CHARTWELL REVIEW

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Trading up

Summer is here and temperatures are getting uncomfortable in many corners. June was one of those months you can summarize in two words: *everything up*! Most assets -- from risky equities and bonds, to safe-haven assets such as gold and Treasuries -- rallied sharply, reflecting market dynamics that are typical of an environment in which global central banks show their big guns. The Fed is likely to cut rates at its next Federal Open Market Committee (FOMC) meeting, despite a benign G20 outcome and recent strong employment numbers. The ECB has also opened the door for cutting rates further into negative territory and restarting QE – having ended the program only a few months ago. There is now close to $12 trillion of global debt with negative yields! Some European "high yield" bonds trade at yields-to-maturity below 0%.

The re-emergence of the central bank safety net, which appeared to be in withdrawal mode for most of 2018, is a clear positive for global risk assets. We view global growth conditions as weak, and inflationary pressures absent, thereby validating the dovish stance of central banks. We do not view global macro conditions to be at the cusp of a recession, *yet*. Global trade developments could decidedly change all that.

The rally in global risk assets has been sharp over the past quarter, as Figure 1 reflects. Sentiment has improved, and expectations of the Fed are high. Markets are heating up, and there are a few areas of bubble signs. The two most notable ones are near record high valuations of US large-cap growth stocks, and very low credit spreads for high-yield bonds, both here and in Europe. We would not be surprised to see pullbacks of risk assets. Will these be buying opportunities given the return of easing bias amongst core central banks?

All in all, systems are "go" for a pedestrian return from markets through the rest of 2019, with high volatility. May and June risk asset returns offset one another, as did 4Q18 and 1Q19. The S&P500 index returned 19% during the first half of 2019, but just 8.2% (before dividends) over the past year. This, despite sharp declines in long-term interest rates and bond yields, because earnings growth has flatlined.

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	2Q 19	1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	4.3	10.4	14.2	10.7	14.7
U.S. Top-cap Stocks	4.3	10.9	14.9	11.2	14.6
U.S. Mid-cap Stocks	4.1	7.8	12.2	8.6	15.2
U.S. Small-cap Stocks	2.1	(3.3)	12.3	7.1	13.5
Non-US Stocks (**EAFE**)	3.7	1.1	9.1	2.3	6.9
Non-US Stocks (**Emerg**)	0.6	1.2	10.7	2.5	5.8
3 mo. T-Bills	0.6	2.3	1.4	0.8	0.5
U.S. Aggregate Bonds	3.1	7.9	2.3	3.0	3.9
High Yield Bonds	2.6	7.6	7.5	4.7	9.2
Global Aggregate Bonds	3.3	5.9	1.6	1.2	2.9
Consumer Prices, p.a.	*3.0*	*1.7*	*2.1*	*1.5*	*1.7*
Blmbrg Commodities	(1.2)	(6.8)	(2.2)	(9.2)	(3.7)
MSCI World REITS	2.2	13.6	4.9	6.8	12.7
Chartwell 65/35 Global	2.9	5.9	9.0	5.7	9.1

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	2Q 19	1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	3.9	8.3	12.8	9.0	13.5
U.S. Mid-cap	3.2	2.4	10.4	6.4	13.2
U.S. Small-cap	2.3	(3.9)	10.9	6.1	13.0
International Lg. Cap	3.4	0.0	8.6	2.5	7.1
International Sm. Cap	2.8	(5.7)	8.7	4.0	10.5
Emerg. Mkt. Equity	2.0	1.9	9.2	2.3	6.2
Balanced/Hybrid	3.1	6.4	7.6	5.1	8.6
General Bond	4.2	9.5	3.3	3.6	5.9
High Yield Bond	2.3	6.3	6.4	3.7	8.0
Hedge Funds, Equity	1.7	0.5	6.8	3.5	5.4

*Annualized trailing returns for periods ending 6/30/19.

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Economies, Economics, Prices, and Policy

	6.30.19	6.30.18
CPI - headline, y-o-y	1.7%	2.9%
CPI - core, y-o-y	2.1%	2.3%
Unemployment Rate	3.7%	4.0%
Labor Force (millions)	163.0	162.1
Employed (millions)	157.0	155.6
Employment/Population	60.6%	60.4%
Growth in Real GDP, (y-o-y)	3.2%	2.6%

Core inflation rose slightly less during the last twelve months than the prior period, while declining average energy and food prices pushed headline inflation to well below 2%. These numbers mask the fact that inflation "popped" in the first and second quarters, rising at annualized rates of 3-4%. The unemployment rate fell during the past twelve months because 1.4 million more people were employed; the labor force also grew, as did the participation rate and the employment-population ratio.

Figure 3: Breaking Down 1st Quarter* Real GDP

% Change from Preceding Period				
Factor	**1Q '19**	**4Q '18**	**3Q '18**	**2Q '18**
Real GDP Growth	3.1%	2.2%	3.4%	4.2%
Nominal GDP Growth	3.8	4.1	4.9	7.6
Real Final Sales	1.6	2.1	2.9	4.0
Personal Spending	0.9	2.5	3.5	3.8
Private Investment	6.0	3.7	15.2	(0.5)
- Fixed, Businesses	4.4	5.4	2.5	8.7
- Fixed, Residential	(2.0)	(4.7)	(3.6)	(1.3)
*- Chg. In Inventories (**$bn**)*	*$123*	*$97*	*$90*	*($37)*
Export growth	5.4	1.8	(4.9)	9.3
Import growth	(1.9)	2.0	9.3	(0.6)
Government Spending	2.8	(0.4)	2.6	2.5

** BEA final estimate on 6.28.19*

The 3.1% annualized increase in real GDP during Q1 was paced by a notable and unexpected increase in the growth of net exports, as goods exports rose and imports declined. Business fixed investment increased moderately, and inventories jumped sharply once again (not a surprise, given continued weakness in personal spending). Overall government spending rose, especially State and local (+4.6%). Federal non-defense spending dropped 5.8%.

Consensus forecasts of 2nd quarter GDP, with the first official estimate coming at the end of July, remain modestly positive. The Atlanta Fed's GDPNow forecast has recently increased to 1.6% growth for the quarter, up from 1.3% in early April. The *Blue Chip* consensus estimate of 1.8%.

Businesses continued to hire during the second quarter, at nearly the same pace as the first. Payroll jobs rose by 512k. Labor productivity increased at a seasonally adjusted annual rate of 3.4% in the first quarter of 2019, leading to a 1.6% decline in unit labor costs. Despite this productivity bump, and very low unemployment rates, real weekly wages have risen only 1.2% during the past twelve months.

Inflation rates in Q2 rose compared to Q1, but at a less elevated rate than the prior period.

- ⇒ **"Headline" CPI** rose 0.8%, or an annualized rate of 3.1%. Despite the jump, it has increased only 1.7% year-over-year;
- ⇒ **"Core" CPI** (*ex-food & energy*) rose 2.1% annualized during the quarter, and the same for the past year.
- ⇒ The headline **Producer Price Index** for final goods and services rose only 1.7% for the 12 months ended in June, the lowest rate of increase since advancing 1.7% in January 2017. It was brought down by weak energy prices in May/June. Core PPI (before food, energy, and trade) has increased by 2.1% year/year.

On the monetary policy front, the Fed again did not raise the target Fed Funds rate during the quarter; it remains in the 2.25-2.50% range. But, not for long according to futures market pricing. Fed official's dovish commentary in June/July have led the markets to price in a nearly 100% chance that the Funds rate will be cut by 25bps at the end of July. This is consistent with Fed statements earlier in the year. A few very hopeful strategists are projecting a 50bps rate drop in July, which is unlikely.

With the economy growing at an annual rate just over 3%, and employment growth averaging in the 170,000/month range, some are questioning why the Funds rate needs to be cut at this point. The action has been described as an "insurance cut", justified by the continued low inflation rates over the past year and a rather pervasive opinion that GDP growth will stall for the rest of the year and into 2020, especially as a result of reduced business spending.

On the fiscal front, deficit spending in the current year (ending September) is 27% higher than it was one year ago at this time. The deficit will total over $1 trillion for the fiscal year. With this week's agreement to raise the debt ceiling and boost next year's federal spending by $320bn, there is very little likelihood that next year's deficit will not also exceed $1 trillion.

Existing-home sales dropped -1.7% in June, to a seasonally adjusted annual rate of 5.27mm units, which was above the 5.21mm unit pace we saw in March. The current rate is 2.2% lower than one year ago. New housing starts rose to an annualized rate of 1.25mm, up from only 1.14mm in March and 6.8% higher than one year ago.

Total industrial production (IP) slipped in Q2 at an annualized rate of -1.2%. However, total industrial production was 1.3% higher in June than a year earlier.

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Bonds Trade Up

In a nearly complete repeat of the 1st quarter, interest rates in the US and most rich-world countries declined dramatically in Q2. Slowing global economic growth rates have spurred global deflation concerns, which have in turn significantly aided fixed-income returns. The 10-year US treasury rate declined by 40bps during the quarter, to only 2.00%. The 2-year T-bill dropped even more, to a yield of just 1.74%. The 10-year's yield has dropped by 85ps in a year. Yet, it still trades at a significant yield premium to virtually all other developed markets' bonds except Italy.

As noted, the Federal Reserve has put itself into rate cut mode, less than six months after putting itself on hold. The combination of continued job gains, rising consumer spending, improved manufacturing output, the recent détente on trade between the US and China, and a strong stock market has made it hard to recall what the Fed's fuss was about. Yet, there is still the potential for trade developments damaging the local economy. Second, inflation continues to run below the Fed's 2% target. The economy could use more stimulating to get prices running hotter. Finally, market demand for long-term bonds has inverted the heart of the yield curve (10yr-3mo), with this spread dropping just over 1% in the past year (Figure 5).

The Fed's dovish signaling set the stage for price appreciation across all segments of the bond market, leading to every major sector returning more than its coupon. Longer duration bonds did best, with long Treasuries and long investment grade corporate bonds returning 6% and 7.2%, respectively.

The broad market Aggregate Bond index returned 3.1%, led up by the credit sector (+4.3%), especially BBB-rated bonds (+4.8%). The much shorter duration mortgage-backed and asset-backed sectors returned only 2.0% and 1.7%, respectively, during the quarter. The Treasury index slotted in the middle, up 3.0% in Q2.

Globally, the US$ again weakened versus the euro, yen and a number of emerging market currencies. As a result, *unhedged* local currency non-US bonds outpaced their hedged peers for the quarter in both developed and emerging markets, as well as outperforming broad US market returns.

All bond sectors began the year and quarter trading above par, and ended June trading even higher. This has generated robust year-to-date returns, with many sectors up 10-15% for the year-to-date, including high yield, US$ emerging markets, and virtually all long duration US sectors (long financial sectors bonds have returned 17%!). But, there is no free lunch in the bond markets, and this year's furious rally has come at the expense of current yields, as Figure 5 reflects. Even the highest yielding bond sectors, US junk bonds and emerging markets securities, trade at yields of 6% or less. The investment-grade Barclays Aggregate index yields just 2.5%.

Figure 4: Primary Bond Sector Returns (%)

Index	2Q '19	1 Yr	3 Yrs	5 Yrs
US Aggregate Bond index	3.1	7.9	2.3	3.0
US Gov't/Credit: (1-3yrs)	1.5	4.3	1.6	1.5
US Treasury: Long	6.0	12.3	1.3	5.7
US TIPS (1-10yrs)	2.5	4.7	1.9	1.4
Mortgage-Backed (MBS)	2.0	6.2	2.1	2.6
Commercial MBS	3.3	9.0	2.9	3.4
Asset-Backed (ABS)	1.7	5.0	2.0	2.1
Inv. Grade US Credit	4.3	10.3	3.7	3.9
Leveraged Loans	1.7	4.4	5.1	4.2
US High Yield Credit	2.6	7.6	7.5	4.7
Municipal Bonds, broad	2.1	6.7	2.6	3.6
Global Agg., ($ hdgd)	2.9	7.8	3.0	3.8
Global Credit, ($ hdgd)	3.6	9.3	4.7	4.4
Emerg. Mkts Bonds (US$)	4.1	12.5	5.5	5.3

Figure 5: Fixed Income Yields – 2nd Quarter 2019

(YTM, % p.a.)	Jun-19	Mar-19	Dec-18	Jun-18	*1-Year Change*
US Treasuries					
3-month	2.12	2.40	2.45	1.92	***0.20***
2-year	1.74	2.29	2.50	2.53	***(0.79)***
5-year	1.76	2.23	2.51	2.73	***(0.97)***
10-year	2.00	2.41	2.69	2.85	***(0.85)***
30-year	2.53	2.82	3.02	2.98	***(0.45)***
BarCap Aggregate	2.49	2.94	3.28	3.29	***(0.80)***
BBB Credit	3.53	4.03	4.65	4.38	***(0.85)***
AA Credit	2.54	2.99	3.37	3.35	***(0.81)***
Agency MBS	2.70	3.08	3.39	3.41	***(0.71)***
Emerging Mkts ($)	5.54	5.31	5.95	6.52	***(0.98)***
US High Yield	6.06	6.48	7.95	6.53	***(0.47)***
UST 10yr - 3Mo	(0.12)	0.01	0.24	0.93	***(1.05)***

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	Jun-19	Mar-19	Dec-18	Jun-18	*1-Year Change*
Switzerland	(0.50)	(0.40)	(0.15)	0.00	***(0.50)***
Japan	(0.20)	(0.10)	0.02	0.01	***(0.21)***
Germany	(0.30)	(0.10)	0.16	0.32	***(0.62)***
Britain	0.90	1.00	1.34	1.41	***(0.51)***
Spain	0.30	1.00	1.41	1.29	***(0.99)***
Australia	1.30	1.80	2.29	2.64	***(1.34)***
United States	2.00	2.41	2.69	2.85	***(0.85)***
Italy	2.10	2.50	2.70	2.83	***(0.73)***
Poland	2.40	3.00	2.75	3.23	***(0.83)***
China (5 year)	3.10	3.00	2.97	3.44	***(0.34)***
Greece (new bonds)	2.50	3.80	4.40	4.05	***(1.55)***
Brazil	6.00	7.30	7.22	9.50	***(3.50)***
India	6.90	7.30	7.35	7.87	***(0.97)***
Russia	7.50	8.30	8.81	8.13	***(0.63)***

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US Stocks Trade up (again)

US Equity markets continued to march higher in the second quarter, resulting in the best first half of a calendar year since 1997. Getting there wasn't without some drama. A strong April was followed by a risk-off May amid concern around heightening trade wars. New highs in June were fueled by expectations of a dovish Fed and a temporary (?) trade war truce. The S&P 500 index posted a 4.3% gain during the quarter, and had risen 25% from its December 24th trough of 2351. It has kept rising in July, briefly hitting a new record of 3024. The NASDAQ Composite (a tech stock proxy), which had entered bear market mode in late December, bounced 3.6% in the quarter. That index is up over 30% from its December low.

Figure 7: U.S. Equity Market - Size/Style Returns

		Trailing			
	2Q '19	1-year	3-yrs	5-yrs	10-yrs
Growth					
Large Cap	4.4	10.8	18.6	14.3	16.4
Mid Cap	5.4	13.9	16.5	11.1	16.0
Small Cap	2.8	(0.5)	14.7	8.6	14.4
Value					
Large Cap	4.2	10.9	10.8	7.8	12.7
Mid Cap	3.2	3.7	9.0	6.7	14.6
Small Cap	1.4	(6.2)	9.8	5.4	12.4

In terms of the size premium, it wasn't evident for the quarter. Quite the contrary, in fact. Small-cap stocks substantially underperformed large- and mid-cap stocks, whether Growth or Value style. Of this, the small-cap shortfall was greater in Value. This has persisted during the past twelve months, with the small-value sector underperforming large-value by 17%. Small-growth stocks have lagged large-growth by 11% during that time. The one-year skew toward large/mid-caps has been so great that it has completely reversed the trailing 3-, 5-, and 10-year performance comparisons.

This performance pattern is surprising on two levels –

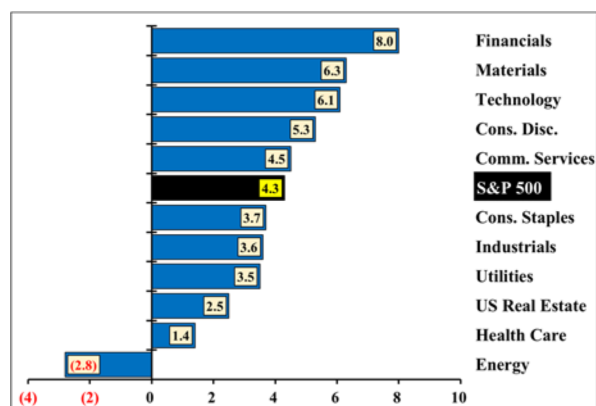
- Small cap stocks generate around 80% of revenues within the US, compared with 50% for S&P 500 companies. Given this domestic focus, they should be doing better in general as US growth has been favorable;
- Smaller companies tend to rely on borrowing, which makes them more sensitive to interest rates. As expectations for rate cut(s) have solidified, one would have expected this to favor small-caps.

The explanation is about fear of an economic slowdown. Small-caps tend to rise ahead of a wider market rally and fall ahead of a broader capitulation. Investor skittishness about global growth has manifested itself in a flight to the relative stability of large/mid-caps.

In terms of style only, the second quarter was a risk-on market once again favoring growth stocks, but by a smaller margin than in Q1. Growth stocks performance exceeded value by 0-2% across the entire size spectrum, rather than the 4-5% we observed during the first quarter. The persistence of that outcome is not consistent with the very long-term value>growth effect, but has now been the case for over 5 years. Only 2016 was the recent exception. The result is the longest and largest growth stock outperformance cycle in history, with trailing 10-year returns now favoring growth by 2%, p.a.

Sector return differences in Q2 were also much less dramatic than those observed in Q1, with only an 11% spread between "first and worst." The best performing S&P 500 sector was financials, up 8%. This sector had been the first quarter laggard, along with health care.

Figure 8: US Sector Returns –2nd Quarter 2019



The other two top performing large-cap sectors were materials and technology. The large-cap tech sector was up over 27% during the first six months of 2019. At the other end of the spectrum were energy and heath care. Energy was the only negative performing large-cap sector, dropping 3%. Health care stocks have returned only 8% this year, while energy stocks are up "just" 13%.

Drilling a bit more into style/sector returns, small-cap industrials were up 8% for the quarter, trailed by financial services stocks (+6%) and tech (4%). Unlike in large-cap space, there were three sectors which posted negative returns: energy (-12%), consumer staples (-3.5%), and telecom (-1%). The worst performing small-cap sectors in the year through June have been consumer staples (+4%) and energy (+4%). The best have been tech (+29%) and industrials (+24%). Huge differences.

The S&P 500 index trades at a 1-year forward PE of 16.8x, up from 16.2x one year ago. It has recovered completely from last year's PE drubbing. The Russell 2000 trades for 21.6x projected earnings, compared to 23.2x one year ago. Small-caps may still have some appreciation potential.

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International Markets – Trade, Tariffs &Turmoil

After the dust settled on a volatile quarter, global stocks advanced. Diminishing trade tensions and indications from central banks around the world that the era of easy monetary policy is *not* over, propelled many markets to new highs. International equities lagged domestic equities, with developed markets (MSCI EAFE) outpacing emerging markets, 3.7% versus 0.6%. Oil prices declined during the quarter, but are still up over 25% year to date. The energy dominated Canadian market rose 5% in Q2. The all-inclusive MSCI AC World ex-US index returned 3%.

Figure 9: International Equity Markets – Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 6/30/19	2Q '19	1-Yr	2Q '19	1-Yr
World ex-USA	**3.8**	**1.3**	**2.8**	**2.2**
- MSCI Growth	*5.8*	*4.4*	*4.5*	*5.1*
- MSCI Value	*1.7*	*(1.8)*	*1.0*	*(0.7)*
- Europe	4.5	1.9	4.0	4.3
- Pacific, ex-Japan	5.2	8.1	5.7	11.0
- Japan	1.0	(4.2)	(1.7)	(6.8)
- United Kingdom	0.9	(2.1)	3.3	1.6
Int'l Small Caps	**1.8**	**(6.2)**	**0.9**	**(5.5)**
Emerging Mkts	**0.6**	**1.2**	**0.2**	**1.8**
- EM Asia	*(1.3)*	*(2.3)*	*(1.2)*	*(1.7)*
- EM Europe	*11.7*	*15.6*	*8.8*	*18.6*
- EM Lat Amer	*4.4*	*18.5*	*3.2*	*18.1*
- EM BRIC	*(0.2)*	*3.3*	*(1.0)*	*3.0*

Within developed markets, the Pacific region rose only 2.4%. Japan was the weak link in the Pacific region, rising only 1%. The Pacific region *ex-Japan* gained 5.2%. Economic data in Japan was mixed. On the positive side, industrial production rose, core machinery orders increased, and retail sales rose. Conversely, US-China trade tensions hammered Japan's exports, which recorded their sixth monthly decline. Automakers fell (Honda, Nissan), while technology firms (Softbank, Nintendo) advanced. Australia led the Pacific region higher, gaining 7.3% as the central bank cut interest rates and the country's center-right prime minister unexpectedly won re-election. Singapore (7%) and New Zealand (4%) also contributed to regional results.

European markets rose 4.5%. Reacting to weakening economic data, ECB President Mario Draghi said the central bank might consider a number of stimulus measures, including resumption of the previously halted bond-buying program and cutting rates further into negative territory (currently -0.4%) to support growth in the EU. Economically sensitive stocks outpaced defensive sectors, led by technology, industrials and consumer discretionary.

Real estate was the only negative performing sector. Larger countries (Germany, France, Switzerland, Netherlands) "caught up" to smaller economies (Belgium, Denmark, Finland Portugal) which were leaders in Q1.

UK stocks lagged (1%), as leaders failed to agree on a plan to exit the European Union. Prime Minister May announced her resignation pending the Conservative Party's selection of a new leader in July. The prospects for a "no-deal" Brexit could hinder European trade relations and export-oriented companies suffered double-digit declines (Glencore, Imperial Brands, British American Tobacco).

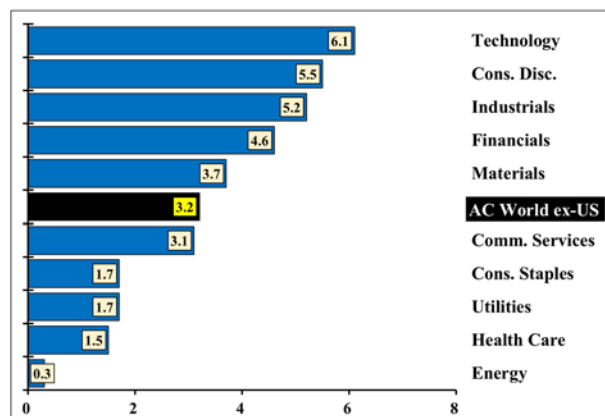
In currency markets, the US dollar weakened 1% versus the euro and 2.7% versus the yen. The British pound fell sharply (-2.3%) on continuing Brexit turmoil. Emerging market currencies were mixed – China, Malaysia and Turkey weakened, while Brazil, Mexico, Indonesia, Poland and South Africa each strengthened versus the US$.

Emerging markets fluctuated with the tenor of the US trade talks; primarily with China, but also with Mexico, Canada and other countries. Emerging Europe (11.7%) was the top performing region, led by a 17% advance in Russia (state-owned Sberbank jumped 25%).

Asia was the weakest region, led by the -4% decline of the Chinese market. Chinese stocks fell after strong gains through April, as trade talks with the US broke down. Alibaba (-6%), Ctrip (-15%) and Tencent (-2%), led the decline. Other major exporters in the region, Korea (-1%) and Taiwan (1%) were also negatively impacted by global trade disputes. Indian stocks broke even (0.5%).

In Latin America (4%), only two countries posted positive returns, Brazil (7%) and Mexico (1%). Other constituents dropped -2% to -6%. Brazilian stocks advanced on hopes that President Jair Bolsonaro can overhaul the country's pension system. From a sector standpoint in emerging markets, financials posted the largest gains (Sberbank, HDFC, Itau Unibanco, Banco Bradesco).

Figure 10: Ex-USA Sector Returns – 2nd Qtr 2019



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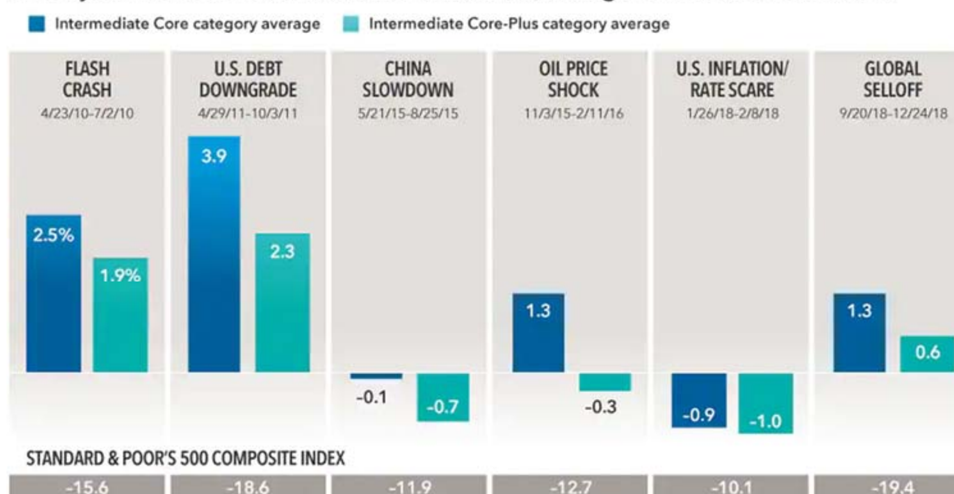
Back Page Perspectives

Using the S&P 500 as our proxy, we've had six corrections during the past ten years, since equity markets bottomed during the Great Financial Recession, as set forth below. The worst was the most recent, during last year's 4th quarter. Risk asset markets have mounted a rather furious rally since then, although one punctuated by considerable downside volatility along the way.

With bond market yields having declined sharply during the past twelve months, it would be easy to dismiss the asset class as offering little at present for investors. From a long-term perspective, the numbers bear this out. Over nearly all 10-year periods stock returns have crushed core bond returns, with current yields on core and core-plus portfolios inspiring very little of an argument to the contrary. Why invest in bonds today? As a store of value.

Another sharp equity markets correction, perhaps precipitated by a global recession, is a very real prospect. The implication for investors with ongoing distribution requirements would be highly negative, as forced selling into a declining market crystallizes portfolio losses. Thus, we recommend a continued strategic allocation to high quality core bonds, to fund required distributions "come hell or high water" during the next 3-5 years. If equity markets do correct, funding ongoing distributions from fixed income will also serve to restore strategic allocation targets. Think of it as a natural rebalancing program.



*Dates shown for market corrections are based on price declines of 10% or more (without dividends reinvested) in the S&P 500 with at least 50% recovery between declines.

Sources: Capital Group, Bloomberg Index Services Ltd., Morningstar, Standard & Poor's.

With the Fed more open to rate cuts, and the possibility that tariffs could lift inflation, positioning portfolios for a *steeper* yield curve makes a lot of sense. One catalyst may be in the corporate credit market. Investors have been worried about rising interest rates for most of the last few years, but the cycle has turned. In this part of the cycle exposure to interest rates can actually reduce volatility and preserve the value of an investor's overall portfolio.

Instead, we think investors need to focus their attention on credit risk. For the last 10 years, companies have leveraged their balance sheets to make large acquisitions, buy back shares, increase their dividends and invest in their businesses. When the credit market turns as the late cycle turns into a recession, some of these companies are going to find that their earnings stream won't cover all the debt that they've issued. Investors who have been focused on interest rate risk and reached for higher yielding bond funds may find that their portfolios have overly large exposures to many of these companies.

We don't know exactly what the next year or two will look like. With trade and the regulatory environment in flux, there will be winners and losers. Given today's rich bond valuations, investors are not being paid very well for the risks they are taking in many parts of the credit market.

At this stage of the cycle, ensuring a portfolio can withstand higher market volatility is a prudent move. One approach is to upgrade the core bond portfolio allocation for better resilience in the face of equity volatility. Another is reducing high yield bond exposure to below strategic targets, despite their excellent 3-5 year *trailing* record. Core bond portfolios provide diversification from equities, capital preservation, and moderate income.

Sell high, buy low. See you next quarter!

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