INVESTMENT REPORT

LYNCH FINANCIAL GROUP LLC
Retirement Wealth Management

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Investment Review and Outlook

The first half of 2019 saw robust gains across most asset classes, but it certainly wasn't a smooth ride

The S&P 500 hit a new high near the end of June. Large-cap U.S. stocks shot up 7.0% for the month – their best June since 1955.

Foreign stocks also notched double-digit gains through the first half of the year.

The 10-year Treasury yield continued to plunge from its multi-year high of 3.2% last October, dipping below 2% following the Federal Reserve's June meeting.

Looking ahead, we still see a high degree of uncertainty and a wide range of plausible outcomes looking out over the next 12 months (and beyond).

We welcome questions or comments regarding this newsletter at jlynch@lynchfinancialgroup.com. Lynch Financial Group provides Retirement Wealth Management Services to individuals within 15 years of retirement, retirees, and surviving spouses. We also provide specialized assistance to professionals, fiduciaries and heirs in wealth transfer situations.

Benchmark and Mutual Fund Performance

The box below contains benchmark (capital market and investment style) performance results. Equity markets performed well for the quarter resulting in excellent year-to-date returns. High quality bonds also performed quite well as interest rates declined during the quarter. This quarter, we discontinued showing mutual fund and benchmark performance to allow more space for market commentary.

Second Quarter 2019 Key Takeaways

In our year-end 2018 commentary, we emphasized the wide range of plausible macroeconomic scenarios and financial market outcomes for the year ahead with the potential for either a positive or negative shorter-term path. Through the first half of 2019 we've gotten a little bit of everything—signs of both scenarios, though so far the ups have outpaced the downs.

The first half of 2019 saw robust gains across nearly every asset class—including both core bonds and equities—but it certainly wasn't a smooth ride. Among the primary drivers of the market sell-offs and their subsequent rebounds were on-again/off-again U.S.-China trade negotiations and two major shifts in central bank policy. We have included a special report on Central Bank monetary policy. (continued on page 2)

Special Report - Central Bank Monetary Policy

Central bank policy has had an enormous impact on financial markets since the 2008 financial crisis. We've seen that continue in 2019, marked by two major shifts in the Federal Reserve's stance. First, the Fed shifted from tightening monetary policy in 2018 (where it was raising the fed funds policy rate and unwinding some of the assets on its bloated balance sheet) to a "patient" stance (i.e., rate hikes are on hold) in the first quarter of 2019.

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Benchmark Returns (Periods Ended 6/30/2019)

	Quarter	12 Months
Large-Cap Benchmarks		
Vanguard 500 Index	4.3%	10.3%
Russell 1000 Growth iShares	4.6%	11.4%
Russell 1000 Value iShares	3.8%	8.3%
Mid-Cap Benchmarks		
Russell Midcap iShares	4.1%	7.7%
Russell Midcap Growth iShares	5.3%	13.7%
Russell Midcap Value iShares	3.1%	3.6%
Small-Cap Benchmarks		
Russell 2000 iShares	2.1%	-3.4%
Russell 2000 Growth iShares	2.7%	-0.5%
Russell 2000 Value iShares	1.3%	-6.4%
Other Benchmarks		
Vanguard Developed Mkts Idx	3.3%	0.0%
Vanguard Emerging Markets	0.9%	3.3%
Vanguard REIT Index	1.7%	12.0%
Vanguard Total Bond Mkt Index	3.1%	7.8%
Credit Suisse High Yield Index	2.6%	7.1%

Large-cap U.S. stocks gained 4.3% for the second quarter, and a remarkable 18.5% for the first six months of the year—more than earning back what was lost in the fourth quarter of 2018. Developed international stocks also experienced a healthy rebound from 2018's losses, up 3.2% for the second quarter, and 14.2% for the year to date. European stocks have done a bit better, gaining 15.6% on the year so far. In April, the "Brexit can" was kicked down the road at least until October 31, but the risk of a disruptive "no-deal" exit remains.

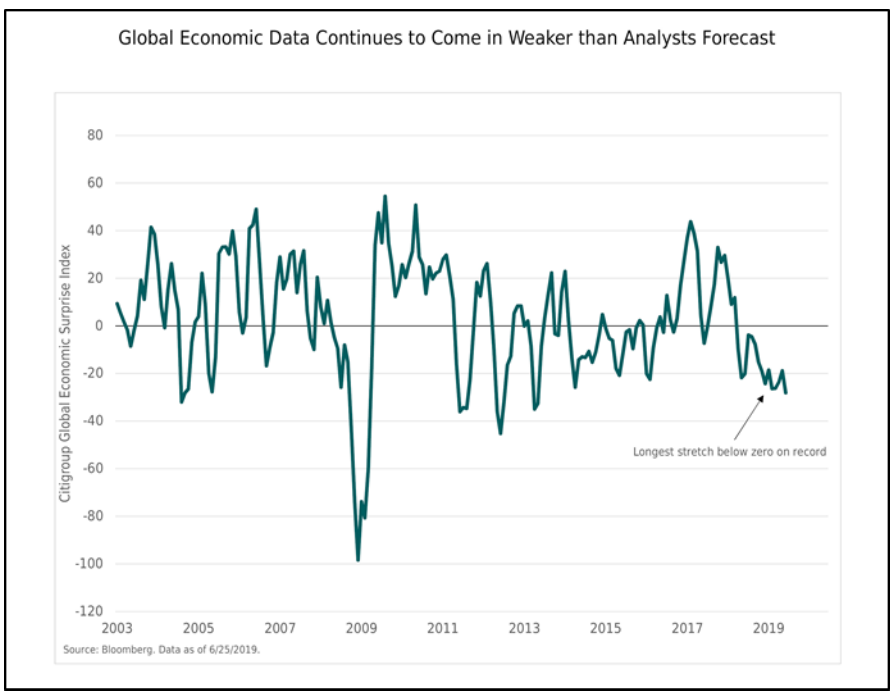
Emerging-market stocks, up just 0.8% for the second quarter, absorbed more of the uncertainty surrounding global trade tensions. But for the year so far, they have gained 12.6%.

In fixed-income markets, the 10-year Treasury yield dipped below 2% following the Federal Reserve's June meeting. This was a near three-year low, and among its lowest levels ever, reflecting promises of further easing later this year. These falling yields drove the core bond index to a 3.1% gain for the quarter and an impressive 6.1% return so far this year. Floating-rate loans gained 1.7% for the quarter and are up 5.7% for the year.

Market and Portfolio Outlook

Not surprisingly, we still see a high degree of uncertainty and a wide range of plausible outcomes looking out over the next 12 months (and beyond). But at the margin we think the macro risks have increased. Trade uncertainty has damaged global business confidence in what by many measures is an already weak global economy. While this is for now being offset by easier monetary conditions, the inevitable impact of any additional central bank rate easing is certainly muted.

The risk of a geopolitical shock on financial markets is also ever-present. Most recently, there is heightened potential for a military conflict with Iran. But there are many other potential geopolitical flashpoints and unknowns: Brexit remains unresolved. The tug of war between democracy, populism, nationalism, and autocracy continues around the globe. The U.S. presidential election next year will likely create additional market uncertainty. China's rise and challenge of the United States as a global superpower goes well beyond just the current trade conflict. The Middle East (beyond Iran) remains a potential flashpoint, as does North Korea.



To what extent stock markets are already pricing in these fears and risks is also an unknown. On the heels of yet another strong quarter for U.S. stocks, their valuations are looking more stretched than ever. Our analysis of U.S. stock market valuations and expected returns implies the market consensus is discounting an overly optimistic outlook. And it can certainly be said that any investors chasing stocks higher simply because of the tailwind of more monetary stimulus face potential dangers. Our analysis—informed by history and applying forward-looking judgment—leads us to a base-case scenario where the expected annualized return from U.S. stocks over the next 5 to 10 years is in the very low single digits. This is well below the upper single-digit expected return we require to compensate for the full risk of owning stocks. As such, we remain underweight to U.S. stocks across our portfolios until the risk/reward trade-off improves.

On the other hand, we continue to have modestly overweight positions to foreign developed and emerging-market stocks. Our analysis indicates their valuations are very attractive relative to the U.S. In our assessment, these markets are implicitly discounting a lot of bad macro news and poor sustained corporate earnings growth. Our base case generates high single-digit expected returns for European and emerging-market stocks over the medium-term horizon.

Over the shorter-term, if the global economy starts recovering from current depressed levels—with China's fiscal and monetary stimulus being a key to that outcome—and the United States avoids recession, we would not be surprised to see strong absolute returns from stocks, with outperformance from foreign stocks versus U.S. stocks. Further, if the growth differential between the United States and the rest of the world narrows, the U.S. dollar will likely depreciate, providing an additional tailwind to foreign stock returns for dollar-based investors.

A solid global economy would also be beneficial for our flexible fixed-income and floating-rate loan investments relative to core investment-grade bonds, which have much lower yields and would be hurt by rising interest rates.

On the other hand, if the global economy continues to weaken and the United States falls into a recession and bear market, our balanced (stock/bond) portfolios have "ballast" in the form of core bonds as well as lower-risk fixed income that should hold up better than stocks on the downside.

In Closing

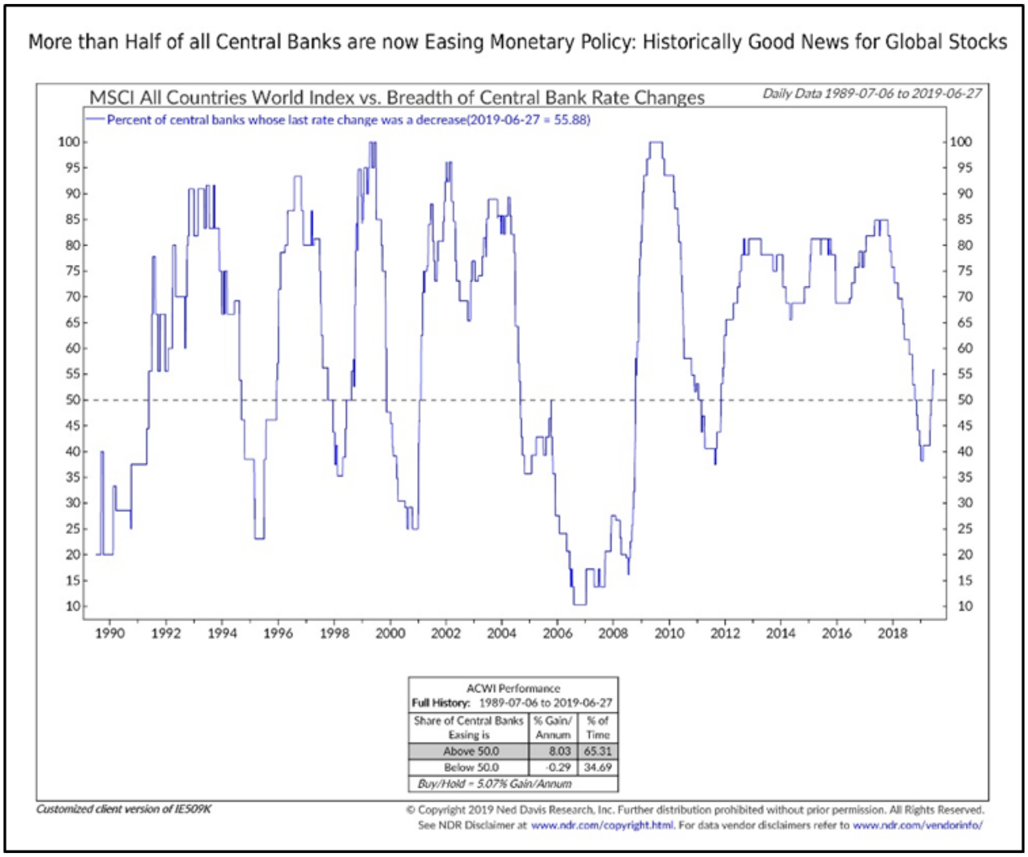
As we experienced this past quarter, uncertainty is a constant presence and volatility can return to markets at the drop of a pin (or a tweet, it seems, these days). Regardless of our tactical diversification efforts, those of us who own stocks need to be prepared to ride through the inevitable down periods. It's the shorter-term price we pay to earn their higher expected returns over the longer term.

This has been an unusually long U.S. economic and market cycle. But we firmly believe it is still a cycle, and that our patience and fundamental valuation discipline will be well-rewarded as it turns again. As always, we appreciate your continued confidence and trust, and we work hard every day to continue to earn it.

Special Report - Central Bank Monetary Policy ***(Continued From Page 1)***

Then at its recent June Federal Open Market Committee (FOMC) meeting, the Fed signaled it was inclined towards loosening policy once again, setting the stage for rate cuts later this year (possibly as early as its July 31 meeting) and/or next year. Fed chair Jerome Powell cited heightened uncertainty around the outlook for global growth, trade policy, below-target inflation, and falling inflation expectations. While the fed funds rate was left unchanged at 2.25% to 2.5%, Powell stated "the case for somewhat more accommodative policy has strengthened." He also noted, "many FOMC participants believe some cut in the fed funds rate will be appropriate in the scenario they see as most likely." Specifically, eight of the 17 FOMC participants now project the Fed will cut the benchmark rate this year, with seven of those projecting two quarter-point reductions (50 basis points). Eight participants expect the rate to remain unchanged and one thinks the Fed will hike rates this year.

Other global central banks are also pivoting back towards looser policies, including recent dovish statements from European Central Bank (ECB) President Draghi. The following chart from Ned Davis Research (NDR) shows that a majority of the world's central banks are now cutting rates (indicating an easing cycle), up from just 38% of banks easing in January. Historically, this has tended to be bullish for global stocks.



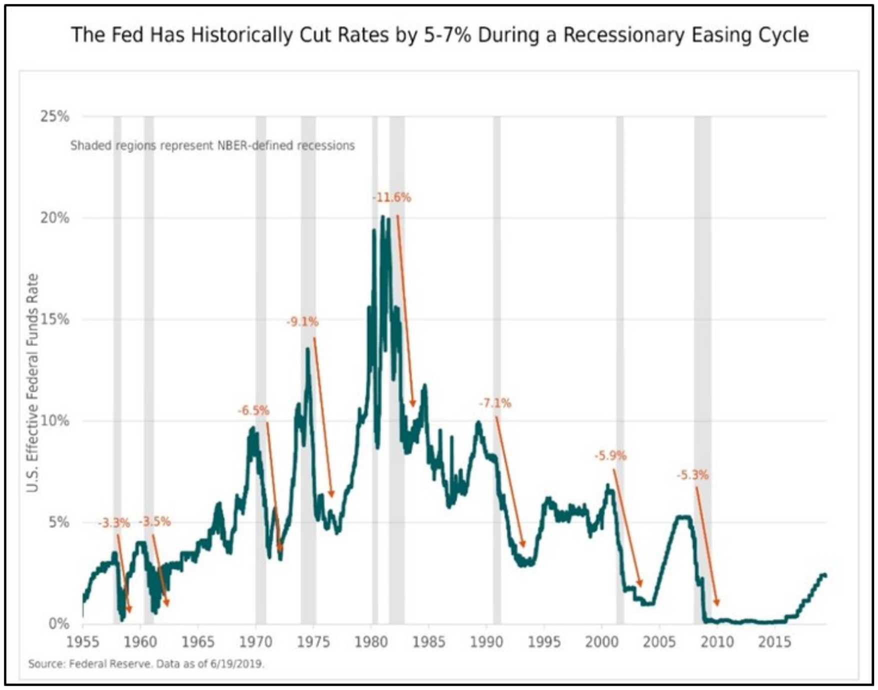
To state the obvious, looser monetary conditions are generally a stimulant for financial markets and asset prices, all else equal. A lower interest rate implies higher asset valuations (e.g., higher P/E multiples). But all else is rarely equal. And the implications of lower rates and monetary stimulus are not so obvious when you go beyond simple, first-level thinking to consider the broader economic context for these low rates (i.e., concerns about slowing growth and very low inflation). It is also critical for an investor to understand what information and expectations are already being discounted in current market prices.

Regarding the latter, the fed funds futures market is now discounting a 100% probability the Fed cuts rates by at least 25 basis points in July, 92% odds of at least two quarter-point rate cuts by year-end, and 60% odds of three or more rate cuts. Meanwhile, the S&P 500 index hit a new all-time high in the aftermath of the June Fed meeting and Treasury yields hit a multi-year low.

So, there is a non-trivial possibility the Fed surprises (disappoints) the markets by not cutting as much as expected, or at all. (While the Fed set the table for a cut in July, they still say they are "data dependent.") Of course, the Fed is aware of market expectations. And it knows that market reactions to its behavior can impact the real economy, which can lead to further market reactions, Fed reactions, subsequent market reactions, economic impacts, etc. Such self-reinforcing feedback loops may be helpful or harmful to achieving the Fed's economic mandate. But the Fed can't always control them.

If this does mark the beginning of another Fed easing cycle, it should give us (and the market) pause looking out beyond just the next few quarters. As the chart below shows, the fed funds rate is barely above levels where it has ended most other monetary easing cycles. The Fed will have little room—2.5 percentage points—to cut rates before hitting the "zero lower bound," economist-speak for a zero percent fed funds rate.
Historically, the Fed has ended up cutting rates by around five to seven percentage points during a recessionary easing cycle. That's impossible from current levels. Also, starting from such low yield levels, the benefit to the economy from additional rate cuts will likely be more limited, thereby diminishing returns. As such, the Fed seems highly likely to engage in quantitative easing (QE) in the next recession as well, despite its questionable economic benefits and with government debt already at historic highs. Will finan-

cial markets react similarly to the next round(s) of QE as they did after the financial crisis?



While U.S. bond yields are very low, at least they are still positive. Across much of Europe and Japan, government bonds have negative yields; the total dollar amount of negatively yielding debt recently shot above $13 trillion, a record high. About half of all European government bonds have a negative yield, including almost 90% of German government bonds. The German 10-year Bund recently yielded negative 0.33%, its lowest ever. The ECB's policy rate (the "deposit rate") stands at negative 0.4%.

None of this normal. The consequences of these unprecedented monetary policies are highly uncertain. And we've seen the market disruption caused by even modest attempts to unwind them (in the U.S.), or even just the suggestion of beginning to tighten policy (in Europe).

In the face of continued weak eurozone economic growth, below-target inflation, and falling inflation expectations (dropping from 1.8% in January to below 1.2% on one closely followed measure), the ECB was forced to reverse course in the first half of 2019 as well. Markets now expect the ECB to lower the deposit rate later this year and restart QE asset purchases next year.

The market's expectations for imminent central bank easing are clear. But the Fed and ECB's decisions will still depend to some extent on their assessment of incoming U.S. and global economic data. If the economic indicators improve (e.g., due to a lessening of trade tensions) and the Fed does not cut rates, will equity markets sell off, or will they respond positively to the better-looking economic fundamentals? Alternatively, if the Fed does feel the need to cut rates by 50 basis points in July, will markets have a knee-jerk rally? Or, will they do nothing because such a cut was already discounted in prices? Or, will stocks sell off on fears the cut indicates the Fed is worried about a sharp economic slowdown or recession on the horizon that it won't be able to prevent?

Historically, stocks have performed well in the 12 months after an initial Fed rate cut, unless the economy is heading into a recession. In the last two cycles, in 2001 and 2007, the Fed's first rate cuts came several months before the start of recessions, but severe bear markets followed anyway.

It's true that ongoing and unprecedented Fed stimulus was eventually the impetus for the 2009-onward bull market recovery, but it didn't prevent the bear market or recession from happening. So, while "don't fight the Fed" is a good rule of thumb, the Fed is not all-powerful in preventing recessions via monetary stimulus. On the other hand, the Fed can ensure a recession happens by tightening too much!

Suffice it to say, global central bank policy remains a significant uncertainty and potential market catalyst over the short- and medium-term. Clearly, and relatedly, the economic outlook matters as well.