J.W. Burns & Company

Investment Counsel

Quarterly Update - July 2019

A Torrid Pace But This Bull Can Still Run

"The investor's chief problem - even his worst enemy - is likely to be himself." - Benjamin Graham

Dear Clients and Friends,

At the midway point of 2019, stocks are enjoying a fine year, with the S&P 500 Index up 18.54%, small and mid-cap stocks both up between 13-17%, and international stocks, as measured by the MSCI All World ex-USA Index, up 13.39%. Overall, bonds have also done well, with the Barclays Aggregate Bond Index up 6.11% through June 30.

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We remain constructive on stocks as we move into the second half of this year, acknowledging, however, that any equity market gains will probably be more muted than 2019's torrid first half.

We are very pleased with the performance of both your equity and, where appropriate, fixed income positions. As you know, we review all client performance results twice a month, and we combine this work with relentless research and analysis of not only your current equity holdings but potential new opportunities as well. I can say with confidence that the overall quality, structure, and growth profile of your portfolio is healthy and robust, and I foresee only slight changes as we head into the back half of 2019. Rest assured, however, we remain vigilant and focused on achieving an above-average return with below-average risk for you, our valued clients. Simply put, we constantly strive to improve the risk/reward profile of your portfolio on a daily basis.

A quick summary of the second quarter – stocks got off to a great start in April when positive trade headlines bolstered investor confidence in an imminent trade deal with China, and the broad market gained 3.93%. However, volatility returned in the month of May when trade talks appeared to break down and threats of new tariffs emerged. That, combined with rising geopolitical tensions with Iran, sent stocks down 6.58% for the month before rallying to post their best June in decades, up over 7% on the expectation of a Federal Reserve rate cut(s) later this year. For the quarter, stocks, as measured by the S&P 500 Index, were up a very healthy 4.30%.

The bookended pattern that the second quarter took proves that market volatility – and market rallies – can (and do) emerge at any time, and ***the best way for investors to be prepared for these swings is to be invested in a carefully constructed portfolio of high-quality growth stocks.*** This is exactly how your money with J.W. Burns & Company is managed.

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As I write this in early July, stocks have continued their strong upward momentum. 2019 marks the 11th year of this bull market, the longest on record, but bull markets do not die of old age. They die when they finish climbing the wall of worry and euphoric investors ignore weaknesses or when some major unseen event knocks trillions off global GDP.[1] From our vantage point at J.W. Burns & Company, there is little sign of investor euphoria that usually accompanies market tops, and economic growth remains positive.

Trade Tensions

Certainly, trade tensions between the United States and China are a lurking danger for this bull market. However, thus far, the global economy has been able to withstand both the uncertainty and subsequent supply chain disruption the tariffs have caused.

Our best guess is that some deal between the two economic superpowers will get done, maybe before the end of the year, as both nations have a real incentive to keep their economies healthy. Even a modest trade deal that results in the reduction of tariffs would improve business confidence, capital spending, and would result in a pickup of GDP growth heading into 2020.[2] ***Regardless of if – and when – any new trade agreement happens, the battle for global technology dominance is likely to continue for years, if not decades.*** In the meantime, we caution our clients to be prepared for headline risks and broad stock market gyrations around current trade negotiations.

The Economy

Currently, the basic fundamentals of the United States economy are healthy. Inflation remains below estimates, unemployment and weekly jobless claims remain at a 50-year low, and consumer confidence is at a 15-year high. Wage growth has posted seven straight months of above 3%, which well outpaces inflation. Finally, United States GDP will likely slow to a modest ***but reasonable*** 2-2.2% growth rate to round out 2019.

While the basic economic fundamentals in the United States are holding up well, around the world there are incipient signs of a material economic slowdown that could negatively affect the U.S. This month China reported economic growth that was the slowest in over 25 years, which was surely exacerbated by the impact of tariffs. Additionally, growth in the European Union is expected to slow to just 1.1%, a significant cut from what was initially expected. Nevertheless, on the whole, we currently believe the economy has enough momentum to support stocks as we head into the second half of the year.

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Earnings

First quarter S&P 500 earnings were projected to be lower by 4-5% but ended up being essentially flat.[3] This quarter, estimates are for S&P 500 earnings to be lower by about 3% – and again, I believe these estimates are too low. Despite the flattish earnings growth in Q1 and Q2, markets are rising in part because investors expect a healthy earnings bounce in the second half of the year.

Most importantly, our focus is on the earnings results of your portfolio companies. We track the results intensely, assessing competitive market forces, profit margins, earnings and revenue results vs. expectations, and management's forward outlook. Specifically, we look for signs of acceleration – or deceleration – in their fundamentals and consider which companies to add to our green list (possible stocks to buy or increase positions in) or to add to our red list (possible sells).

Interest Rates

The real story of 2019's market recovery has been the 180-degree shift in the Federal Reserve's direction on interest rates. Incredibly, just eight months ago in November, the 10-year treasury was around 3.2%. The Fed was also signaling possibly three rate hikes in 2019. Now, the 10-year treasury yields 2.09%, and the markets are expecting three rate cuts over the next year! This just reiterates the need to stay focused on your investment plan, not on economic forecasts.

The fact that investors are heartily cheering the Fed's more accommodative stance is understandable as credit and liquidity availability will remain ample. Keep in mind, however, if the underlying fundamentals of the economy start to deteriorate, future rate cuts could be viewed simply as a mechanism to forestall an economic downturn which could be viewed negatively by investors.

Bottom line, stocks have challenges to navigate during the second half of 2019, but the fundamental backdrop on which they rest remains intact. We believe this bull market has legs to run.

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Now let's get to some of your questions.

Q: What exactly is an inverted yield curve, and what does it mean for stocks and the economy?

A: An inverted yield curve occurs when shorter term Treasury bonds yield more than longer term Treasury bonds. At the time of this writing, the three-month Treasury note yields more than the ten-year note. This indicates that investors were buying more ten-year notes seeking to lock in a higher rate before a possible economic downturn. Historically, an inverted yield curve has been a recession indicator and, accordingly, raises significant concern among analysts and economists.

That being said, the yield curve generally needs to stay inverted for a quarter or more to have any sort of economic predictive power. So while the yield curve here in the United States is inverted at the time of this writing, it has only been so for several weeks.[2] Furthermore, a Fed rate cut, which looks more and more likely, could eliminate the inverted yield curve altogether.

It is worth noting that in the 21st century, the world of finance is no longer solely centered on New York City, Chicago, and Los Angeles – it is in fact global. Therefore, it is a mistake to focus only on America's inverted yield curve while overlooking the rest of the world. The global yield curve, which is made up of interest rate data from 32 countries, is currently still positive, rebutting the traditional view that an inverted U.S. yield curve signals a global recession.[1]

Q: I see that healthcare stocks continue to lag in 2019. Is there more pain ahead with the 2020 election around the corner?

A: Many major healthcare stocks are flat to negative for the year, as the industry has come under significant political scrutiny. Currently, healthcare companies face bipartisan pressure over prescription drug prices, the opioid crisis, and access to affordable care. Additionally, many of the Democratic presidential nominees are proposing major overhauls of the healthcare industry, including a single payer, Medicare for all system.

So, it is clear that healthcare will be a driving political issue in the upcoming 2020 election, and the increased scrutiny for the industry will likely remain for some time.

However, the politics and negative headlines aside, I remain confident in the long-term investment thesis of your healthcare companies. These best in breed businesses will continue to deliver powerful medical innovations and life-saving treatments. Furthermore, while this sector is unpopular now, healthcare was the best performing sector of 2018 – and has been one of the top-performing sectors since the market low in 2009. So, while there is a short-term shadow over the industry, we believe your core healthcare holdings, namely, the medical device and pharmaceutical companies, remain a "vital" area to be invested in for serious long-term investors.

To sum up – the U.S. economy remains healthy, valuations are still reasonable, but there are signs of economic weakness overseas. Your portfolio is carefully constructed and positioned for growth. The market indeed had a torrid first half of 2019, but we believe this bull has room to run.

We will be watching him closely.

Thank you for your continued confidence, and have a wonderful summer!

James C. Burns, CFA

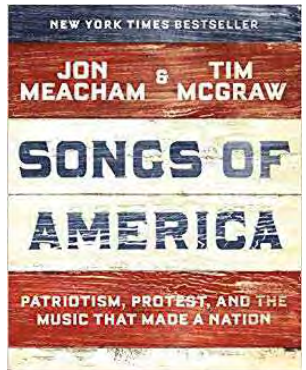
Jim

President

P.S. These books might enhance your summer…

Last quarter I shared a brief highlight on long-time Senior Portfolio Manager Peter Bunitsky. Since then, Peter has taken off to Alaska for the summer, but I still require a full day's work from him! He even has learned to answer emails and fish for salmon at the same time, believe it or not. LOL. While another employee highlight is coming later this fall, I wanted to pass along two fine summer reading recommendations I thought many of you might enjoy.

Red Notice: A True Story of High Finance, Murder, and One Man's Fight for Justice by Bill Browder is an autobiographical political thriller about an American hedge-fund manager who finds himself mixed up in "the Wild West of Russia." The book details Browder's harrowing run-ins with the Russian government, including a murderous cover up going all the way up to Vladimir Putin himself. Fast-paced and well-crafted, this book is a fascinating page turner, and its details of the Russian government's corruption and brutality will make your stomach turn. You can find the book on Amazon for around $13.



While I haven't read it yet, I just picked up *Songs of America: Patriotism, Protest and the Music that Made a Nation*, written by respected historian, Jon Meacham, and country music star, Tim McGraw. From the Revolutionary War to the turbulent 1960's and beyond, the book highlights the music and songs that shaped this great country. It is #10 on the New York Times Best Seller List and has been getting rave reviews.

1 Fisher Investments, Stock Market Outlook, 2019: Part II

2 The Haverford Trust Company, 2019 Summer Outlook

3 LPL Research, Weekly Market Commentary, May 2019