HIGHMARK®
CAPITAL MANAGEMENT

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Town of Los Gatos

RE – 2Q2019 Pension report

Risk-hungry investors, buoyed by the prospect of the Fed cutting rates, drove the S&P 500 index to record highs during the quarter, and the index recorded the best first half year since the first six months of 1997: a total return of 18.5%.

Unlike the volatility of the prior two years, the U.S. dollar, when measured against a trade-weighted basket of foreign currencies, has been remarkably stable so far in 2019. This is one of the most notable differences compared to 2017 when most asset classes also performed well, but the dollar sold off from the near-term highs reached in December of 2016.

With market return trophies in hand, investors may wonder if the risk-on party will ever end. Equity market enthusiasm is somewhat surprising given the fact that domestic stock valuations are rich at 17 times earnings and, having nearly recovered from the year-end 2018 sell-off,[1] now stand at the high end of their historic range. Expectations that second quarter corporate earnings will fall have not deterred investor appetite for stocks in an environment of persistent trade tensions.

Meanwhile, the global economy is fragile with most regions struggling to regain economic momentum. Many key indicators pointing to economic growth—industrial production, manufacturing, consumer confidence and trade—saw disappointing second-quarter readings. The odds of a manufacturing and capital expenditure recession have risen substantially given deteriorating global growth outlooks. The World Bank downgraded their 2019 forecast to 2.6% from 2.9% due to weaker-than forecast trade and investment momentum. Global GDP growth in this range might be considered "stall speed", neither indicative of growth, nor indicative of a decline. In remarks after June's Federal Open Market Committee meeting, Chairman Jay Powell noted concerns regarding global trade tensions and the impact they may have on U.S. economic growth. Shortly after Powell's comments, President Trump and Chinese Premier Xi Jinping wrapped up their Group of 20 (G20) meeting by announcing that trade negotiations would resume after collapsing in the prior month. This last walkout was due to the Chinese balking at the prospect of rewriting domestic legislation to meet U.S. demands on dismantling the government's investment in state-owned businesses. For now, the 25% tariffs on $250 billion worth of Chinese imports will continue to have a negative impact on Chinese GDP and U.S. producers will continue to face export barriers. With the threat of additional 25% tariffs on $300 billion of Chinese imports still on the table, the trade wars with China continue, despite the Osaka G-20 cease-fire, as does the risk of a domestic policy response that could pour oil on the fire.

As trade tariffs drive consumer prices higher and dampen demand, disrupt supply chains and spark uncertainty regarding business investment and capital expenditures, the administration is playing a high risk/potentially high reward endgame. A trade policy mistake would be highly destabilizing to markets, and could easily lead to a global recession. The Fed also faces a dilemma as it considers how far to move from its previously hawkish stance, to an easing policy. All of this, in the face of continued pressure from President Trump on Chair Powell and his fellow FOMC Board of Governors.

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[1] Source: FactSet

ATTACHMENT 3

Performance and Positioning

The PARS/PRSP Capital Appreciation Index portfolio gained 2.95% gross of fees in the second quarter. While not duplicating the enormous gains of the first quarter, equities were positive across the board for the second quarter. The Plan's equity segment generated a 3.4% return. Most domestic equity categories generated low single digit returns. The S&P500 gained 4.3%, the Russell Mid Cap Index gained 4.1%, and small caps, as represented by the Russell 2000 Index returned 2.1%. REITs lagged slightly for the first time in several quarters, gaining 'only' 1.6% (Wilshire REIT Index). Equities traded around the narrative of international trade. In May, equities struggled as President Trump appeared to attempt to link the USMCA trade deal with Mexico with that country's ability to stem the tide of illegal immigration. In this manner, the weaponization of tariffs, served to damper both investor sentiment, as well as corporate executive's sentiment. However, in short order, the President reversed this course, and combined with a modest truce in the trade spat with China, served to re-invigorate risk appetites among investors – leading to strong gains in the month of June for stocks.

Fixed income returns were strong in the quarter, with 10-year Treasury yields declining 41 basis points in the quarter, to finish at a 2.0% level. Yield curve inversion, which some believe predicts economic recession, continued to deepen with the one-month Treasury yielding 18 basis points more than the 10-year Treasury at the end of the quarter. The Bloomberg Barclays Aggregate Bond Index posted its second quarterly back-to-back +3% return, gaining 3.1%. Bonds reacted favorably to signals from the Fed that they may be on the sidelines with respect to future rate hikes. Additionally, with over $13 trillion of sovereign debt trading at a negative yield, buyers flocked to our domestic fixed income market. The Plan's fixed income returns were slightly less than the benchmark, posting a gain of +2.6%. The Plan's allocation to the shorter-than-benchmark position in the Vanguard Short-Term Corporate Bond Fund (+1.92%) provided a modest drag to returns.

There was no change to the investment managers during the quarter. The Plan's overall target asset allocation was 76% stocks, 22% bonds, and 2% cash at quarter-end.

Andrew Brown