 10%, Emerging Markets and International markets alike have gotten in on the action as well, and nearly all equity indices have rallied this year. It has been a great year for investors in 2019 thus far as nearly all corners of the market have experienced positive price appreciation. What's more, the unemployment rate at 3.7%, though at a slight uptick from the cycle low of 3.6%, is still basically the lowest unemployment rate since the late 1960s. As long as we do not slip into recession by the end of the month, we will find ourselves in the midst of the longest expansion in US history. According to CNBC, June 2009 - July 2019 will mark 121 months of expansion, longer than the previous record set from March 1991 to March 2001. In June, the U.S. Economy added 224,000 jobs, which continued the record pace of job growth with 105 consecutive months. Everything seems to be getting along just fine. So then, why is the Federal Reserve set to cut rates by the end of the month? Are we still living in LaLa land thanks to Central Bank policy?

At face value, many metrics seem to substantiate the strong economic/equity backdrop. However, the devil is in the details it would seem. Last Monday's ISM Manufacturing print further confirmed the slowdown in the manufacturing sector of the economy. The measure continued to fall as a deceleration in new orders impeded the growth of manufacturing. Per the ISM report, "Customer demand did not expand for the first time since December 2015." Elsewhere, company's continue to guide earnings lower. According to Liz Ann Sonders, Chief Investment Strategist at Charles Schwab & Co., and FactSet, the number of companies issuing negative EPS guidance for Q2 will mark the second highest number of companies issuing negative guidance using data back to 2006. Furthermore, excesses are beginning to pop up around the market. Investors Intelligence Bull-to-Bear ratio surpassed 3.0 at the end of June. This was a signal that was present prior to the selloff in May, the selloff in Q4 of 2018 and Q1 of 2018. It was also present as the market topped out in 2015, 2011, 2010, and 2007. The signal is not necessarily indicative of an imminent pullback, as it was also present throughout much of 2014 and 2017. However, it does signify that bulls currently seem to have the upper hand. Yet, even the market leaders could give bulls cause for concern. Utilities, REITs, and Consumer Staples are all trading near all-time highs. The S&P 500 and Dow Jones are both at all-time highs. However, small caps have been left out of the party. The Russell 2000 is still nearly 10% from its August 2018 all-time highs. More defensive stocks and blue chips have seemingly led us back to all-time highs, so the market seems to be adopting a more defensive posture.

Finally, much of the yield curve remains inverted. The 90-day T-Bill yields 2.22% as of Friday's close, while the 10-year yields only 2.04% . Per Bespoke Investment Group, the 10-year to 3-month spread has been inverted for 30 straight days. This last occurred following the bursting of the Tech Bubble and leading into the market top prior to the Financial Crisis (see chart below, the red shaded area marks periods where the 10Y to 3M has been inverted for 30+ days, while the blue line marks the S&P 500).



Yes, the United States is currently setting record low unemployment rates, its markets are trading at all-time highs, and the current expansion is set to be record breaking. At the very least though, there is cause for some concern as a result of the earnings and manufacturing slowdowns, and the defensive nature of the recent equity markets — which brings us back to the Federal Reserve. Many pundits have been critical of the Federal Reserve for potentially cutting rates this month with markets at all-time highs. It seems that our Federal Reserve actually may be proactive instead of reactive, as we have all grown to expect from our central bank. If weakness continues to build on the periphery, it very well could lead to a pause in our economic expansion. The New York Fed's Recession probability model now indicates that there is a 30% chance of a recession in the next 12 months. Since 1970, a recession has ensued following each reading over 30%. Regardless, no one knows with any certainty what the economy or the stock market will do. We are not in the business of predicting market direction,. However, as Seth Klarman, CEO and Portfolio Manager of Baupost Group, once said, *"The problem is that with so much attention being paid to the upside, it is easy to lose sight of the risk."* As markets continue to trade at all-time highs, it is ever-important to monitor any cracks in the foundation.

Upgrades/Downgrades & Dividends

SBNY — Upgraded to overweight from equal-weight at Morgan Stanley, target increased from $142 to $146 (7/1).

SYK — Downgraded to in-line from outperform at Evercore ISI, price target of $210 (7/2).

YUM — Downgraded to underperform from neutral at Longbow Research, price target is $91 (7/1).

Portfolio News & Notes

It was rather slow in terms of headlines last week for Tandem names, with little meaningful news to report. However, beginning in just a few weeks, earnings will be rolling in. Using FactSet data, Tandem holdings reported EPS growth of 13.1% in Q1, well above the estimated 6.7% growth that was forecasted at the end of 2018. Tandem holdings also reported 12.3% sales growth. The S&P 500, on the other hand, had earnings fall 0.3%, which was a disappointment relative to the year-end estimates of 2.7% growth. Sales painted a prettier picture for the index though as reported sales growth was 5.34% for Q1 — a slight disappointment from the expected 6.61%. In Q2, Tandem holdings are expected to grow earnings 7.0% and sales 11.58%. The S&P 500 is expected to have a further earnings decline of 2.86%, but sales growth of 3.7%. The continued margin pressure on the index will be an important story to watch play out.

	WTD	MTD	QTD	YTD
Dow Jones	1.21%	1.21%	1.21%	15.41%
S&P 500	1.65%	1.65%	1.65%	19.29%
Nasdaq	1.94%	1.94%	1.94%	23.01%
Russell 2000	0.58%	0.58%	0.58%	16.84%
Comm. Svcs	2.74%	2.74%	2.74%	21.58%
Con Disc	2.07%	2.07%	2.07%	23.50%
Con Staples	2.18%	2.18%	2.18%	16.96%
Energy	-0.94%	-0.94%	-0.94%	10.09%
Financials	1.94%	1.94%	1.94%	18.17%
Health Care	1.18%	1.18%	1.18%	8.38%
Industrials	0.11%	0.11%	0.11%	20.33%
Info Tech	2.23%	2.23%	2.23%	28.93%
Materials	0.52%	0.52%	0.52%	16.56%
Utilities	1.60%	1.60%	1.60%	14.63%
REITs	2.42%	2.42%	2.42%	21.15%