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"*We've always had economic cycles and I believe we always will.*" – Howard Marks

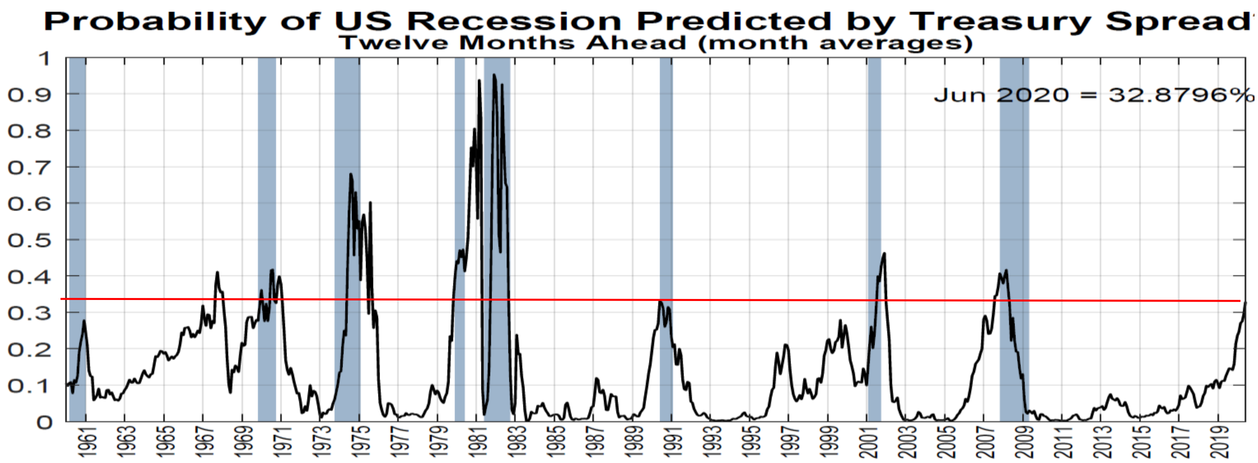
U.S. equity markets once again proved resilient in the second quarter, as a May selloff was quickly followed by one of the best June's on record. The S&P 500 ended the quarter at new highs and with total returns of 10% over the trailing 12-month period. These returns were achieved despite a 20% correction in the fourth quarter of last year and a 7% drawdown in May. Not surprisingly, recent volatility has been highly correlated to trade war news. Similarly, recent rallies have been highly correlated to the Federal Reserve and investor expectations for easy monetary policy going forward.

Trade tensions with China and other key U.S. trading partners continue to ebb and flow. After U.S.-China talks stalled out in early May, the much anticipated meeting between President Trump and Chinese President Xi at the end of June was successful in getting both countries back to the negotiating table. For its part, the U.S. agreed to hold off on new tariffs on $300B of Chinese imports, while China agreed to buy more U.S. agricultural products. These concessions buy both sides time, but still leave major terms unresolved and uncertain. If talks again break down and new tariffs are imposed, most economists estimate a direct impact of half a percentage point to U.S. economic growth. Such an impact would be significant to baseline growth expectations of 2%, but not yet be recessionary. The likely knock-on effects of reduced business and consumer sentiment, higher prices for consumer goods, lower wages for workers, lower corporate earnings, and global supply chain disruptions could have an even greater impact. If these events play out, it would be very unlikely to avoid a recession or a significant sell off in equity markets. Trade talks remain perhaps the biggest driver of near term market performance and are something we continue to follow closely.

If trade has been the primary driver of markets, the actions of the Federal Reserve have been a close second. After adopting a decidedly more dovish tone late last year, the Fed has so far left interest rates unchanged. At its June meeting the Committee noted a strong labor market, but inflation trending below target. Citing heightened economic uncertainties, they left the door open to possible rate cuts, saying the Committee would "act as appropriate to sustain the expansion." The futures market is currently pricing in a 94% chance of a rate cut at the Fed's next meeting (7/31), with at least one additional cut expected by year-end. While lower rates would likely be cheered by investors in the short term, they reflect lower confidence in the outlook over the medium term. Rate cuts may allow the current expansion to achieve greater duration, but are not a cure for low growth and low inflation. This is especially true given the already low absolute level of rates that limits the marginal benefit of future cuts. An extended period of low rates can create its own set of hazards as well. Low borrowing costs can encourage greater levels of debt financing by the Federal government, corporations, and consumers. Lower quality borrowers can later become vulnerable to default when rates rise or the economy enters a recession. Both Federal debt levels and corporate debt levels have continued to climb relative to GDP since the current expansion began. These are two areas that pose risks to the economy going forward, especially under a recession scenario.

Where do the odds of a recession currently lie? There is no crystal ball to answer that question, but several well-known models make attempts. One such model from the New York Fed uses the Treasury yield curve to predict recession risk. In this model, the difference between the 10-year and 3-month Treasury rates is used to calculate the probability of a recession 12 months ahead. In a normal economic environment this spread is positive, as investors are paid more for taking on the risks associated with the 10-year holding period. In the Fed model, the more positive the spread, the lower the probability of a recession, and vice-versa. When the spread turns negative, meaning the 10-year rate is below the 3-month rate, recession risk begins to escalate.

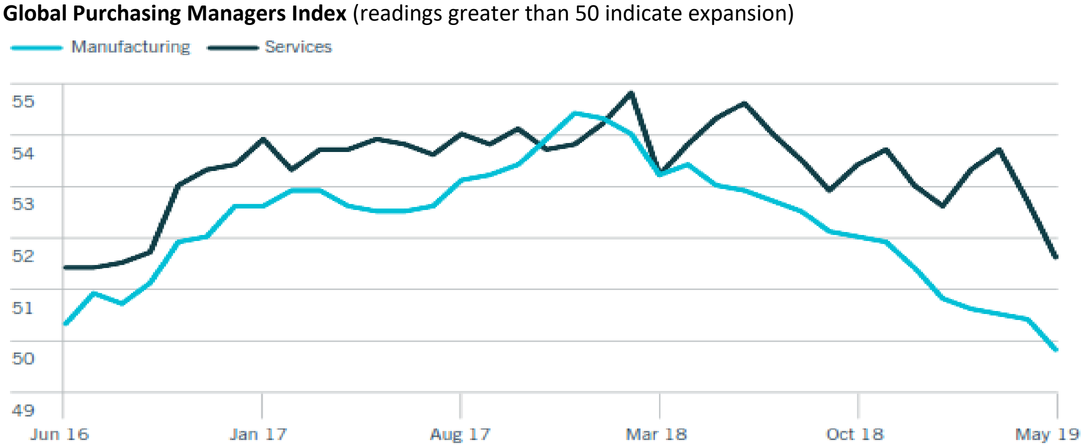
The 10-year to 3-month spread has now been negative since May 23rd. Based on this inversion, the Fed model currently shows an almost 33% chance for a U.S. recession one year from now (see chart below). This is a level that has previously been meaningful from a probability standpoint. An inverted yield curve has historically been one of the most reliable indicators of the timing of recessions.



Source: New York Federal Reserve July 2019. Black line indicates probability of recession 12 months ahead based on the spread between the 10-year Treasury and 3-month Treasury rates. Blue vertical bars indicate past recession periods. Model does not predict recession severity.

Other key economic data points have been mixed, but generally show a trend of slowing growth, if not outright contraction. The widely followed Global Purchasing Managers Index (PMI) has been decelerating for the last several months and recently fell below the 50 mark for manufacturers. PMI readings above 50 signal expansionary activity in the manufacturing and services sector, while readings below 50 signal contraction. Manufacturing PMI readings provide particular insight into the strength of the manufacturing sector, which tends to be highly correlated with economic growth and the business cycle. Of the 30 nations for which a June Manufacturing PMI reading was available, 60% signaled contraction. China, Japan, Germany, the UK, Taiwan, South Korea, Italy, and Russia were among the key nations experiencing manufacturing contraction in June. Conversely, the U.S., India, Brazil, and Australia were among the major countries with PMI numbers still above 50. The U.S. Manufacturing PMI has slowed to 50.6, one of the weakest levels since 2009. Among the key components, declining growth in new orders reflects weakening demand conditions. Survey respondents have cited trade tensions and tariffs as the key factors in the decline. PMI readings for the Services sector remain positive but with a weakening trend.

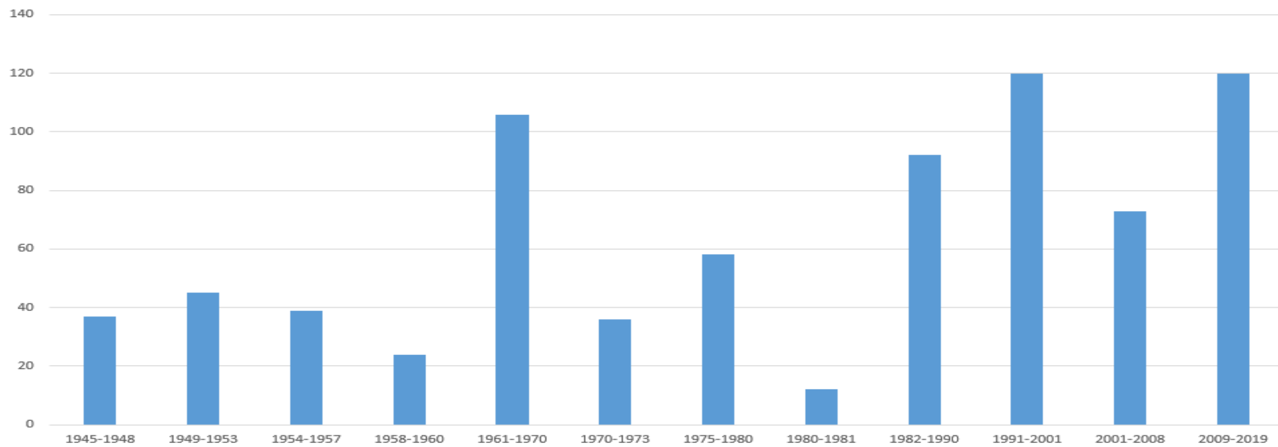
Global Purchasing Managers Index (readings greater than 50 indicate expansion)



Source: IHS Markit, July 2019

The current U.S. economic expansion is now tied with the 1991-2001 tech era for the longest growth period in post-war history (120 months). By the end of July, it will be the longest modern cycle on record, a milestone most economists expect it to reach.

Length of U.S. Economic Expansions: 1945-Present



Source: Factset, June 2019; Y-axis data is in months.

Can the expansion continue, is this time different? As is often said, expansions do not die of old age. Rather, they typically require some sort of extreme condition or exogenous shock to meet their demise. The current expansion has been characterized by growth that is below average compared to previous cycles. This fact generally means that fewer excesses have been created this time around: stock market valuations remain reasonable, consumer debt levels have improved, and inflation is muted, among other factors. Combining these conditions with a highly accommodative Fed and a strong jobs market could reasonably allow the current cycle to extend over the near-to-medium term.

Despite this potential, we remain cognizant of increasingly weaker economic data and the objective message that data sends. Likewise, we are aware that as the cycle ages, there is diminished capacity for demand and employment growth, as well as greater hurdles for profit margin expansion. In this environment, we continue to favor stocks over bonds based on relative value, but remain focused on higher quality and lower volatility investments across a diversified and balanced portfolio of assets. We do not know when or how the current cycle will end, but we do know that this time will likely not be different.

The Private Capital Management Team

By the numbers…

Index	YTD
S&P 500	18.54%
Dow Jones Industrial Average	15.28%
Russell 2000	16.98%
MSCI EAFE	14.03%
MSCI Emerging Markets	10.58%
Barclay's US Aggregate Bond	6.11%
Bloomberg Commodity	5.06%

Source: Morningstar as of 6/30/2019