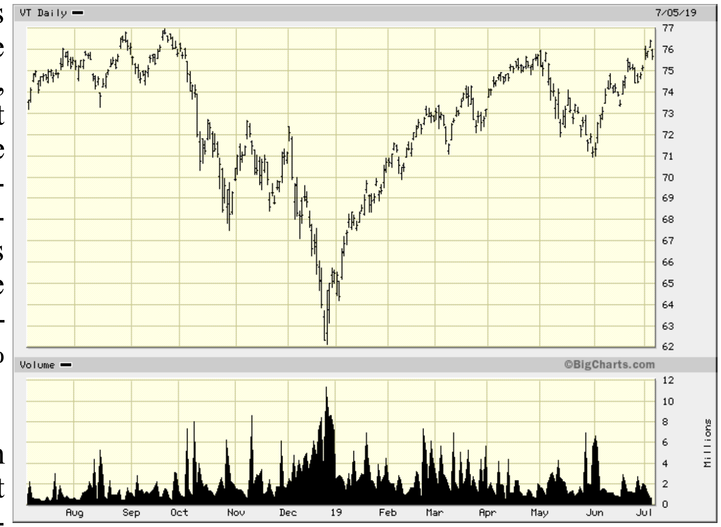
Market Review and Outlook—July 5, 2019

Another, Smaller, V—Last December brought a sharp decline in stock markets, largely tied to global trade tensions. These tensions eased in the first calendar quarter, and the markets recovered very steadily. In May we had a rerun, and June brought another steady recovery. As shown by this graph, presenting price and volume of the **Vanguard Global Stock Fund (VT)** over the past year, there are many smaller Vs during the year; however, not all declines are quickly followed by rebounds. We see that a 10% decline in October was followed by a subsequent 10% decline in December before a sustained recovery took hold. The graph also shows that, despite the ups and downs, VT barely changed over the past year. The actual results are better, as the chart doesn't show the impact of dividends, which helped this fund return over 5% during the full year through June 30th.



We have become desensitized to the on-again, off-again trade tensions, and this concern has subdued, if not chilled, investor confidence in recent quarters. The Administration announces plans for a sharp tariff, the other country/region proposes a painful retaliation, some days pass, and the U.S. backs off, providing some justification for how this more moderate path is a far better outcome. Wait a few months and repeat this with a different, or even with the same, country/region. As only 8% of our economy comes from exports, the impact of these threats are greater overseas. The pattern of claim/ retaliation/rollback makes it easier this year to take these threats of trade wars in stride—not easy, but easier.

Quarterly Results—The table below shows solid three-month returns, yet the graph above shows that for both US and foreign stocks, the quarter brought a rocky path that ended higher. Both quality and opportunity bonds provided steady gains, as current interest rates fell by up to ½% during the quarter. The very strong one-year gain by bonds (7¼%) reflects the new view that interest rates will no longer rise, a view that just began earlier this year. The 3-year results present a fairly typical mix, with low, yet steady, bond returns, coupled with higher, but much more volatile, results from various stock categories. The homogenous 3-month results mean that rebalancing could be modest this month, unless there are strategic changes (and we have several).

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.52%	+1.95%	+1.07%	+0.65%	+0.35%
Intermediate Term Bond	+2.83%	+7.24%	+2.09%	+2.55%	+3.86%
Intermediate Muni Bond	+2.06%	+5.93%	+2.05%	+2.99%	+4.07%
Large-Cap Stock	+3.81%	+8.20%	+12.53%	+8.76%	+13.24%
Mid-Cap Stock	+3.04%	+2.41%	+9.98%	+6.04%	+12.87%
Small-Cap Stock	+2.21%	-3.76%	+10.09%	+5.65%	+12.70%
Foreign Large-Cap Stock	+2.97%	-0.06%	+8.13%	+2.03%	+6.44%
Health	+0.71%	+5.12%	+11.82%	+9.15%	+15.80%
Real Estate	+1.93%	+10.45%	+4.66%	+7.23%	+14.53%
Technology	+3.22%	+8.12%	+22.67%	+15.05%	+16.74%
Moderate Allocation (60% stocks)	+2.95%	+5.73%	+7.79%	+5.04%	+8.93%

The data in this table comes from Morningstar and is as of June 30, 2019

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Economic Growth—The U.S. economy received a boost from the December 2017 tax cut, leading to strong earnings gains in 2018. This 'sugar boost' is wearing off, and growth is expected to slow from the 3% rate to 2%-or-so later this year, and could fall toward 1%. The largely flat yield curve (3-month treasuries yield more than 10-year treasuries) sometimes precedes recessions; however, other factors lead us to conclude that a recession is not likely for the next year—merely slowing economic growth. There are many reasons for slowing growth, chief among them that there are few reasons for accelerating U.S. growth. We have a very low unemployment rate, anemic growth is projected in the working-age population (partially due to reduced immigration), and thus the employment base cannot grow appreciably, preventing any normal or above-average growth. The perpetual tariff war episodes prevent global companies from making substantial long-term commitments, and there are no signs that this cycle will end soon.

Global growth is also likely to slow, yet remain positive for the near future. The ongoing global trade tensions may explain the decline in expectations for global manufacturing we've seen the past two years. Two countries with the lowest manufacturing expectations, Germany and Taiwan, both have substantial levels of exports. Global services, also, have declined from their 2017 peak, but remain in an expansion level.

Bonds—With increased concerns of a slowing U.S. economy, the Fed has switched from expecting to raise interest rates further, to preparing to lower rates. This completely changes our strategy on allocating bonds within a portfolio. In a weakening economy, we reduce our Opportunity bonds, those which rely on the underlying credit-worthiness of their issuers—bonds like high-yield and emerging-market bonds. Further, we increase our Quality bonds, those which have solid credit-worthiness, and those whose price is more closely tied to the maturity and yield of the bonds.

Keep in mind that, since the Fed has shared its expectation to lower interest rates in the coming months, stock markets can behave perversely. Today, we had a fairly strong jobs report, and stocks fell. The likely reason? The strong jobs report could lead the Fed to wait a bit longer before lowering interest rates. Many stock investors are relying on rates to be lowered as soon as possible, and intervening good economic news interferes. Thus while the stock market can often seem random, in the coming weeks it could seem downright insane.

Stocks—The chart on the prior page shows the volatility in the global stock markets over the past year. In such environments, it is particularly difficult to assess whether stocks are cheap or pricey, for it can change in a week's time. While U.S. stock prices are near historic highs, profit levels are also high. P/E levels, which combine the two figures to show pricey/cheap levels, have jumped around quite a bit, from fairly cheap in December, to slightly expensive this month, and this could change next week! While there are several factors indicating that U.S. stock prices are high, there are two factors that support continuing to keep stock dollars at normal levels—very low inflation levels and very low bond yields. Companies that don't need to worry about sharply rising prices, with very modest wage inflation, and very low borrowing costs, are able to maintain solid profitability. These same measures indicate that foreign stocks are cheaper than normal, and substantially cheaper than US stocks. For these reasons, we are holding onto normal stock levels, and continue to favor a relatively high level of foreign stocks, with an overall 52/48% level of U.S./foreign stocks.

Bonds—As Joe's article in the newsletter notes, we appear to be in a 'near normal' environment for bonds, for the first time in over a decade. The downside is that this warrants a substantial change, but the upside is that the change is a return to a standard allocation. What is standard/normal? In normal times, investors' bonds should be normal, high quality, generally intermediate-term bonds. It is traditional to include some aggressive bonds (we call these Opportunity bonds); however, our normal level is 80/20 quality/opportunity, and we have finally, recently shifted to this level from our 10-plus year balance of more than 30% opportunity bonds.

A normal balance of bonds provides for steadier results, and substantial support if/when the economy slows and enters a recession. While we maintain a modest level of opportunity bonds to benefit should the economy continue its positive, albeit anemic, economic growth rate, we limit that to better protect the overall portfolio should the economy falter sooner than we have expected.

In summary, we are maintaining our ongoing stock approach, but have restored bonds to normal levels. We don't see an imminent end to this historically long economic recovery, but we want to be prepared.