Mid-Year Update

Dear Members of Flower City Capital,

We hope you are enjoying the beautiful weather and have a wonderful holiday week with your families. For those of you who need it, we will be reaching out for tax planning in the next month or two. Please let us know if we can help with anything else in the meantime.

Executive Summary

As always, we begin with an executive summary:

- Stock and bond markets are at all-time highs, though you may never know it
    - There is a lot to be uncertain about: slowing global growth, trade wars and the extended duration of this market
- However, the US economy is still good and the potential for rate cuts both suggest that this bull market and economic cycle aren't over yet
- We feel the bond market has priced in lower growth/inflation expectations while the stock market has priced in responses by central banks to lower rates and keep the expansion going
- We are rebalancing and maintain neutral positioning in portfolios as we view markets as fairly priced at the moment
    - We will look to change this positioning based on the trajectory of global growth
- Lastly, we review proposed legislation to make material changes to retirement accounts, which may have considerations for retirement planning and investing

Market Overview

What's going on in the markets? Well, US stocks, bonds and real estate are all currently at/near all-time highs. In fact, the S&P 500 has had the best first half performance since 1997 and this has been the best June since 1955. Granted these numbers are coming off lower levels from the end of last year.

Similar to 1997, the Initial Public Offering (IPO) market has also been strong. The Renaissance IPO exchange-traded fund (IPO) is up 35%, with the highest listing day average return since 2000. While the returns are reminiscent of the late 90's, the companies themselves are a bit different. The median age of a 2019 IPO company is 12 years, vs. 4 years in 1999. This is largely due to a significantly larger private market of venture capital and growth equity firms and to some extent a more mature public market. Beyond Meat trading at 40x revenue does seem a bit bubbly, but there are few other areas of the market that are showing irrational valuations.

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Figure 1. Market Return Summary

	Total Return (As of June 30, 2019)			
	1 Mo	**3 Mo**	**YTD**	**Yield**
Equities				
US Large Cap (S&P 500 Index)	5.2%	5.0%	18.5%	2.0%
US Mid Cap (Russell 2500 Index	5.1%	3.4%	19.2%	1.4%
US Small Cap (Russell 200 Index)	4.4%	2.4%	17.0%	1.4%
Intl. Developed USD (MSCI EAFE Index)	2.3%	3.8%	14.1%	3.5%
Emerging Markets USD (MSCI Emerging Markets Index)	5.6%	1.4%	10.2%	3.0%
Fixed Income				
US Bond (BBarclays US Aggregate Index)	1.9%	3.0%	6.1%	2.5%
International Bond USD (BBarclays Global Aggregate Index)	2.7%	3.2%	5.6%	1.5%
High Yield (BBarclays US High Yield Index)	1.7%	2.7%	9.9%	6.3%
Emerging Market Bond USD (BBarclays Emerging Markets Index)	2.9%	3.9%	9.4%	4.9%

Source: Factset

Figure 2. Strong IPO market this year with some froth

Zoom Video	Market Value	Return to Date
	$24.6 B	150.80%
Lyft	Market Value	Return to Date
	$19.0 B	-9.40%
Pinterest	Market Value	Return to Date
	$14.8 B	43.30%
Slack	Market Value	Return to Date
	$18.3 B	39.40%
Beyond Meat	Market Value	Return to Date
	$9.8 B	551.60%

Source: Barrons 6/29/2019

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Figure 3. US markets are all at all-time highs

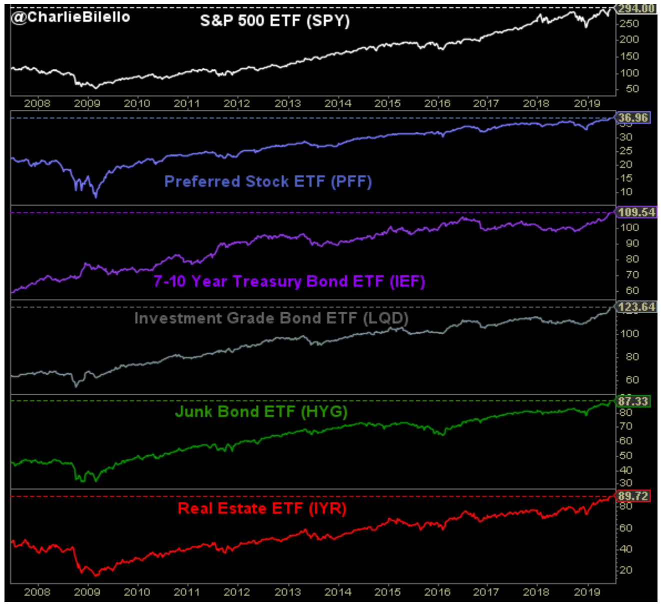
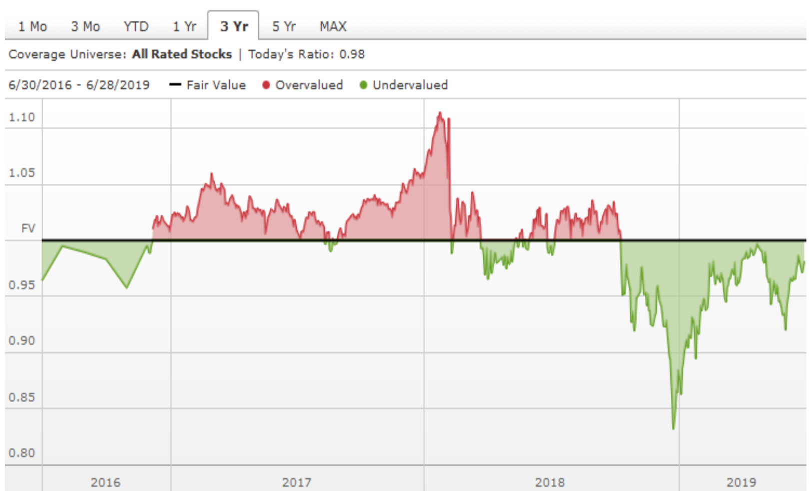


Figure 4. This has not however led to overvaluation in the broader market, which remains fairly valued



Source: Morningstar Market Fair Value

So why are people not partying like it's 1999? We can think of several reasons. One is the baby boomers (possibly the largest investor group) are 20 years older and much more focused on retirement and safety rather than chasing riches in the markets. Another reason is the growing uncertainty stemming from trade wars and political polarity.

As a result, investors are voting with their feet. Funds have been flowing out of stocks and into safer assets as quickly as during previous recessions.

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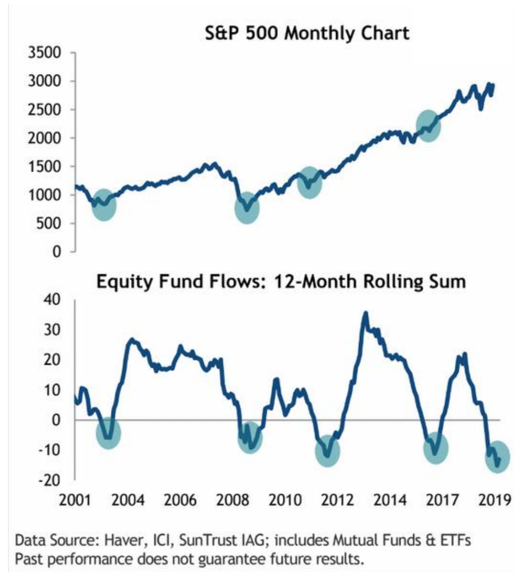
Figure 5. Economic policy related uncertainty has weighed on investors…

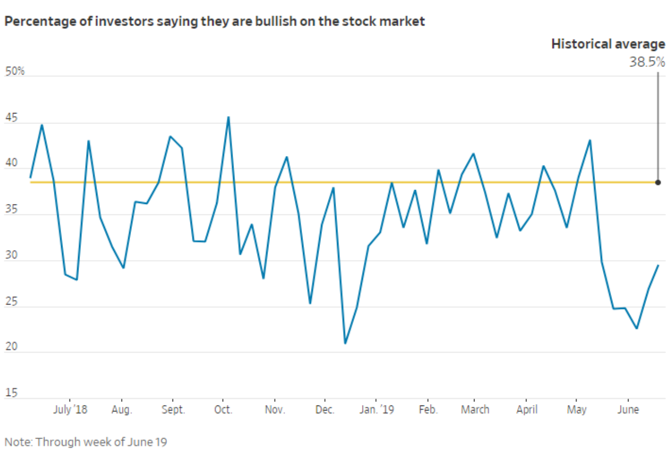
…Figure 6. Contributing to significant movement of capital out of stocks



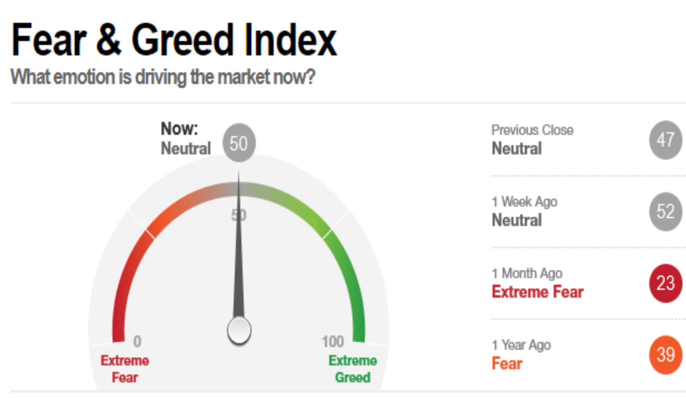
Investors do not like uncertainty which has kept investor sentiment down. Despite being at all-time highs, we have not heard the usual anecdotal chatter from friends or gotten stock tips from cab drivers in recent months.

Overall sentiment measured by the CNN Fear & Greed Index is currently neutral, but as recently as a month ago was at extremely fearful levels.

Figure 7. Investor surveys are decidedly not bullish on the market…



…Figure 8. Overall sentiment is neutral after hitting extreme fear only last month



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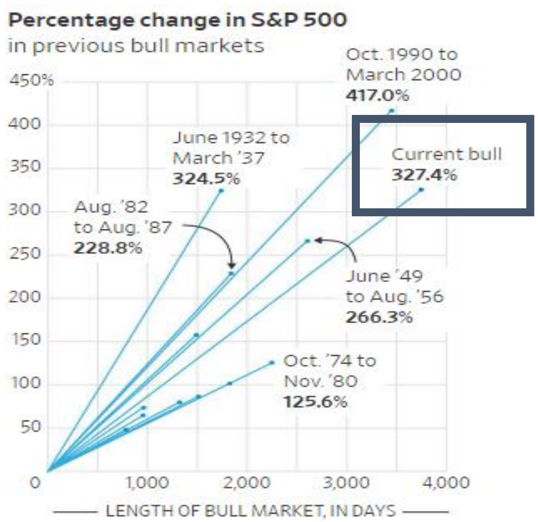
Adding to the benign sentiment is the fact that this is the longest bull market of all time, which naturally causes a lot of people to wonder when it's all going to end.

Figure 9. This is the longest bull market on record



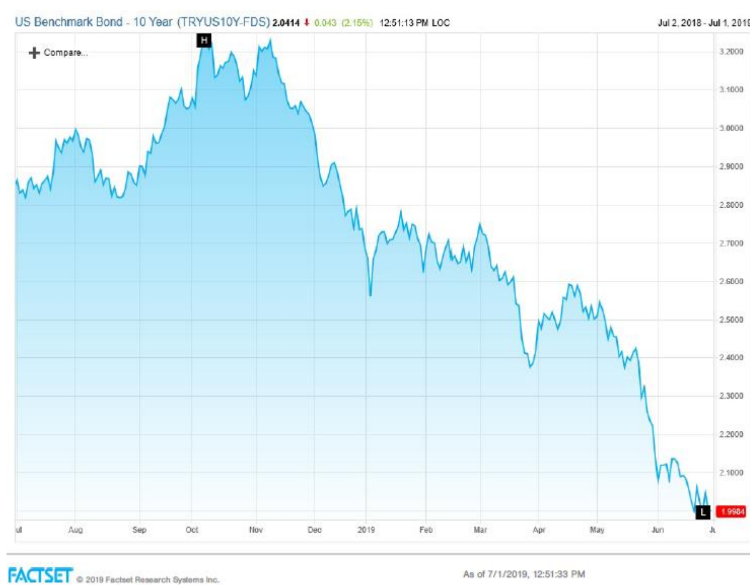
Source: S&P Dow Jones Indices via WSJ

This year is a perfect illustration that bull markets don't necessarily die of old age. They are usually ended by some form of excess like housing or dotcom valuations that cause systematic imbalances. This market is very much indicative of a famous John Templeton quote "Bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria." We are presently growing on skepticism. Despite their recent run, stock prices remain on the high end of their fair value range, not quite euphoric.

It's not just the stock market that has rallied this year. Bond prices (which rise in a falling interest rate environment and vice versa) have rallied. As the global economy has cooled (more on that in a minute) and uncertainty has risen, investors have fled to the safety and security of bonds.

As recently as November of last year the 10-Year US Treasury bond was yielding 3.25%. Since then yield has declined to 2.0% driven by lower growth and inflation expectations.

Figure 10. Bond yields have dropped precipitously



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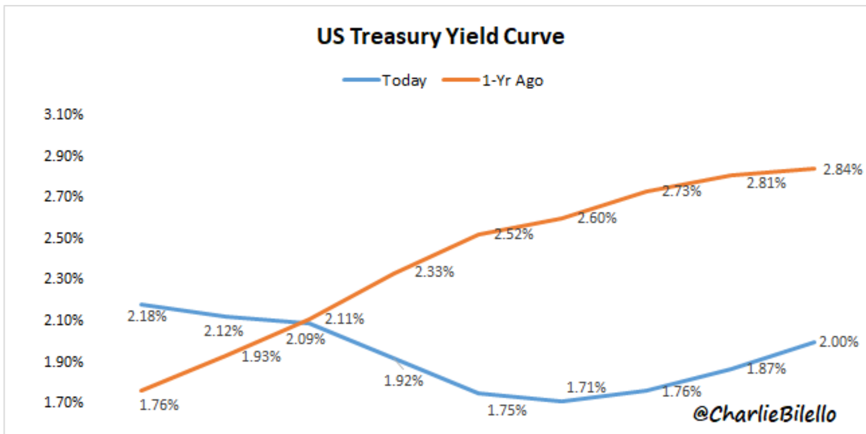
Government bonds are arguably the safest bonds and therefore are used to benchmark interest rates. To simplify, the market's expectation for economic growth and inflation set long-term bond rates while the Federal Reserve Bank sets monetary policy to drive short-term interest rates. Comparing interest rates across time periods can be quite helpful in gauging the market's expectations for the economy. See the yield curve graph below highlighting short-term and long-term interest rates.

Figure 11. The yield curve is currently "inverted"



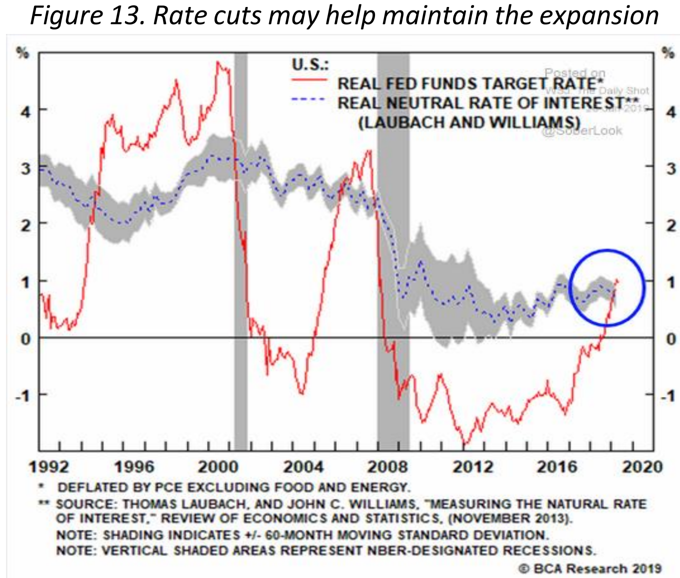
	1-Month	3-Month	6-Month	1-Year	2-Year	3-Year	5-Year	7-Year	10-Year
Today	2.18%	2.12%	2.09%	1.92%	1.75%	1.71%	1.76%	1.87%	2.00%
1-Yr Ago	1.76%	1.93%	2.11%	2.33%	2.52%	2.60%	2.73%	2.81%	2.84%

It is important to remember that US economic growth is still strong, growing at roughly 3% in Q1 2019 and ahead of its long-term potential of ~2%. Currently unemployment is near all-time lows, people are working, and wages are steadily rising. To prevent times from getting too good, the Federal Reserve raised short-term interest rates 4 times in 2018. It's the 4th rate hike that arguably caused the stock market correction at the end of last year as the market thought the Fed was doing too much to slow the economy.

Falling long-term rates and rising short-term rates have led to an "inverted yield curve" Currently with the 10-year Treasury bond yield 2.0% and the short-term Federal Funds rate pegged at 2.5%, markets are fearful that short-term interest rates are too high relative to long-term growth potential.

It's for this reason that markets are pricing in 100% chance of an "insurance cut" to keep interest rates low enough to help keep the economic expansion going.

Figure 13. Rate cuts may help maintain the expansion



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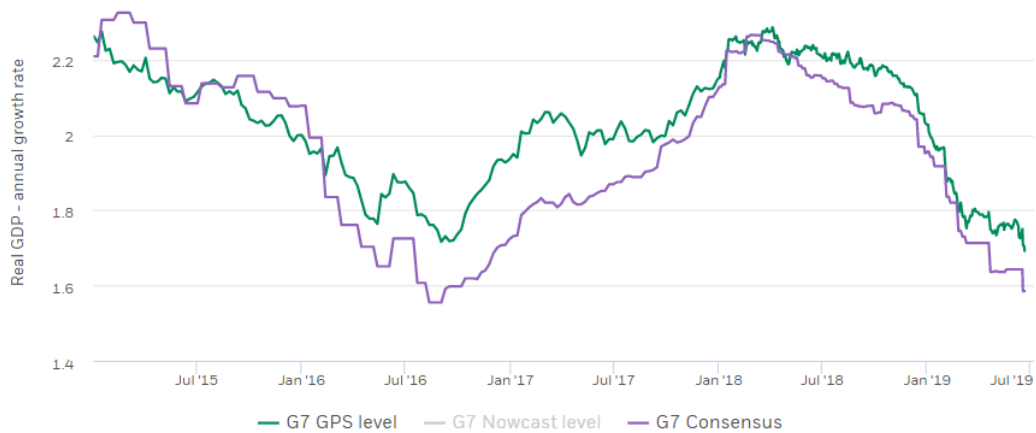
The reason bond yields are falling and central banks feel the need to cut interest rates is that global growth has been slowing over the last year. The chart shows GDP levels in the seven largest countries are back to their levels in the summer of 2016. Hence the decline in bond market expectations.

Figure 14. Global growth has certainly been slowing



Sources: BlackRock Investment Institute and Consensus Economics, June 2019. Notes: The GPS shows where the GDP weighted G7 12-month consensus GDP forecast may stand in three months' time. The purple line shows the current 12-month economic consensus forecast, as measured by Consensus Economics. The nowcast (orange line) shows the GDP forecast based on BlackRock's composite of traditional macroeconomic indicators. Forward-looking estimates may not come to pass.

Despite their recent decline, the US actually has some of the highest interest rates in the developed world. In fact, there is over $13 Trillion in debt with negative yields overseas. This means investors pay borrowers to take their money. The most extreme case is Switzerland where yields are negative out to 30 years.

Figure 15. Global interest rates are more likely to be negative than positive

@CharlieBilello	The Negative Bond Yield Matrix												
Country	6-Mo	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	30-Year
Switzerland	-0.75	-0.64	-0.89	-0.91	-0.89	-0.87	-0.79	-0.76	-0.69	-0.63	-0.52	-0.29	-0.01
Germany	-0.58	-0.68	-0.74	-0.76	-0.74	-0.68	-0.64	-0.58	-0.46	-0.40	-0.31	-0.10	0.27
Netherlands	-0.59		-0.72	-0.70	-0.64	-0.61	-0.50	-0.42	-0.32	-0.25	-0.15	-0.01	0.30
Japan	-0.13	-0.17	-0.20	-0.22	-0.23	-0.22	-0.22	-0.22	-0.21	-0.16	-0.12	0.07	0.36
Denmark	-0.66		-0.70	-0.70		-0.68			-0.45		-0.28		
Austria		-0.54	-0.65	-0.63	-0.57	-0.47	-0.39	-0.28	-0.22	-0.14	-0.03	0.31	0.70
Finland			-0.66	-0.63	-0.61	-0.54	-0.45		-0.19		-0.01		0.56
Sweden	-0.40		-0.62			-0.55		-0.26			-0.01	0.18	
France	-0.59	-0.60	-0.68	-0.66	-0.62	-0.53	-0.41	-0.31	-0.21	-0.10	0.02	0.38	1.15
Belgium	-0.57	-0.58	-0.60	-0.66	-0.60	-0.54	-0.42	-0.25	-0.14	-0.06	0.09	0.40	
Slovakia		-0.33				-0.24	-0.50		0.00	0.18	0.26		
Ireland	-0.41	-0.55	-0.45		-0.46	-0.39	-0.24	-0.14	0.45		0.22	0.58	1.16
Slovenia		-0.48	-0.30			-0.31		-0.14			0.25		
Spain	-0.41	-0.39	-0.40	-0.34	-0.27	-0.21	-0.06	0.08	0.20	0.29	0.43	0.80	1.47
Portugal	-0.38	-0.34	-0.37	-0.25	-0.17	-0.14	0.05	0.16	0.28	0.44	0.55	0.95	1.50
Malta	-0.23	-0.20		-0.10		0.02					0.74		
Bulgaria		-0.13		-0.01		0.05		0.37			0.58		
Italy	-0.16	-0.02	0.22	0.71	1.03	1.31	1.53	1.61	1.77	1.82	2.12	2.45	3.17
United States	2.19	2.03	1.81	1.75		1.78		1.89			2.03		2.52

Why are their yields negative? Similar to the US, foreign central banks are trying to stimulate or support their economies by keeping interest rates low. There is a healthy debate on the merits of this approach as it can wreak havoc on banks and other rate sensitive institutions, but it also can make borrowing more affordable and incentivize people to spend their money.

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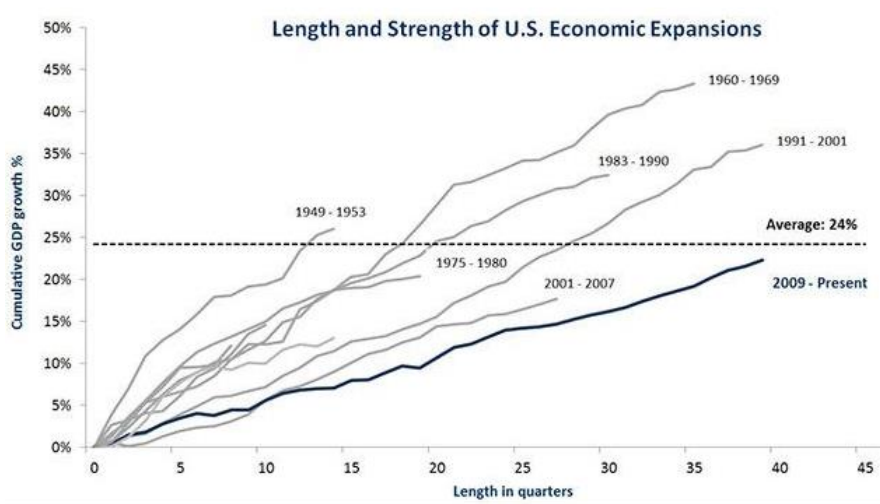
An example of the stimulative benefits of lower interest rates is the cost of a 30-year mortgage loan which has decreased back toward record lows. This is helping drive demand for housing and home improvements, supporting the economy. We have helped several clients refinance their mortgages in the last couple months. Please let us know if that is something you're interested in.

Figure 16. Mortgage rates have decreased, lifting the housing market

Source: @stlouisfed

In summary, we think both the bond and stock markets are right. The bond markets have priced in slower growth and inflation while the stock market has priced in a central bank response to stimulate economic growth. Coming out of the Great Recession, US growth has been "low and slow." Though this month marks the longest economic expansion in US history, it's not quite caught up to average aggregate expansion in terms of magnitude and there is certainly more room to run. When everyone is concerned about a recession and markets are priced accordingly, you tend not to see too many excesses.

Figure 17. The longest bull market has coincided with the longest economic expansion



Source: Alpha Gen Capital

Our Portfolios

Where does that leave our portfolios? The biggest decision we make in constructing our portfolios is whether we are “risk-on” or “risk-off.” We are currently neutral as both stock and bond markets are pricing in the data fairly well. We’re watching for either renewed signs of growth or continued evidence of a slipping economy.

One of two things can happen: 1) Global growth could bottom and turnaround which would cause us to rotate into overseas stocks and give bonds a wide berth, or 2) the global economy could continue to decelerate in which case we would reduce our equity exposure.

We don’t want to move risk-off too soon as rate cuts can help to extend the economic cycle. Most bull markets end in a blaze of glory not a slow burn, so there could be more upside from here.

Figure 16. As there are no signs of an imminent recession, this bull market likely has more room to run

We are taking this recent market run-up as an opportunity to rebalance back to our targets. This will bring portfolios back to their strategic target weights in order to bank some recent gains and maintain a neutral risk exposure.

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Spotlight: Retirement RMD Age Delayed to 72?

The House of Representatives recently passed the “SECURE Act” 417-3 and it’s on the way to the Senate. The most relevant provision for our clients is a possible increase in the required minimum distribution (RMD) age from 70.5 to 72 for retirement accounts. This would make contributing to retirement plans easier and more accessible. On the other hand, there are other provisions that could negatively impact savers. Notably, beneficiaries of an inherited IRA may be required to take distributions over a shorter time period as opposed to their lifetimes, which would negate some of the tax benefits. The Senate version does not have the increase in RMD age, and the bills need to be reconciled before going into law. The SECURE act changes are largely positive, and we’ll be monitoring this as it would create the opportunity for greater tax-free compounding and more opportunities to potentially convert 401K/IRA assets into Roth IRAs at lower tax rates.

Please do not hesitate to contact us with any questions, investment or otherwise.

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