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Investment Committee Update

Q3 Review ■ 2019

In this Q3 recap: the U.S. and China intensify their trade dispute, but agree to negotiate again, the Federal Reserve cuts short-term interest rates once more, and stocks ride through some volatility to end the summer higher.

THE QUARTER IN BRIEF

Summer doldrums? Not exactly. The third quarter brought a number of attention-getting events, and while investors took some cues from them in the short term, Wall Street's confidence remained – the S&P 500 rose 1.19% in Q3. The abrupt devaluation of the Chinese yuan shocked traders, and shifting Treasury yields also made headlines. Trade negotiations between the U.S. and China broke down, but as the quarter ended, it looked like they would resume in the fall. Manufacturing was giving mixed signals, both here and abroad, breeding concerns about the health of the global economy. Both the Federal Reserve and the European Central Bank took steps to ease monetary policy.[1]

DOMESTIC ECONOMIC HEALTH

Wall Street and Main Street had plenty to think about in the quarter. Trade remained the big issue, with China and the U.S. amplifying their ongoing dispute. On August 1, the U.S. announced tariffs on an additional $300 billion of Chinese products – some would be effective September 1; others, effective by December 15. Four days later, China devalued its main currency, the yuan, to a level unseen in 11 years – a move that immediately sent U.S. stocks 3% lower. (Devaluing the yuan made Chinese goods cheaper for buyers paying for them in dollars, effectively offsetting the impact of U.S. tariffs.)[2,3]

On August 23, China unveiled a plan to put new tariffs on $75 billion of U.S. goods, threatening to place import taxes as high as 43% on cars and trucks exported from America. Just hours later,

the White House announced that current and planned tariffs on Chinese goods would increase by 5%. September was less acrimonious: China stated that it would remove 16 U.S. products from its tariff list, and the White House said that it would delay the new tariffs on Chinese goods planned for October 1 until October 15. Late in the month, word came that trade representatives from both nations would resume talks on October 10.[2,4]

On August 15, traders took note of another development: the yield of the 2-year Treasury bond exceeded the yield of the 10-year Treasury bond for the first time since 2007. In past years, this has sometimes signaled an oncoming interruption in U.S. economic expansion. Longer-term Treasuries commonly have higher yields than shorter-term Treasuries; when the opposite is true, it indicates that domestic and foreign investors have less optimism in their economic outlook. (Bond yields often fall when bond prices rise, and vice versa.)[5]

The Federal Reserve lowered the country's short-term interest rate by a quarter-point on September 18, to a range of 1.75% to 2.00%. Federal Reserve Chairman Jerome Powell, speaking to the media after the decision, called the outlook for the U.S. economy "favorable." At the same time, he noted "a lot of uncertainty" surrounding the near-term economy and the Fed's monetary policy views. An updated dot-plot forecast came with the latest policy statement; the Fed uses this tool to try and project the cost of borrowing money in the future, i.e., where the benchmark interest rate may be. The dot-plot showed that while seven Fed officials thought at least one more interest rate cut would happen before 2020 arrived, ten others did not.[6]

Fundamental indicators were a mixed bag. Employers hired 130,000 net new workers in August, according to the Department of Labor; that was a drop from July job creation levels, and it reduced the monthly average for 2019 to 158,000. In both July and August, unemployment was at 3.7%; the U-6 rate, which counts the underemployed and unemployed, was at 7.0% in July, 7.2% a month later. U.S. manufacturing activity also slowed in both August and September, according to the Institute for Supply Management; the September slowdown was the sharpest monthly contraction since June 2009.[7,8]

Consumer spending rose by 0.5% in July, then just 0.1% in August, according to the Bureau of Economic Analysis. Retail sales were up 0.8% in July and another 0.4% a month later. (The BEA also concluded that the economy had grown 2.0% in the second quarter.) Consumer prices were advancing at 1.7% annually through August.[9]

The Conference Board's Consumer Confidence Index rose to a (revised) mark of 135.8 in the quarter, but fell to 125.1 in its final Q3 reading (September). The University of Michigan's Consumer Sentiment Index was at 98.4 in July, but 93.2 by September.[10,11]

GLOBAL ECONOMIC HEALTH

Factory activity slowed in some of the world's larger economies. By September, the Markit factory purchasing manager indices (PMIs) for the euro area, the United Kingdom, Russia, Mexico, Germany, and Japan were all under 50, meaning the manufacturing sectors in those economies were shrinking rather than growing. There was also a positive development, however: the JPMorgan Global Manufacturing PMI rose twice, to 49.5 in August and 49.7 in September.[12,13]

The European Central Bank made two moves in the quarter to try and stimulate the euro area economy. The ECB took its overnight deposit rate to a record low of -0.5%, and it also announced another round of monetary stimulus, stating it would buy €20 billion in bonds per month, beginning in November. Lawmakers in the United Kingdom continued to argue over the path toward Brexit; in August, new Prime Minister Boris Johnson moved to suspend Parliament for several weeks in September and October, a move ruled unconstitutional a month later by the country's highest court. Johnson refused to resign despite pressure to do so. He claimed the U.K. would make its Brexit from the European Union by October 31, as scheduled, though some analysts worried that it might be a "hard" one, with no trade deal with the E.U. in place.[14,15]

China's industrial output faltered in the quarter. It slowed to a 4.8% pace in July, which became 4.4% in August. Both numbers were 17-year lows. Year-over-year retail sales had grown by 7.5% through August, also representing a decline. The People's Bank of China enacted some strategies in Q3 in response to this disappointing data. Besides devaluing the yuan, China reduced capital reserve requirements for its banks in the quarter and set new, pro-growth standards for commercial lending.[16]

WORLD MARKETS

In the big picture, the developed markets outgained the emerging ones. The MSCI EAFE index, a benchmark for developed equity markets in Europe and the Asia-Pacific region, improved 3.7% in the quarter; MSCI's Emerging Markets index rose just 0.6%.[17]

Russia's Micex benchmark led the way among notable indices, up 16.9% in Q3. Brazil's Bovespa rose 7.2%; Germany's DAX, 7.1%. France's CAC 40 gained 6.5%. Lesser Q3 gains were registered by Spain's IBEX 35 (2.6%), Mexico's Bolsa (1.1%), and Japan's Nikkei 225 (1.0%). South Korea's Kospi lost 0.9% for the quarter, and China's Shanghai Composite fell 4.0%.[17]

COMMODITIES MARKETS

Drones attacked two large Saudi Arabian oil facilities on September 15, interrupting about 5% of global oil production. West Texas Intermediate crude oil closed at $62.90 on the New York Mercantile Exchange the next day, taking a 14.7% leap. This was oil's biggest one-day advance in 11 years. The price eventually fell: WTI crude closed out the quarter at $54.20 a barrel.[18,19]

Gold finished Q3 at $1,479.40 an ounce on the NYMEX, silver at $17.08 an ounce. Quarterly gains in the commodities sector included silver, 13.20%; gold, 6.00%; palladium, 5.93%; the U.S. Dollar Index, 2.92%; soybeans, 1.21%.[19,20]

The following commodities made Q3 retreats: cocoa, 2.85%; natural gas, 3.29%; sugar, 4.38%; copper, 4.79%; wheat, 4.86%; unleaded gasoline, 6.12%; corn, 7.10%; cotton, 8.41%; WTI crude, 8.91%; coffee, 11.83%.[20]

REAL ESTATE

Home buying picked up in the quarter. The National Association of Realtors noted that a 2.5% advance for existing home sales in July and a 1.3% gain for August. Its pending home sales index, down 2.5% in July, reversed course and rose 1.6% a month later. New home sales represent only a sliver of the residential real estate market by comparison, but it is worth noting that Census Bureau data showed new home buying rebounding – down 8.6% in July, then up 7.1% for August. Yearly home price appreciation slowed: the 20-city S&P/Case-Shiller home price index saw a 2.0% annualized increase through July and was flat for that month.[9]

Thirty-year home loans grew less expensive. Comparing Freddie Mac's June 27 and September 26 Primary Mortgage Market Surveys, the average interest on a 30-year, fixed-rate mortgage fell from 3.73% to 3.64%. In both of those surveys, the average interest rate for the 15-year, fixed-rate mortgage was the same: 3.16%.[21]

30-year and 15-year fixed rate mortgages are conventional home loans generally featuring a limit of $484,350 ($726,525 in high-cost areas) that meet the lending requirements of Fannie Mae and Freddie Mac, but they are not mortgages guaranteed or insured by any government agency. Private mortgage insurance, or PMI, is required for any conventional loan with less than a 20% down payment.

Construction activity also increased during the summer. Building permits, as tracked by the Census Bureau, rose 8.4% in July and another 7.7% in August; housing starts, down 1.5% in July, surged 12.3% in August.[9]

MARKET INDEX	Y-T-D CHANGE	Q3 CHANGE	Q2 CHANGE
DJIA	+15.39	+1.19	+2.59
NASDAQ	+20.56	-0.09	+3.58
S&P 500	+18.74	+1.19	+3.79
BOND YIELD	**9/30 RATE**	**3 MONTHS AGO**	**1 YEAR AGO**
10-YEAR TREASURY	1.68	2.03	3.09

Sources: barrons.com, barchart.com, treasury.gov - 9/30/19[22,24,25]

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly. These returns do not include dividends. 10-year Treasury yield = projected return at maturity given expected inflation.

LOOKING BACK, LOOKING FORWARD

In a statistical coincidence, the Dow Jones Industrial Average and S&P 500 gained the same percentage in the quarter. The Dow settled at 26,916.83 on September 30; the S&P, at 2,976.74. Both indices registered their third straight quarterly advance. The NASDAQ Composite went sideways for Q3, ending September at 7,999.34.[22,23]

Investors may recall this past quarter as volatile, but that was not always the case: in September, the S&P did not have a single 1% daily loss, and it saw just two daily gains of 1% or more.[22]

The Dow, NASDAQ, and S&P each entered the fourth quarter with year-to-date gains of at least 15%. Can that kind of momentum continue? Much could depend on corporate earnings and the guidance that accompanies them. Tariffs imposed by the U.S. and China are not the only potential drag on profits; dollar strength has to be counted as well. The coming earnings season is expected to be watched closely on Wall Street, and while it might not exactly dictate what happens in the market this month or this quarter, it could set a mood that investors might retain through the end of the year.

TIP OF THE QUARTER

- If you **own or manage a business**, now is a great time to plan out any year-end client gifts and employee bonuses.

TFA Perspective

It takes patience and discipline to grow wealth over a lifetime, and the deck is stacked against you. If the headlines and tweets and talking heads don't convince you to change your thoughtful investment strategy, your emotions will. The eternal struggle between fear and greed affects us all differently, and the uncertainty that seems to be ever present in the investment world tests our long-term resolve frequently. Now is one of those times when market commentary casts doubts on what has been a mostly optimistic run in the markets.

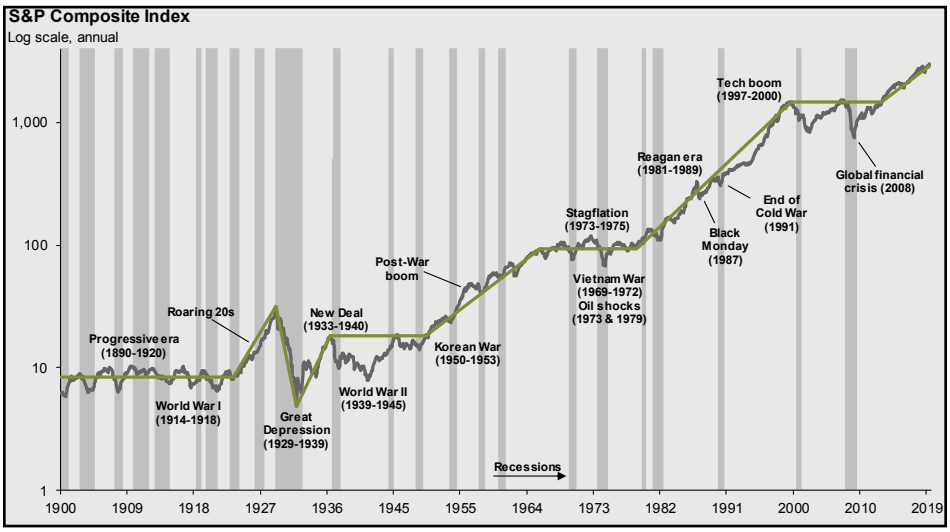
We're in the eleventh year of the longest bull (positive, rising) market on record, in full swing since the great financial crisis of 2007-2008. The world's economies are cyclical, however, and follow a recurring loop of expansion, peak, recession and recovery. Where we are in the current cycle is debated daily. What is apparent is that growth has slowed and staying fully invested but cautious and flexible may be the prudent play. Remember, the sporadic downturns and worrisome periods represent buying opportunities for long-term investors (like us).

After a big year for US stocks, it's reasonable to expect turbulence ahead for investors. Whether its lofty valuations, tentative economic outlooks, global trade worries, shifting monetary policy or a fractious political landscape, the markets' prospects over the next 12-18 months look unsettled. Several economic and market forces are influencing our thought patterns at TFA:

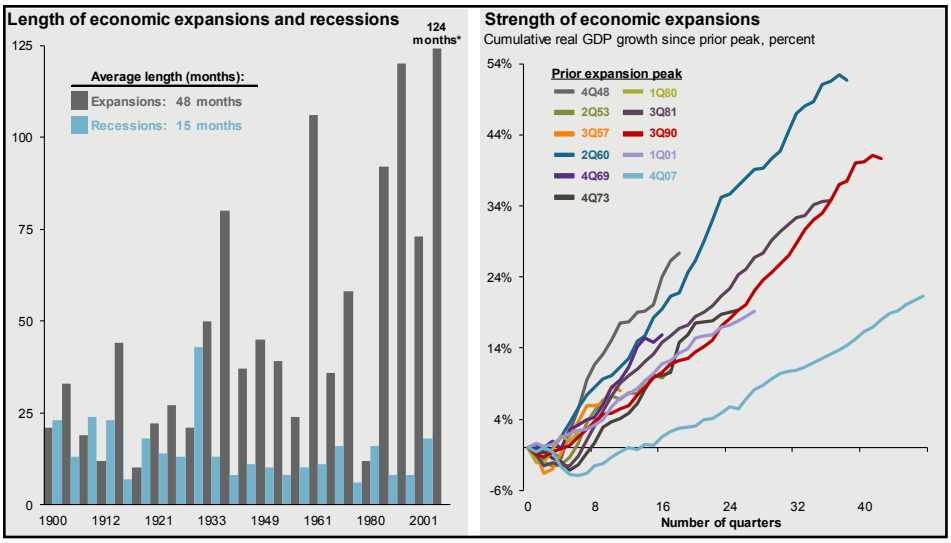
A Slowing Global Economy

Economic data has improved since the summer as equity markets move toward all-time highs. Corporate earnings announcements have generally outperformed, Brexit shows promise and US-China trade tensions have eased. Nonetheless, investors seem more wary about the downturn following the end of the bull market than they are in its prolonged run. Third quarter earnings results were ahead of expectations but forecasts for future growth were tempered for next year. Earnings results were also clearly skewing toward US-based companies as international exposures were under pressure. Global manufacturing has been contracting at the same time, especially in China and Europe. In a sign of good news, the pace of that contraction appears to have slowed, but it will take more than a couple months of positive factory output to reverse the trend. Consumers still drive economic growth worldwide, supporting a substantial percentage of the world's GDP. They can only hold the world up so long, though, before manufacturing needs to recover and lend support. Trade uncertainty remains high as two superpowers jockey for the upper hand. Whether it's to boost economic growth, garner better approval ratings or preserve an autocratic way of life, the effects of the US-China trade dispute have seeped into global distribution channels and negatively affected commerce.

Our outlook is for markets to remain range bound and for volatility to continue. Corporate earnings expectations may be overly optimistic and the risks for disappointments in 2020 are high. Additional progress on the trade front and/or improvement in the manufacturing sector could help the earnings outlook, but both of those trends appear a stretch at this time. While recession is on most forecasters' minds, we're not necessarily seeing one soon. Being increasingly aware of a market correction, though, keeps us focused on continuing to provide portfolio downside protection. And, even if a recession does occur (it's a lagging indicator, so we won't know it until we're in it), there's no guarantee it will persist nor be severe in magnitude before recovery starts. The cycles of Greed (Expansions) far outlast the cycles of Fear (Recessions).



Source: FactSet, NBER, Robert Shiller, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns. Past performance is not indicative of future returns.

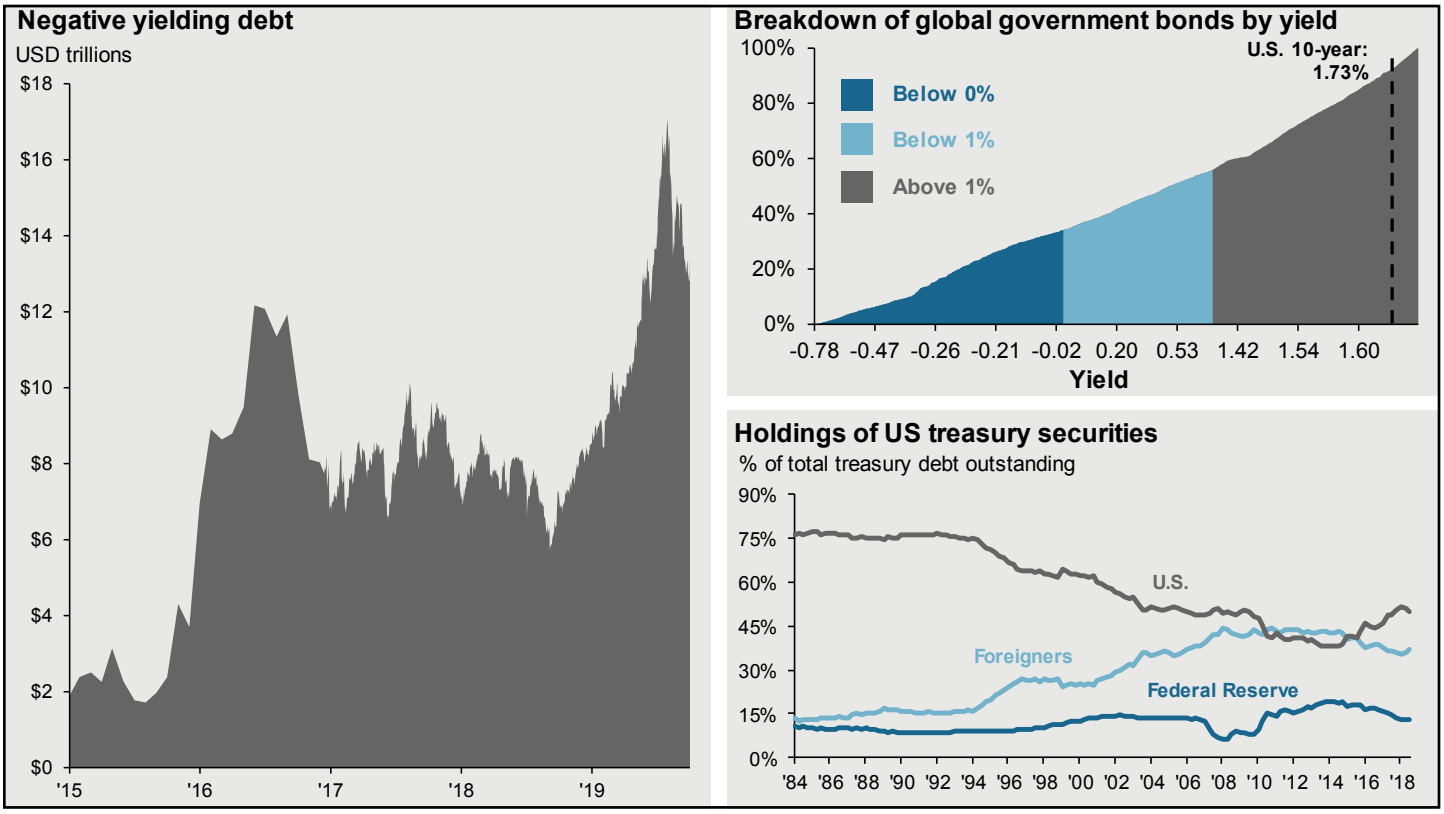


*Source: BEA, NBER, J.P. Morgan Asset Management. *Chart assumes current expansion started in July 2009 and continued through October 2019, lasting 124 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER).*

Ultra-low Interest Rates

Incredibly, almost one-third of all sovereign government bonds around the world are trading with negative interest rates. That means that investors are willing to pay high enough prices to guarantee losses on those bonds if held to maturity. Put another way, lenders are prepared to get back less than they give. That's a shocking concept when you stop to think about it. Banks are not structured to operate under such stress without severely impacting credit creation and short-circuiting economic growth.

In the past twelve months, US rates have sharply contracted and then abruptly risen. The 10-year Treasury was yielding 3.25% a year ago. After bottoming at 1.43%, it now stands at 1.82%. Why the roller coaster ride of sorts? Disappointing economic data and diminished expectations about future growth are the prime drivers. Trade war worries, a global manufacturing downturn, geopolitical uncertainties (Brexit, Hong Kong, Saudi Arabia and Syria), impeachment inquiries and Election 2020 are just some of the headlines causing fixed income market volatility. Global central banks, especially the Federal Reserve and the European Central Bank, are also helping to keep rates low, especially at the short end. While they are loading up on high quality issues for themselves as they "organically" grow their balance sheets again, there's less inventory for other investors to divvy up at a time when the perception of safety is paramount. This almost guarantees higher prices and lower yields.



Source: J.P. Morgan Asset Management, (Left) Bloomberg; (Top right) BofA/Merrill Lynch; (Bottom right) FactSet, Federal Reserve Board.

Rates may have fallen too far in the third quarter, but don't expect substantial changes to current conditions anytime soon. Negative rates will probably remain in some corners of the world. Here at home, the Fed may slow or pause its interest rate-cutting campaign and give the economy a chance to jumpstart itself. If growth doesn't materialize, more cuts may follow. At TFA, we prefer higher quality assets in fixed income given the still narrow credit spreads. US-denominated credit is favored compared to issues of foreign markets and exposure to high yield corporate debt has been tempered. Municipal bonds continue to be strong performers with rates decidedly positive.

All told, we don't anticipate making sweeping changes to our investment strategies. We have always maintained a slow and steady course of action and are decidedly the tortoise, not the hare, in the race to the financial finish line. That means that our normal investment protocol of preserving portfolio principal while growing capital responsibly is especially appropriate at this time. We are broadly neutral on equities, with a preference for domestic stocks. We favor the more defensive characteristics of large capitalization companies with their earnings consistency, free cash flow, wide competitive moats and perceived margin of safety. Dividend-paying companies seem especially attractive to us during a time when safety is a perceived benefit. Areas of the market that are interest rate sensitive and susceptible to trade-related supply chain disruptions are seen as less favorable at present. International investments are still sound long-term diversifiers, but are expected to remain under pressure for the time being. With interest rates apparently lower for longer, we're comfortable with some duration risk. Our preference for high quality credit endures, as fixed income allocations typically serve to dampen portfolio volatility for the majority of our equity-biased client portfolios.

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