Investment Commentary

HANOVER ADVISORS

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As Momentum Slows, Uncertainty Grows

The current U.S. economic expansion, which began in June 2009, has now hit its 10th anniversary. Now, in the midst of the longest uninterrupted period of economic growth, the question becomes how much longer it can last. The U.S. economy grew by 3.1 percent in the first quarter, much more than most had estimated. The lingering impacts of tax reform and a more accommodative stance from the Federal Reserve have allowed the U.S. to maintain strong economic growth. However, economists expect that GDP growth for the rest of the year will fall below 2 percent. The likelihood of an impending recession is also increasing. We agree with analysts who posit a 40 percent chance of a recession in the next 12 to 18 months.

Two historical indicators of a recession have been seen in recent months. The first is an inversion of the yield curve. This occurs when the yield for long-term debt falls below the yield for short-term debt of the same type, which signals that investors are losing confidence in the long-term potential of the economy. Each of the last four recessions has been preceded by an inverted yield curve. Recessions are also historically preceded by a decline in investments in the housing sector. Housing investment in the U.S. has decreased for the last five consecutive quarters. Economic growth in the coming months will be determined by the decisions of the Federal Reserve. While they have been prudent in backing away from their planned rate increases, they must now decide if they are going to cut rates in an attempt to prolong the expansion. In the 1990s, in an effort to combat sluggish inflation and an inverted yield curve, the Fed implemented a preemptive "insurance cut," which allowed the economic expansion to continue. By implementing a similar cut now, the Fed may allow the U.S. to escape the slowdown seen in much of the rest of the globe.

In the International Monetary Fund's most recent World Economic Outlook, the organization cut its growth estimates for 2019 to 3.3 percent and warned of softening momentum and high uncertainty. A slowdown in China—which may be more severe than many have expected—and continued weakness in Europe make it unlikely that the world will return to synchronous growth anytime soon. Political uncertainty, such as Brexit, our ongoing trade dispute with China, or increased tensions in the Middle East, could complicate an already precarious global economy. In times like these, it is important that you reassess the level of investment risk you are able to tolerate and ensure that your portfolio is protected in a rapidly changing environment.

U.S. Stock Market

The signs of a slowing economy and the ongoing trade war sparked a massive sell-off in May, but the markets have rallied in June, erasing the previous month's losses. The S&P 500 recently

reached a record high. Despite all this, the U.S. stock market remains in a vulnerable position. The market will likely remain healthy in the near future. A rate cut from the Fed could provide a temporary boon, increasing the market by 5 to 6 percent, but beyond the next 6 to 12 months, there are some red flags. Asset valuations remain historically high, meaning that an eventual sell-off could be deeply felt. The U.S. could eventually join the rest of the world in its economic slowdown, leading to a reduction in corporate profits. Increased tariffs could also diminish corporate earnings. Financial data group FactSet is predicting that third-quarter S&P 500 earnings will see a 0.3 percent decline. Earnings for the first quarter saw a 0.3 percent decline, and the second quarter is widely expected to see negative earnings. If this all comes to pass, this will be the first year with three consecutive quarters of negative earnings growth since 2016.

The markets are also waiting with bated breath for the Federal Reserves to act on interest rates. After the central bank signaled that it is open to cuts at its most recent meeting, it is widely expected that we will see a rate cut in the coming months. If the central bank opts not to cut rates, it could have negative ramifications for the markets. However, even if they do cut rates, the impact of those cuts could lag months behind the decision. Though a rate cut could serve as a fleeting boost to the market, it may be too little, too late to spur larger economic growth and prevent a slowdown.

With the markets in such a precarious position, your portfolio needs to be protected. Diversifications is key. We recommend assets that are not highly correlated to the stock market, such as commodities like precious metals or as U.S. Treasuries, which have historically generated higher returns during periods of turmoil in the stock market. This means that as the market declines, the value of these investments increases. A percentage of equities held should also be from stable companies with secure, steady earnings and strong balance sheets. Avoid highly leveraged companies that carry large amounts of debt.

Bonds

As uncertainty grips the stock market, the relative security of the bond market looks more attractive. Again, the decisions that the Fed makes in the coming months will have a significant impact on the bond market. We believe that U.S. Treasuries should serve as the cornerstone of your fixed-income investments. Medium-term bonds, such as 10-year bonds, will continue to generate solid income. More importantly, they can serve as a shock absorber, limiting your losses in the case of an economic slowdown or market sell-off. If the Fed does decide to cut rates, currently issued bonds with their higher rates would also see an increase in value.

The corporate bond market is showing signs of optimism in the near term. Strong demand is helping to ease worries about an impending slowdown. Rate cuts from the Fed could make corporate borrowing more amenable. However, in the long term, there is reason for caution in the corporate bond market. Huge amounts of corporate debt now hold suspect credit ratings and are on the verge of losing their "investment-grade" classification. An economic slowdown or reduction in corporate profits could see much of this debt be downgraded to high-yield or "junk" status. If this were to occur, it could spark a massive sell-off and destabilize the bond market, resulting in big losses. While corporate bonds can be a good method of diversification, we recommend that your portfolio give preference to investment-grade bonds with high credit ratings and only a modest allocation to riskier high-yield bonds.

Municipal Bonds

With recent changes in the tax law putting limits on deductions, investors are looking for additional sources of tax-exempt income. Because of this, muni bonds are becoming an increasingly attractive investment. Municipal bonds have seen record inflows in the first few months of the year. Analytics firm Lipper reports that the asset class has seen inflows of more than $1 billion per week in 15 of the year's first 20 weeks. This means that 2019 has already seen the 3rd highest annual inflow ever.

This high demand is coming at a time when supply is constrained. Summer traditionally sees the highest rate of municipal bond maturities, and $117 billion of bonds are expected to mature between June and August. New issuances will likely not be able to keep pace. With demand outstripping supply, prices will see steady increases, but it may also force investors into riskier investments. High-yield, or "junk," municipal bonds have seen an inflow of $8 billion in the first five months of the year. This is the highest inflow since 1992, according to data from Refinitiv.

Investment-grade municipal bonds with a high credit rating can be a strong asset for your portfolio. They can offer secure, reliable income at a time when U.S. Treasury bonds have low yields. Tax-exempt municipal bonds, which traditionally have lower yields, can be a good way to generate income without increasing your tax bill. Even taxable municipal bonds, which do not offer the same tax benefits, can be a good way to diversify your portfolio. Taxable municipal bonds generally have a low risk of default, low correlation to the rest of the market and offer strong returns. Over the last 10 years, taxable municipal bonds saw annualized returns of 6.9 percent, well above the 4.6 percent returns for investment-grade corporate bonds over the same period.

Commodities

In times of market uncertainty, commodities can be a good way to diversify your portfolio. They are not highly correlated to the stock market, and some commodities even have a negative correlation. This means that including commodities in your portfolio can protect or even bolster its value when the market shifts. However, by their nature, commodities tend to be more speculative and any investment in them should be well researched and cautiously approached. The high relative value of the U.S. dollar is putting downward pressure on several commodities, as it makes exports less attractive to foreign buyers. Trade tensions have also made international trade of several commodities less profitable. The slowdown in China has also reduced consumption and lessened demand for many agricultural commodities.

Our preferred commodity is gold, which has seen big price increases in recent weeks. Changes in international banking rules have spurred demand from central banks around the world, driving prices higher. Gold is also a good way to protect your portfolio from inflation. Though inflation has been tame in recent years, rate cuts from the Fed could spark inflation in the future.

International Markets

While investing in international markets is a potentially inexpensive way to diversify your portfolio, the rest of the world continues to underperform compared to the U.S. The IMF recently lowered its global growth forecast for 2019 to 3.3 percent. This is the third time in six months that the forecast has been revised down, and the lowest growth estimate since the financial crisis. The IMF expects a decline in growth for 70 percent of the world's economies.

China's economy, already slowing is expected to slow further. The Chinese central bank will likely try to implement fiscal stimulus policies. However, increased financial regulations and the ongoing trade war with the U.S. are expected to stifle growth, which could have a negative impact on the larger Asian region and global commodity prices. Japan will see an increased consumption tax this fall, and economists are unsure of how it will impact the economy. Europe continues to see widespread slowdown, particularly in Germany, the Eurozone's manufacturing center. Soft domestic demand and environmental regulations have caused Germany's industrial production to contract recently. The looming threat of American tariffs on the German auto industry make the Eurozone more precarious. The European Central Bank has signaled that it is willing to inject a financial stimulus to combat the slowdown, but much of the region already have zero or negative interest rates, so the options for the bank are limited.

Hanover Advisor Bulletins

Special Reminders to all Hanover Clients

- The Hanover Advisors website can be accessed at hanoveradvisorsinc.com. There you will find our latest newsletter and investment commentary, articles, our blog, and videos. You can also learn more about our services, access both the Black Diamond performance reporting system and your Pershing brokerage account(s).

- **New enhancements to our portfolio reporting system**. All Hanover clients have free access to our internet-based reporting system known as Black Diamond. This robust system provides comprehensive performance reporting, asset allocation and risk assessment on clients' portfolios. The system will have a new look and major enhancements starting this fall. Our office is available to assist in accessing and utilizing the Black Diamond system.

- As a reminder to our clients that Hanover Advisors, Inc. now has an office in Greenville, SC. Meetings can be scheduled at either the Greenville office or our conference facilities at Concourse Parkway in Atlanta. Please see our website, HanoverAdvisorsInc.com, for detailed contact information.

- We want to invite all clients to contact our office to schedule a portfolio review. We would be happy to coordinate a sit down meeting, a conference call, or an online meeting at your convenience. Please call our office to schedule an appointment.