

Contentious Summer Ends with Optimism & Caution

October 2019

My Dear Client:

The end of summer was filled with continuing rancor between the U.S and China, the U.K. its members of Parliament and the E.U., Federal Reserve policy direction among that organization's members, economists over short-term yields rising above long-term bond yields (the dreaded inverted yield curve), oh and Congress and the White House. Which of course meant that the U. S market paid attention nervously and then continued its rise.

Equity markets ended the quarter in mostly positive territory despite mixed economic data and a continuation of trade tensions. The S&P 500 outperformed international equities as the U.S. dollar strengthened even in the face of interest rate cuts by the Federal Reserve Bank. Investors also sought the safety of long-term bonds: The Bloomberg Barclays US Agg10+Yr rallied 6.6% in Q3, pushing its year-to-date return 20.9%.



The U.S. economy grew at a slow and steady rate of 2% in Q2. Weak exports and lower business investment weighed on growth, yet consumer spending had its strongest quarter in almost five years. With unemployment hovering at historic lows (3.7%), the U.S. consumer has been resilient this year although confidence has dropped recently – likely a result of China trade policy and domestic political rancor. Concerns remain about the strength of the economy, as the ISM US Manufacturing PMI Index slipped to its lowest level since 2009.

The Fed showed its commitment to addressing a possible slowdown by cutting rates twice this quarter, lowering its target rate to 1.75% to 2%. Fed board members are far from unanimous agreement regarding Chairmen Powell's policy direction: Seven of the 17 members believe that more cuts are not warranted. At the September 18th meeting, two members voted against what they saw as unneeded cuts and one voted against because he thought the cut was not big enough.

Despite cuts, the yield curve remained inverted, as the 3-month yield was still slightly above the yield on a 10-year bond, indicating a higher probability of recession. The divergence between signaling- *all is good, and all is not good*- amongst the various economic and business indicators tell us an inflection point is near or already here already.

Domestic Equity Market

Returns in the third quarter were mixed in equity markets. The broad U.S. equity market (as measured by the MSCI USA IMI Index) finished positive, up 1.09%. U.S. large-cap stocks (as measured by S&P 500 Index) posted a better gain, 1.7%. U.S. small caps were laggards, finishing at -2.4%. Within Large-Cap, Growth and Value performed roughly in line with each other. That wasn't the case for smaller companies. In Small- and Mid-Caps, Value outperformed Growth 3.6%

to 1.9%. Mid-Cap Growth continues to be the best-performing asset class this year, up 25.2% YTD.



U.S. equity sectors were decidedly defensive in Q3, with strong returns from Utilities (+9.3%) and Consumer Staples (+6.1%). Low interest rates also drove the rally in the Real Estate sector (+7.7%). Energy stocks bounced around, as did oil prices, and ended up being the worst-performing sector for the second quarter in a row with a decline of 6.3%. On the year, Information Technology remains the strongest performer, with a 31% return. Energy (-6.30%) was far and away the worst sector, reflecting concerns about slowing global growth and tensions between Saudi Arabia and Iran.

Immediately following Labor Day, Value and sectors such as Utilities, Staples, and Real Estate outpaced Growth and sectors such as IT for the first time in memory while the overall market was rising. This might be the early indicator of a change in leadership from Growth to Value, which would also be indicative of the ending of the bull cycle.

International Markets

Following the political debacle of 2Q, the British Parliament and Prime Minister continued their dust up, this time heading to the British High Court which ultimately sided with the Parliament and forced the Prime Minister back into negotiations for Brexit. This helped keep International developed markets down, as measured by the MSCI EAFE Index (net of taxes); they were -1.10 for the quarter. The combination of a strengthened U.S. dollar, daily gyrations of Chinese trade talks and slowing GDP in the world's second-largest economy sent Emerging markets (as measured by the MSCI Emerging Markets Index) falling 4.28% for the quarter.



Within International markets, Japan +3.12% was the strongest Developed and Taiwan (+5.24%) best of the Emerging. Hong Kong (down 12.1%), impacted by the ongoing protests against Chinese encroachment, and South Africa (down 12.63%), dealing with its own political and economic challenges, were the biggest decliners.

Bond Markets

With a mix of investor sentiment leaning towards quality and less risk in the quarter, the U.S. bond market as measured by the Bloomberg Barclays US Agg. Index was a positive 2.30% in Q3. In July, the Fed's rate cut and aggressive tone, along with rising global tensions, drove large demand for U.S. Treasuries and pushed rates down to 2016 levels.

The Bloomberg/Barclays US Agg. 10+Year bond yielded 1.66% at the close of the third quarter, a decline of 34 basis points from the prior period. Investors' eyes were further directed back to the 3-Month versus 10-year bond spread which remains (inverted) negative as it has been since March, with the 10-year minus .2% as compared with the 3-Month.



While the bigger ongoing story regarding fixed income continues to be that \$15 trillion of government bonds worldwide, or 25% of the total market, now trade at negative yields, according to Deutsche Bank. This number has nearly tripled since October 2018. Even banking CEOs like Jaime Dimon of JP Morgan Chase are becoming vocal critics about the unintended and potential perverse outcomes of investors functionally paying governments to hold their cash.

A Look Ahead

The canary in the coal mine could likely be the cash crunch that surfaced in September in the overnight Repo market, where banks go to borrow from each other. A spike in rates occurred while the Fed was *lowering* the Funds rate that this market is supposed to follow, leading the Fed to institute programs to maintain proper liquidity levels. These programs look very similar to the Quantitative Easing employed for nearly a decade post.



Now once again the Fed is using its balance sheet to make sure banks have enough reserves and an adequate amount of capital is flowing in the financial system. This effort also is aimed at keeping the Fed's own overnight funds rate within the 25-basis point range it employs.

"The repo market has been drugged into submission by the Fed," said Jim Bianco, the head of Bianco Research. "That's fine for a while. But what I am getting concerned about is that they're not figuring a way to get it off the drug and get it back to normal, and that will be a problem longer-term for them."

Similar to when last quarter I talked about– the increasing defaults in the leveraged loan market – this action within this area of the fixed-income market heightens my concerns about the underlying health of the economy. As is often the case when others claim *This time is different* or ignore signals like:

- the yield curve inversion;
- slowing of both GDP growth and U.S. corporate profit growth;
- the Purchasing Managers Index (PMI) below 50 for the first time since September 2009;
- the catastrophe of profitless or profit light IPO's such as Uber, Lyft and the delayed WeWork;
- and gold, long seen as comparable to the safety of U.S. Treasuries, rising in price.



Yes, the consumer continues to spend. Yet I leave you with a observation from the auto market, where the average price of a new American car is now a record \$36,718, where the average loan term exceeds 72 months and where sales of new cars ... are declining. These are all expressions of distortions created by cheap money available for too long and now approaching the point of diminishing return. So, while this is not panic time, attention now can prevent anxiety later.

I remain vigilant in monitoring markets for the cues to patterns that lead to trends that guide our allocation decisions. Rebalancing is never easy or comfortable, yet its long-term benefits are well-documented. The last quarter of 2019 and the first quarter of 2020 is the time to begin if you have not already. As Barron Rothschild is famously quoted to have said, "I made my fortune by selling early."

Maintain a focus on a risk-balanced, multi-asset class approach, and evaluate opportunities when larger short-term declines occur. My portfolio considerations remain consistent with the recommendations of the past few quarters, as the periods of high multi-year gains are very likely behind us.

Appreciatively,

A handwritten signature in black ink that reads 'Walid L. Petiri'. The signature is written in a cursive, flowing style.

Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, Edmunds.