DON'T FIGHT THE TAPE

Dow Jones Industrial Average – 11 Years Ending 07/22/19

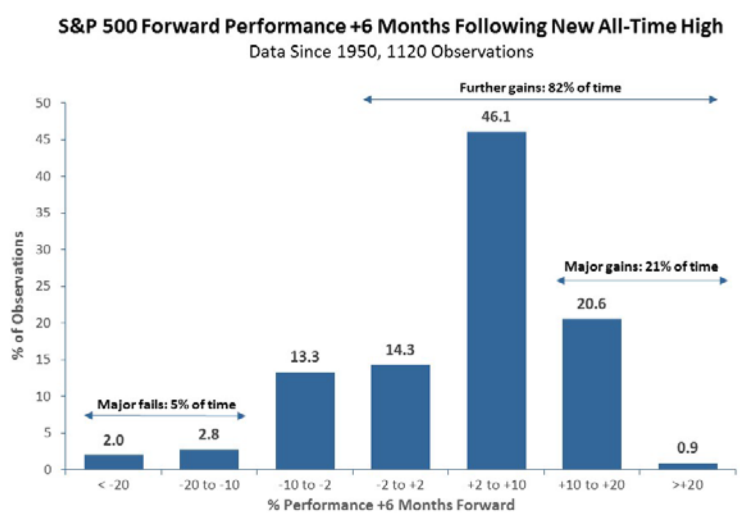
The first half of 2019 ended with the strongest and broadest stock and bond rallies in a decade, with every major asset class but a handful beating their long-term annual averages after just six months. All-time highs for the S&P 500 (up 18.5% YTD), Dow Industrials (up 15.4%) and NASDAQ (up 21.3%) were recorded. As interest rates declined during the first half of the year, the Barclays U.S. Intermediate Government/Corporate Bond index produced a respectful 4.9% return.

The last time gains were so broad was in 2009-10, when the global economy was recovering post-Lehman, the Fed was launching its quantitative easing policy (making it easier for businesses to borrow money) and valuations were relatively cheap across asset classes.

Despite better-than-expected GDP and earnings growth in 1Q 2019 and excellent market returns, many investors remain skeptical and skittish bulls. Few feel confident the good times can last. And there is little doubt that the start of the 2020 Presidential election cycle has contributed to the general sense of unease regardless of party affiliation.

What are the spoilers? A second US-China truce that leads eventually to stalemate; higher tariffs and reciprocal technology bans; a poor corporate earnings season despite an interim trade truce; a Fed that eases much less than expected; and a US debt ceiling/budget cap debate that turns dramatic.

WHAT'S AHEAD FOR THE ECONOMY AND ASSET CLASS PERFORMANCE?



The current U.S. economic expansion is the longest and slowest on record. It turned 10 years old this month. We aren't surprised, as our thesis of "no boom, no bust" continues. **This expansionary period could last for a few more years.**

The economic forecasts are showing some modest downward revisions. This is not unusual given the elevated trade tensions, but is not consistent with a severe global recession. **If the forecasts start to prove correct, we envision the Fed will cut interest rates more than expected.**

The shape of the yield curve (10-year U.S. Treasury's yield minus 2-year U.S. Treasury's) is extremely flat at about 25 basis points (0.25%). Historically, whenever the yield curve has been flat it's been **favorable** for both U.S. stock and bond returns over the next 1 and 3 year periods. When the curve inverts (spread is less than 0%) the ensuring periods are also positive for stocks and bonds.

BULL MARKET TOP CHECKLIST

Generally, there are advance warnings of an impending top in the stock market. We keep a close watch on a number of potential signals, but as seen below, **we see no evidence of the bull market's demise at this time.**

Bull Market Top Checklist

	2000	2007	Current	Comments
1. Heavy inflows into equity funds	√	√	X	Net inflows into equity funds is underwhelming while inflows into bond funds remain robust
2. Blow-off top	√	√	X	Equity market expectations remain constrained since the low in 2009. There is no evidence that investors paid peak multiples for peak earnings.
3. Big pick-up in M&A activity	√	√	X	M&A activity has picked up from past years. In absolute dollar terms, activity has come off the historical highs, and as a percent of market cap still remains low.
4. IPO activity	√	√	X	While IPO activity has been rather lackluster this bull market, the current list of expected IPOs will be an important litmus test as to whether fear among investors will ultimately give way to greed.
5. Rising real interest rates	√	√	X	Real rates have declined meaningfully after peaking back in early November.
6. Weakening upward earnings revisions	√	√	X	Earnings revisions have come down more recently, but still remain at safe growth levels.
7. Erosion in the number of stocks making new highs	√	√	X	Breadth has expanded significantly during the current rally.
8. Shift towards defensive shares	√	√	X	Following the sell-off at the end of last year, cyclical shares have outperformed defensives.
9. Divergence in moving averages	√	√	X	Advance / Decline lines are confirming market highs.
10. Widening credit spreads	√	√	X	High-yield and investment grade credit spreads have moved higher recently, but compared to a long-term history, remained contained.

STOCK MARKET TECHNICALS: SEPARATING NOISE FROM REALITY

The formation of a major market top is a process, not an event. Specifically, the eroding strength that ends a bull market is a gradual progression occurring over a period of months, not days or weeks. Proponents of the bear market thesis might reply that the market's apparent lack of upside progress over the past 19 months represents just such a gradual erosion. **However, a closer examination of market conditions reveals little to suggest an end to the bull market is imminent.**

Historically, major market tops have been preceded by a sustained period of rising **supply**. We see little evidence of a significant reversal of the downtrend in selling pressure dating from November 2016. While **demand** has been sluggish over the past year, **there is little evidence of a sustained downtrend in buying that also frequently occurs prior to a major top**.

Supply and Demand in the Markets

Regardless of the reasons why, if buyers (**demand**) wish to invest more money in stocks than sellers are trying to take out, prices advance. And, conversely, if sellers (**supply**) are trying to take out more money than buyers are willing to invest, stock prices decline to levels where buyers are again attracted. Demand and supply can be measured and tracked.

Since 1927, eroding **breadth** (the number of stocks advancing relative to those that are declining) has consistently provided a reliable warning of an approaching major market top. Although the S&P 500, by some perspectives, shows only nominal gains since the January 2018 bull market high, there is little evidence suggesting the current 'consolidation pattern' represents a major market top. To the contrary, the advance / decline lines of both the NYSE all-issues and Lowry's Operating Companies Only (excludes closed end funds, preferreds, bond funds) set new all-time highs in July, joined by new all-time highs in the S&P 500, Mid-Cap and Small-Cap advance / decline lines.

We remain modestly over-weighted in stocks. For bonds, we are focused on strong higher-yielding corporates.

Please let us know of any questions or comments.

Alan Moucha, CFA   Carlton Savoye, CFA   George DeCesare   John Capodici   William Hamill

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