It would appear that the seemingly apocalyptic fourth quarter of 2018 has all but been erased from the collective memory of market participants, as the S&P500, shrugging off a sluggish global growth outlook and an ongoing trade war, reached record highs by the end of the second quarter. In fact, one would be remiss in even remembering that the markets were down 6.58% in May, as June returned 6.89%, all but erasing the prior month's loss. Currently, the markets are trading on expectations.

The US economy remains decently healthy: growth is modest, inflation is moderate and the labor market continues to chug along. Recently, GDP estimates have been revised down slightly and corporate profits have begun to show some weakness, as the effects of the trade war between the US and China filter in. Globally, the growth picture is murkier, as Japan and the Eurozone effectively have negative interest rates, Britain is feeling the fallout from Brexit and China grapples with its own domestic downturn. With worldwide interest rates depressed and the US economy performing better than most, investors have been driven to the US as a safe haven, a 'better than the alternative' option. This situation, however, has been status quo for a while now, with the only major change in the equation being the expectations for action from the Fed.

Perhaps much to their chagrin, the Fed is the real mover in the markets, at this moment. The extraordinary returns so far this year, can be almost directly attributed to the Fed's reversal of policy course. While their insistence on tightening short term rates in 2018 sparked Q4's downturn, chairman Jerome Powell's recent remarks regarding not only a pause in the tightening, but the possibility of further cuts, has driven exuberance in markets this year. In fact, the markets have all but priced in a quarter-percentage point cut at the Fed's July 30th meeting. By moving rates lower, the Fed is signaling its intentions to defend their inflation target, acting to offset any potential fallout from the trade war and slowing global growth. It seems that they have increasingly realized that the normal relationship between the jobless rate and wage growth has broken down; record low unemployment has simply not led to a corresponding inflationary increase in wages, thus giving the Fed confidence that rates can be lowered without stoking inflation.

With the Fed concerned about a weakening economic outlook and seeing more inflationary than previously thought, their more dovish stance has fueled expectations that the rally can continue, as lower rates reduce borrowing costs and at the same time, shift the risk/return paradigm in favor of equities. Currently, the market seems to be at or near fair value, trading at 16.7 x forward earnings estimates, which is slightly above the long-term trend.

Certainly, there exist multiple factors that could derail the recent rally, notably: a further escalation in the trade war between the US and China, continued slowing of global growth, corporate earnings widely missing expectations, or any number of simmering geopolitical tensions escalating in to full-blown conflict. However, a downturn does not appear imminent – as the employment and economic data make clear. Presently, investor sentiment is rather neutral, which means that any upside surprises could serve to push the markets higher. Truthfully, we did not expect the market to deliver the returns that it has, so far, nor do we expect the current pace of growth to be sustainable, yet we are pleased with our portfolio's performance and expect to take advantage of the appreciation to realize some profits and reallocate to undervalued sectors.

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