Washington Trust Bank
WEALTH MANAGEMENT & ADVISORY SERVICES

ECONOMIC REVIEW

Steve Scranton, CFA
Chief Investment Officer & Economist

After a stronger than expected result for economic growth in the 1st quarter, it appears that the cumulative impact of tariffs and business caution may result in 2nd quarter growth of 2% or less. The current estimate of Gross Domestic Product (GDP) from the Atlanta Federal Reserve is 1.5%. The forecasts from national economists range from 1.25% to 2.25%.

There were two factors that boosted growth in the 1st quarter and are now reversing themselves in the 2nd quarter.

Net exports (exports minus imports):

If we rewind to the 1st quarter we had a scenario where everyone believed that the US and China were rapidly moving to a trade agreement that would result in the tariffs being removed. As a show of good faith, China resumed their purchases of US soybeans. This created a boost to net exports. During this business cycle, net exports have subtracted .13% from GDP on average. During the 1st quarter of 2019, net exports added .94% to GDP. Trade negotiations broke down in the 2nd quarter with the US raising the tariff rate on $200 billion of Chinese goods from 10% to 25%. As part of their retaliation, China stopped buying US soybeans again. So, GDP growth should slow as the boost in exports declined in the 2nd quarter.

Inventories

Inventories increased more than their average rate in the 1st quarter. During this business cycle, inventories have not contributed to economic growth as the average was .01%. In the 1st quarter inventory build-up added .55% to GDP growth. This would indicate that businesses would work down their inventory in the 2nd quarter which will reduce economic growth.

The positives keeping the economy growing are consumer spending and interest rates.

Consumer Spending

Consumer spending appears to have rebounded in the 2nd quarter from a depressed level in the 1st quarter. Although June data is not available as we go to press, personal spending is currently on pace to hit a 3.8% annualized rate, compared to .9% in the first quarter. Consumer confidence declined in the 2nd quarter, especially after the new round of tariffs was implemented in May, but consumer confidence remains at elevated levels that indicate positive economic growth.

Interest Rates

Since the Federal Reserve stopped raising interest rates in the 1st quarter, bond investors have driven interest rates significantly lower in the belief that the Federal Reserve will have to lower short-term interest rates this year to help offset additional tariffs. Whether that scenario actually plays out remains to be seen, but consumers and businesses benefited from the decline in interest rates via lower borrowing costs.

We will not see the official first estimate of 2nd quarter GDP until after this newsletter goes to press. Be prepared for a lower number than the first quarter due to the one-time items discussed above reversing themselves. When viewed together, the data shows the economy is slowing from last year's pace but still maintaining positive growth.

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ALTERNATIVE STRATEGIES

Rick Cloutier, CFA
Chief Investment Strategist

For the quarter, markets continued to rise, despite remaining uncertainty over trade; however, changing investor sentiment generated significant volatility.

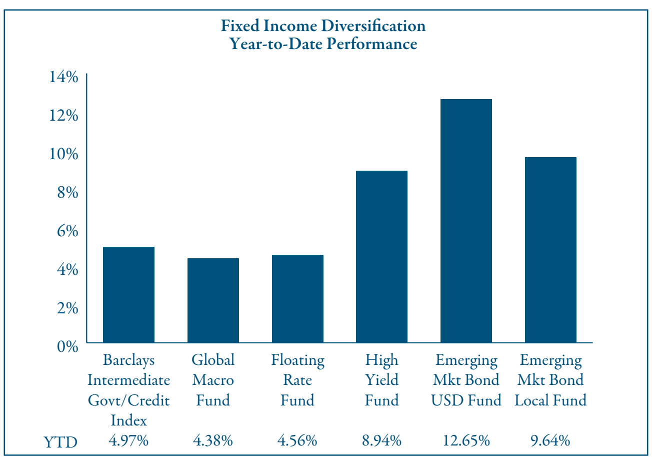
The upward trend was broken in May as concerns over a potential global slowdown dominated. This change led central banks around the globe to signal their willingness to ease in the coming months. As a result, equities continued to advance with the S&P 500 rising 4.3%. Through the first six months, the S&P 500 has risen a stellar 18.5%. Small cap stocks kept pace, but international and emerging markets stocks lagged due to a weaker economic backdrop. Still, through the first half of 2019, they have produced double digit returns.

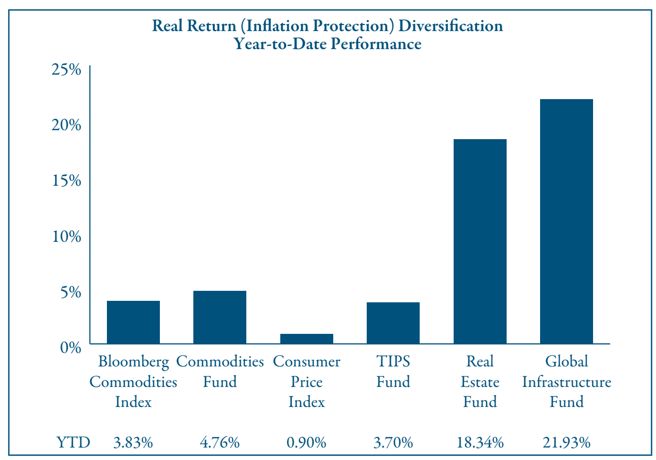
Because of the Fed's more dovish tone, fixed income investments also performed well. Overall, core bonds were up just over 3% and high yield bonds rose 2.4%. For the year, high yield returns are close to 10%, but these returns have been eclipsed by the returns in emerging market bonds, which, year-to-date, have provided double digit returns.

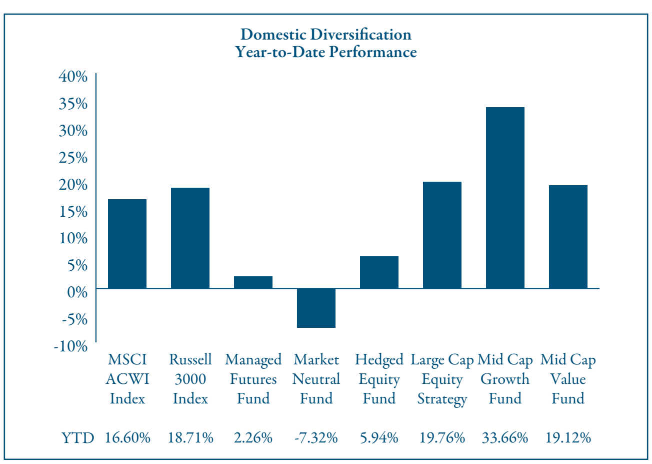
Although the rise in real return strategies lagged the rise in stocks, they continue to outperform historic averages year-to-date with real estate up 19.3% and global infrastructure up 13.1%. Only commodities disappointed with a decline of 1.2%, as metal prices declined due to expectations of softer demands and oil weakened by $1.75 per barrel. Year-to-date though, commodities are still up 5.1%.

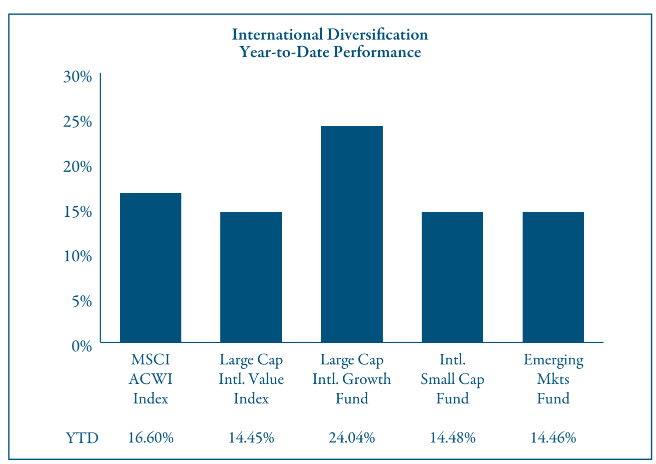
Our absolute return, or risk management, strategies provided returns in line with those of bonds, with the exception of market neutral strategies. While market neutral strategies produced positive returns during the quarter, for the year returns are still below zero.

The quarter ended with a respite in the US-China trade war. At the close of the G20 summit, President Trump announced some concessions, allowing resumption of trade with Huawei on consumer products and China promised to buy more US agriculture. While the immediate threat of raising tariffs has subsided, the agreement does not address the larger issues separating the two. For risk to abate, improvement on intellectual property rights and market reforms has to be made.









DOMESTIC EQUITIES

Gayle Sprute
Senior Portfolio Manager

The rally that began in 2019's 1st quarter continued during the 2nd quarter. It was, however, interrupted by sharp downward pressure in May. The major indices (i.e., Dow Jones Industrial Average, S&P 500, Nasdaq Composite, and Russell 2000) each fell between 6% and 8% during May. Those losses were subsequently offset by 7%+ gains in June.

This two month rollercoaster ride was primarily fueled by news surrounding two significant topics on investors' minds: Federal Reserve (Fed) monetary policy and the global trade war. The sell-off began when China pushed back from trade negotiations and reneged on several aspects of the drafted deal. The US's ensuing tariff increases (to 25% on $200 billion of Chinese goods, along with threats of tariffs on the additional $325 billion of goods), along with actions and posturing from both sides over the next several weeks left investors uncertain about the possibility of any deal. The market had priced in the likelihood of a deal, so an unwinding was inevitable. As the sell-off progressed and investors' risk appetites declined, valuation also declined. The price/earnings (P/E) multiple fell to 15.5X next-twelve-months (NTM) estimates by the end of May.

Concern about slowing economic growth (and a possible recession) drove rising hopes that the Fed might lower interest rates as an offset to economic pressure. Dovish comments from Fed members in early June increased speculation that the Fed might soon consider a rate cut. Although the Fed communicated that it is open to a possible cut depending upon what future economic data shows, the market parlayed that into a question of not if, but when. That enthusiasm fueled a risk-on rally as June progressed. A log was thrown on the "hopefulness fire" at the end of the month after President Trump and Premier Xi Jinping offered some concessions, agreed to resume trade discussions, and said that new tariffs would be delayed during the talks. The P/E ratio expanded to 16.9X NTM estimates by quarter's end. This is above the 5- and 10-year averages of 16.5X and 14.8X, respectively. As we go into the second half of 2019, valuation is being buoyed by expectations that could be challenged if the future does not deliver.

FIXED INCOME

Brian Brill, CFA
Senior Portfolio Manager

Trump, tweets, and tariffs grabbed the headlines and investors' attention, but slowing global economic growth, along with decreasing inflation expectations, was the main impetus to change the world's major central banks' interest rate policies in the 2nd quarter.

Interest rates took a dramatic turn lower as investors priced in multiple rate cuts, moving quickly past the Fed's "monetary pause" that was communicated at the March meeting. Almost daily, investors faced tweets from President Trump regarding the ongoing trade dispute with China. For the first five months, investors were optimistic a trade deal was imminent. But talks broke down in May and investors were faced with the prospect that the trade war with China could go on for a very long time. The basic view from investors is that a trade war between the two largest economies will decrease economic growth, not only to the two main parties but also to the many other countries that are part of the global economic supply chain.

Investors' fears started to come true as economic data from China and the US disappointed. This just added on to an already weak Europe which has Italy in a recession and Germany very close.

The negativity was not lost on the Federal Reserve or the European Central Bank. At the June meeting for both banks, the respective leaders gave clear indications to prepare investors for a rate cut. ECB President Mario Draghi said there is room to cut interest rates from the current record lows. Fed Chair Jerome Powell said the FOMC committee sees the case for "somewhat more accommodative policy" citing trade developments and concerns about global growth.

As a result, interest rates have declined about 50 basis points this quarter, and expectations are running high that the Fed will begin cutting rates at their July or September meeting. Investors are not just pricing in the beginning of rate cuts but have priced an aggressive total of 100 basis points by the end of 2020.

The key for the 3rd quarter will be if the future economic data supports the aggressive market expectations.

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INTERNATIONAL REVIEW

Derrick Wilson
Portfolio Manager

Although concern remains over what looms on the horizon, the party is not ready to end just yet. Global equity markets continued to push slightly higher in the 2nd quarter, adding to the surge experienced in the first three months of the year.

Slowing global growth weighed on investors' minds as European economic data continued to weaken. Chinese economic data also showed some signs of slowing. Adding to the concern of weakening economies, the European Central Bank indicated it could be heading towards lower rates in the future.

The up and down US-China trade roller coaster is still in motion and could be for some time. In case anyone lost touch with Brexit, that too is ongoing. The only noticeable "progress" made on this front was Theresa May stepping down as Prime Minister in early June. Elections are now underway for a new Prime Minister who will get Brexit to the finish line (at least that is the plan). Depending on the election outcome, there could a greater chance of the UK crashing out of the EU with no deal.

Aside from these not-so-new events, tensions in the Persian Gulf are heating up. Conflict between the US, Saudi Arabia and Iran have intensified over the past couple of months. Risk in this region has increased as attacks on both sides have taken place. The threat of war could linger, especially since President Trump called off a planned US air strike. This activity has added to the volatility of oil prices.

As we enter the summer months, things tend to slow down some, but not everything is put on hold. Economic data will continue to be watched closely for signs of further trouble. The potential of central banks cutting interest rates will keep investors waiting in anticipation of when a move could come.

Additional and expanded information to this newsletter discussion may be obtained by contacting your Relationship Manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

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