**Ginsburg Financial Advisors, Inc.**
*Personal Financial Planning & Investment Management*
**Larry P. Ginsburg, CFP®** **Adele Ostomel, CFP®**

phone: **(510) 339-3933**
fax: (510) 339-1611
LGinsburg@GinsburgAdvisors.com
AOstomel@GinsburgAdvisors.com
www.ginsburgadvisors.com

# THIRD QUARTER 2019 MARKET RECAP

## "Fair Trade?"
## Tariffs are Ultimately a Cost to Consumers…
## How do we Navigate "Trade Wars," "Brexit," and Stock Market Volatility?

### What is the Prescription?

Those voices in your head reflect the 24-hour news cycle. Every headline, tweet, news feed blurb, etc. must be as provocative as possible for fear (double entendre) of not capturing the attention of any interested (or non-interested) party. We would not be surprised to learn there has been a meaningful increase in the number of prescriptions written for anxiety medications given the constant barrage of information related to deteriorating global trade conditions and rising geopolitical tensions. The key to dealing with all of this uncertainty, in lieu of obtaining a prescription for Xanax, is a thoughtful assessment of what these issues mean and the potential ramifications, if any, they may have on economic conditions and ultimately the financial markets.

The US stock market has delivered returns over the last ten years close to 40% per year above long-term averages. Given the multiple factors that include the global recession, the impending "Brexit" situation, the impact of tariffs and others, we are now recommending caution with regard to US and foreign (international) stocks. Below you will learn why we are recommending a more conservative approach to investing over the next few quarters. We are not suggesting that investors try to "time" the market. We think that it is prudent to protect gains and try to prevent large losses during what appears to be a confluence of events that can create increased risk. We recognize that continuing to employ a long-term strategy while making appropriate adjustments is a wise way to benefit from the growth the capital markets offer to investors.

This newsletter is longer than our normal quarterly communication about the financial markets. Our purpose is to give you additional information about what is happening in the financial markets to enable you to better understand our views.

### US Stocks Recap

The Standard & Poor's 500 Index ("S&P 500"), which measures the performance of the 500 largest publicly traded companies in the US, rose 2.3% during third quarter 2019 and increased 20.6% over the first nine months of 2019. Expectations associated with monetary policy easing in the US and abroad remained the key drivers of returns over the course of 2019. During the third quarter, the decline in the US Federal Reserve's ("Fed") target for short-term interest rates offset investor concerns over continued trade tensions, heightened political uncertainties, and slowing economic trends (particularly in US manufacturing). Considering the closing price of the S&P 500 on 9/30/19 is only 2.2% higher than the closing price for this index on 9/30/18, the year-to-date ("YTD") (through 9/30/19) return for US stocks can be considered more of a "bounce back" from the -20.2% peak-to-trough correction that occurred in 4Q 2018 rather than a true rally in US stocks.

Within the S&P 500, utilities (+9.3%), real estate (+7.7%), and consumer staples (+6.1%) led all sectors over the third quarter while energy (-6.3%), healthcare (-2.3%), and materials (-0.1%) were the sectors with the poorest results over this timeframe. YTD, technology (+31.4%), real estate (+29.7%), and utilities (+25.4%) led all sectors while healthcare (+5.6%), energy (+6.0%), and materials (+17.1%) were the laggards. During 3Q 2019, value stocks, or shares of defensively-oriented companies that generally have slower growth and higher dividend payouts, rose 2.8% while growth stocks, or shares of companies growing sales and profits faster than the broader market, increased 0.7%. During the first three quarters of 2019, growth nominally outperformed value, rising 21.1% versus +20.0%. After keeping pace with large cap stocks during the first half of 2019, the Russell 2500 Index, a measure of small and mid-cap stocks (i.e. companies with a market capitalization lower than $10 billion) declined 0.3% in 3Q 2019.

## International Stocks Recap

Foreign stocks, both international developed market and emerging market, underperformed US stocks during 3Q 2019 and over the first three quarters of 2019. The MSCI EAFE Index ("Europe, Australia-Asia, and Far East"), which measures the US dollar-denominated return of medium-to-large capitalization stocks in developed markets outside of the US and Canada, declined 1.1% during the third quarter while rising 12.8% YTD. On a local currency basis (i.e. not translating returns into US dollars), however, the MSCI EAFE Index increased 1.8% in 3Q 2019 and +15.7% YTD. Considering Europe, the United Kingdom ("UK"), and Japan account for 70-75% of the MSCI EAFE Index, the index's local currency return is heavily influenced by the euro and British pound sterling (the Japanese yen is pegged to the US dollar).

During the third quarter, the euro was negatively impacted by deteriorating economic trends in Europe, which weighed on the performance of the MSCI EAFE (US dollar) Index. Since exports represent 20% of euro area gross domestic product ("GDP"), versus 8% for the US, the region is disproportionately exposed to the slowdown in global trade. International developed market stock valuations were further impacted during the quarter by pound sterling weakness because of heightened uncertainty over the UK's inability to ratify a withdrawal plan ahead of its exit out of the European Union ("EU"), otherwise known as "Brexit," on 10/31/19. Without a deal in place, there is concern that the EU and UK may not be able to avoid the economically disruptive effects of a "disorderly" Brexit.

Developed international small-to-mid ("smid") cap stock returns outperformed their larger cap peers during the quarter. The MSCI EAFE SMID Cap (US dollar) Index declined 0.5% in 3Q 2019, bringing the YTD return for this index to +12.6% or roughly in line with the return for the MSCI

EAFE (US dollar) Index. Smid cap, developed international stocks did not lose as much as developed international large cap stocks in 3Q 2019 since their businesses tend to be less leveraged to the global trade environment. During the first three quarters of 2019, developed international stocks, both smid and large cap, benefited from the easing of central bank policy (or the expectation of easing financial conditions) in the EU, Korea, Australia, and New Zealand.

Emerging market stocks (countries with less than a $25,000 per capita income), as measured by the MSCI Emerging Markets USD Index, declined 4.3% (on a US dollar-denominated basis) in 3Q 2019. Emerging market stock performance continues to be heavily influenced by the results of Chinese stocks, which declined 3.8% (as measured by the MSCI All China USD Index) during the same period. The slump in Chinese stocks post the breakdown in trade negotiations between the U.S and China in May continued through the third quarter reducing the YTD return for Chinese stocks and emerging market stocks to +15.5% and +5.9% respectively.

## Real Assets and Alternatives Recap

The S&P Real Asset Index, which measures the results of physical assets including those that can produce relatively stable income streams, such as real estate and infrastructure assets, rose 1.2% during 3Q 2019 and was up 13.6% YTD. The decline in commodity and natural resource prices during the quarter in response to heightened global economic growth concerns was more than offset by higher demand for tangible, income-generating assets. The Dow Jones Global World Real Estate Index and the MSCI World Core Infrastructure Index rose 3.7% and 2.1%, respectively, during the third quarter due to higher demand for comparatively safe, income-generating assets that can be owned in place of lower yielding bonds. For the year ending 9/30/19, the Dow Jones Global World Real Estate Index and the MSCI World Core Infrastructure Index continued to outperform US and foreign stocks, rising 20.9% and 22.2%, respectively.

The Alerian US Midstream Energy Index, which measures the results of US companies that gather, process, transport, and store oil and gas, underperformed the broader global infrastructure index during the third quarter, dropping 3.7%. The decline in US midstream energy company valuations was driven by the 8.7% decline in oil prices during the quarter. During the first nine months of 2019, the Alerian US Midstream Energy Index was up 16.5% versus +13.0% for Brent Crude Oil.

The Wilshire Liquid Alternatives Index, which measures the returns of investment assets that have very low correlation (i.e. relationship) to traditional stocks and bonds (i.e. “alternatives”), increased 0.4% in 3Q 2019 and is up 5.0% YTD. Since alternatives historically provide single digit returns with bond-like volatility, they are viewed as an attractive alternative to owning more fixed income (bonds) or cash as means to lower overall portfolio volatility. Alternatives have also tended to outperform when stocks or bonds face challenging conditions. Since 1990, the average outperformance of alternatives in equity bear markets was 23% while the average outperformance in rising interest rate environments was 15%.

## US Fixed Income Recap

The Bloomberg Barclays US Aggregate Bond Index (“Barclays Agg”), a measure of high-quality US bonds of all types, rose 2.3% in 3Q 2019 and increased 8.5% over the first three quarters of 2019. During the third quarter, US investment grade bonds benefited from the Fed’s reduction in its target for overnight borrowing rates (i.e. the federal funds rate). This rate declined by 0.25% (one-quarter of 1% or 25 basis points {“bps”}), which caused the yields on the 3-month Treasury bill and the 10-year Treasury note to decline 24bps and 32bps, respectively (bond prices move inversely to their yields). Treasury bond returns were roughly in-line with the Barclays Agg during for 3Q 2019 and YTD, while investment grade corporate bonds continued to outperform all other investment grade bond sectors due to their relatively high correlation (i.e. relationship) to US stocks. The Bank of America Merrill Lynch US Corporate Bond Index increased 3.1% and 12.9% in 3Q 2019 and YTD, respectively, Mortgage-backed securities (“MBS”), as measured by the Bank of America Merrill Lynch US MBS Index, lagged the Barclays Agg in 3Q 2019 and YTD rising 1.4% and 5.8%, respectively. The drop in mortgage rates over the course of 2019 has served as a headwind to MBS returns due to the risk of increased principal repayments (as mortgage rates decline, borrowers refinance at lower rates thereby reducing the yield on new issuances of pooled mortgage instruments).

The S&P National Municipal Bond Index rose 1.6% in the third quarter and was up 6.8% during the first nine months of 2019. Third quarter muni returns benefited from the decline in Treasury bond yields, as the spread between Treasury and muni bonds remained relatively tight. Demand for muni bonds remained strong, especially from investors within high-tax states, like California, that were negatively impacted by the cap on state and local tax deductions. Net negative issuance (i.e. more bonds were called, retired, or matured versus new bonds issued) supported muni bond prices YTD, but this dynamic was less of a factor during 3Q 2019.

## International Fixed Income Recap

Outside of the US, the Bloomberg Barclays International Aggregate Bond USD Index, a measure of international developed market investment grade bonds of all types, declined (in US dollar terms) 0.6% in 3Q 2019 but was up 4.4% during the first nine months of 2019. Like international developed market equities, international developed bond returns were negatively impacted by adverse currency trends relative to the dollar, particularly in the third quarter. Local currency-denominated foreign government bonds, as measured by the Bloomberg Barclays Intermediate Foreign Local Government Index rose 3.1% in the third quarter and increased 6.2% YTD. Over the first nine months of 2019, both international, developed market investment grade corporate and sovereign bonds benefited from loosening of monetary conditions and the expectation of further monetary policy easing.

The JPMorgan GBI-EM Global Diversified Index, which measures the performance of USD-denominated debt of emerging market government and corporate issuers, declined 0.8% in 3Q 2019. During the quarter, investor sentiment towards emerging market currencies worsened as US-China trade tensions escalated. The surprise defeat of Argentina’s pro-business president in the first round of Argentina’s presidential elections also increased fears that the country’s financial crisis will spillover to other emerging market economies. The weakness in emerging market currencies offset the rally in local rates. Local bond rates benefited from the “dovish” pivot by the Fed and European Central Bank (“ECB”), which provided emerging market central banks cover to reduce their own policy rates. Removing the impact of currency movements, the JPMorgan GBI-EM Global Diversified Index increased 3.5% during 3Q 2019. Over the first three quarters of 2019, the JPMorgan GBI-EM Global Diversified Index rose 7.9% (in dollar terms).

## The “Grim Repo”

For the first time in over ten years, the Fed conducted an overnight repurchase operation during September in response to a dramatic spike in the overnight repurchase agreement (“repo”) rates. After this “intervention” was completed, the Fed added over $491 billion in cash liquidity to address the dislocation in the overnight credit funding market. So, what are repos and why was this event not indicative of a serious system-wide shortage of reserves like what occurred during the 2008 financial crisis?

A repo is an arrangement between banks and other financial intermediaries where the lending party receives high-quality US government bonds as collateral in exchange for loaning excess cash overnight to the borrowing party. The price at which the borrower agrees to repurchase its collateral is what determines the yield (repo rate) the lender earns on the overnight repo transaction. Repo rates tend to be closely pegged to the federal funds rate, which is the overnight rate the Fed charges to borrowing banks. The repo market is a vital part of the US financial system as it expands the supply of overnight liquidity beyond just federal funds lending. Repos allow the nation’s largest banks, money market funds, corporations, broker-dealers, etc. to generate higher returns on excess cash reserves while at the same time enabling these same entities to get needed financing by leveraging assets on their balance sheets.

Unlike 2008, US banks are now flush with excess reserves to the tune of $1.4 trillion thanks to quantitative easing (“QE”). QE was employed shortly after the start of the 2008 financial crisis and involved the Fed increasing its balance sheet to buy Treasury bonds and government MBS from banks. No money changed hands but rather the Fed “printed money” (essentially creating new money out of thin air) by issuing credit to bank reserve accounts held at the Fed as it purchased securities. The intention of QE was to stimulate the economy by shoring up bank reserves, raising asset prices, and lowering longer-term rates to encourage businesses to borrow. The Fed ended QE in October 2014 after accumulating $4.5 trillion of Treasury bond and MBS securities assets on its balance sheet.

If banks are flush with reserves, why did the Fed inject $491 billion of liquidity into the repo market? Blame it on quantitative tightening (“QT”) and a “perfect storm” of events. (QT is the reduction in the amount of Fed Treasury and MBS holdings by systematically selling, otherwise known as “tapering,” the amount of bonds it would purchase each quarter to zero over time). While the Fed was conducting QE, it did not have to execute overnight repurchase operations because it was continually injecting cash into bank reserve accounts. Even when the Fed started to “normalize” its balance sheet in October 2017 through QT, the effects on the repo market were inconspicuous due to the relatively slow pace at which the Fed administered this program. The net effect of the Fed’s normalization activities is that banks are still flush with reserves, but these reserves are comprised more of Treasuries and MBS versus cash. This means there is a lot more collateral in the market versus liquid cash prior to the start of QT.

A low probability “perfect storm” of events is what triggered the sharp increase in repo rates and the ensuing liquidity injection by the Fed. These events, which took place on the same day, include broker-dealers’ need for cash to purchase $54 billion of net new Treasury bonds issued by the Treasury as a result of Congress raising the US debt limit (Congress has raised the debt limit 22 times since 1997) and the drawdown of $30 billion of cash from institutional money market funds by corporations to pay quarterly taxes. While the above events and QT conspired to disrupt the repo market last month, it is not an indication that the US financial system is in jeopardy. It does highlight, however, in spite US banks being well-capitalized, repo market liquidity issues can arise now and then. This just means the Fed has to go back to more actively supporting the repo market rather than solely relying upon adjusting the interest it pays on excess reserves and the federal funds rate to manage repo rates, which had been its strategy since the start of QE. The Fed will unlikely go back to adding and subtracting aggregate system reserves to stabilize repo rates on a daily basis, like it used to prior to the 2008 financial crisis when the repo market was significantly larger, but it does mean it will need better anticipate future events that may lead to dislocation within the repo market. Fortunately, the Fed was very quick to address the spike in repo rates, and the ending of QT on 7/31/19 is expected to lead to less distortion of bank reserves going forward.

## Intensifying Trade Tensions Triggers Global Monetary Policy Easing

The US-China trade war as well as US tariff skirmishes with Europe, Korea, Canada, and Mexico have created a contractionary downturn in global trade and manufacturing. This downturn is set to worsen should US tariffs on China increase on December 15 or the Trump administration decides to impose tariffs on European auto imports by November 11. Diminishing expectations of a US-China compromise prior to the US presidential elections next year could also prolong the uncertainty over the outlook for trade. Uncertainty over future US trade policy has already impacted business confidence and caused a slowdown in capital expenditures, which has further weighed on global trade and manufacturing activity.

Since global inflation remains subdued, major central banks, such as the Fed and ECB, have shifted their stance from a desire to normalize monetary policy (i.e. raise interest rates from historically low levels and reduce balance sheet holdings of bonds purchased during QE) to a desire to support economic growth. The Fed has already cut short-term interest rates by 50bps this year, and the financial markets assign a 95.3% probability that short-term rates will fall by at least another 25bps by the end of 2019 (per the CME Group FedWatch Tool). Meanwhile, the ECB cut rates deeper into negative territory and resumed QT, which it had only recently concluded at the end of 2018, and the Bank of Japan (“BoJ”) maintains its easy monetary policy stance. In the emerging markets, the People’s Bank of China (“PBoC”) further reduced its reserve requirement ratio and introduced the loan prime rate to facilitate bank lending. Many other major emerging market central banks also cut rates, such as India, Brazil, Mexico, and Korea.

Renewed monetary policy easing around the world means that the overall interest rate environment will remain low. It also means the global supply of negative-yielding bonds, which currently stands at $17 trillion, or 25% of global investment grade bonds tracked by the Bloomberg Barclays Global Aggregate Bond Index, will likely increase. Continued uncertainty over the global trade and manufacturing activity will further drive investment grade bond yields lower as investors seek to protect principal should economic conditions continue to deteriorate. As the supply of positive yielding investment grade debt declines, investment grade bonds with positive yields, which tend to be longer maturity bonds, will command a premium. Non-bond assets that provide a stable source of income will also see higher demand (e.g. dividend paying stocks, infrastructure assets). Investors chasing higher yields may also feel compelled to take on higher credit risk (i.e. the risk of the bond issuer defaulting on its payments) by purchasing non-investment grade bonds or bond sectors that have a high relationship to stocks, such as non-investment grade (high yield) bonds and convertible bonds, a strategy we are not in favor of at this point in the US business cycle.

## Potential for US Recession Risk has Increased

A more accommodative monetary policy environment globally provides the potential for higher asset prices, but it may not be enough to counteract further deterioration in global economic growth due to a potential for increased tariff activity between the US and its trading partners. The strategists we speak with believe countries most leveraged to global trade, such as Europe and Japan, will also need to pursue fiscal stimulus to prop up their respective economies. Countries, like the US, that derive a predominate amount of GDP from internal consumption, however, are most insulated from a contraction in global trade and manufacturing trends.

Our market strategist contacts also expect that a US-China trade deal or even a détente (halt in further tariff activity) would help to improve business sentiment. Without such agreements, however, business optimism among corporate executives is expected to languish and could ultimately start to impact US consumer confidence should, for example, US companies decide to moderate pay increases or implement hiring freezes. We will continue to monitor for adverse changes to the trend in key indicators, such as weekly jobless claims, job offers, wage growth, consumer confidence, and consumer spending, to provide insight into the health of the US consumer and its propensity to spend in the future.

As noted above, consumption is the largest component of US economic output, accounting for 68% of GDP. The consumer dwarfs other components of GDP, which include housing (3.7%), investment ex-housing (13.9%), government spending (17.5%), and net exports (-3.1%) (the US imports more than it exports). Gauging the health of the US consumer is not only important for determining if weak business sentiment is spilling over to the consumer, but it helps to determine where the US is in its business cycle. Like most major developed market economies, the US is firmly set in the late phase of its business cycle, as evidenced by tight labor markets, slowing corporate earnings growth, and an inverted yield curve (i.e. 3-month Treasury bill rates are higher than 10-year Treasury bond rates.). Consumer confidence, a measure of US consumers' propensity to spend in the future, tends to be a key leading indicator of a recession given the importance of consumption to the US economy. Historically, this economic indicator experiences a precipitous decline in the months leading up to a start of a recession, and recessions typically occur just prior to or at the beginning of structural bear markets in stocks. A structural bear market is when an index, such as the S&P 500, declines 20% or more in value over a period of at least 12 months.

US consumer trends are still in very good shape, and a trade truce is expected to elongate the current business cycle thus pushing out the timing of the next recession. While the consensus view among our strategy consultants is that the US will not fall into a recession over the next 12-24 months, the probability of a recession occurring within this timeframe has increased given the potential for a continued escalation in US-China trade tensions. If implemented, the next round of US tariffs on China are expected to bite into consumer spending trends because they will involve consumer products, namely mobile technology devices (mobile phones, laptops, and tablets) and toys, which have not yet been hit with US import duties. Higher US consumer prices coupled with further weakening in business sentiment and heightened political uncertainty, especially related to the Trump impeachment inquiry and the 2020 presidential elections, could conspire to push consumer confidence lower ultimately leading to a contraction in US economic activity.

## Outlook for US Stocks

We expect heightened stock market volatility over the remainder of 2019 due to multiple trade-related and geopolitical events set to occur by year-end. On the trade side, the US and China recently announced their intention to negotiate "phase 1" of a US-China trade deal, which temporarily halted further escalation in trade tariffs that were set to occur on October 15. Knowing that they could be negotiating with a new administration next year, Chinese representatives are not incentivized to strike a grand bargain with their US counterparts let alone provide major concessions during their "phase 1" discussions with the US. President Trump is also motivated to maintain a hardline stance towards China to maintain the support of his core voting constituency ahead of the presidential elections next November.

Meanwhile, the US is set to impose a 25% tariff on European automobiles and auto parts if there is no progress made on increasing US auto exports into the EU (among other US trade demands). The ramifications of these tariffs going into effect are large when considering global auto trade accounts for 8% of total trade and the US accounts for 29% of total EU auto exports (the EU accounts for 19% of total US auto exports). The US equity market will more meaningfully discount the probability of a recession occurring over the next year if there is lack of meaningful progress towards a trade deal and if more trade tariffs take effect. This discount will manifest in a downward adjustment to the market price/earnings ("P/E") multiple or the price the market is willing to pay for a dollar of expected S&P 500 earnings over the next twelve months.

In addition to the US-China trade war and European auto tariffs, US investors will have to deal with the fallout, and associated market volatility from the potential impeachment of Donald Trump or any incriminating information coming out of the impeachment inquiry that would cause investors to question the stability of the US government. A "no deal" Brexit will also weigh on investor sentiment over "contagion" concerns that any dislocation in international markets as a result of the UK being unable (or unwilling) to negotiate yet another Brexit extension. The US, Mexico, and Canada also have yet to consummate the USMCA, otherwise known as "NAFTA 2.0."

The US economy remains on solid footing, which normally provides a positive backdrop for US stocks. Unfortunately, a worsening of global trade conditions and heightened geopolitical risk could meaningfully impact expectations about the economy and US stock prices over the next few months. Fortunately, we have already taken steps to reduce exposure to US stocks as we have generally maintained US stock exposure at roughly half the levels we would typically recommend earlier in a business cycle. We have also reduced exposure to more volatile smid cap US stocks in favor overweighting the shares of more stable large cap companies. Within large cap, for most clients we are maintaining balanced exposure to growth and value companies. By not over-emphasizing either of these styles, the potential for increased volatility is reduced if either growth or value stocks fall out of favor. The underlying managers we use to gain exposure to large cap US stocks further reduce volatility by owning quality companies with strong financials, favorable growth prospects, and reasonable valuations. For clients whose weightings have meaningfully deviated from their tactical targets for US equities, we will consider reducing exposure and reallocating this money into less volatile asset classes.

## Outlook for International Stocks

We maintain our favorable view of international developed market stocks given their cheap valuations relative to US stocks, but we are concerned that investor appetite for these assets will not materialize until after there is better visibility into the outlook for global trade, manufacturing activity, and economic growth. The EU cannot rely upon monetary policy alone to fully stave off weakening economic trends, but large debt-to-GDP levels have resulted in a disincentive for euro area governments wanting to issue more debt to finance fiscal stimulus programs. Germany, the world's fourth largest economy, has the capacity to stimulate its manufacturing-based export economy, but self-imposed deficit rules limit any meaningful amounts of debt it is willing to issue. German politicians may also be waiting to pull the trigger on a large-scale fiscal stimulus program to offset the impact of US auto tariffs (if imposed), especially since their economy is on the verge of a recession.

Investor sentiment towards international developed market stocks may weaken further if the European Union ("EU") does not grant approval of the UK's request to delay Brexit to 1/31/20 or if the UK is unable to ratify the EU Withdrawal Bill, recently negotiated between Prime Minister Boris Johnson and the EU. There is also the possibility the EU approves the UK's request for a Brexit delay, but only grants a 2-4 week reprieve. This increases the risk of a "no deal" Brexit given the lack of time for the UK parliament to vet the proposed withdrawal agreement. Even if the EU were to grant the 1/31/20 extension, there is the likely prospect for a snap general election and/or a vote of no-confidence. Both of these events raise the risk of further delaying a vote in favor of the EU Withdrawal Bill and a potential "no deal" Brexit.

We maintain our view that a "no deal" will likely culminate in the pursuit of a deal from a different starting point. After the dust settles, we expect Brexit to ultimately serve as potential catalyst for renewed interest in international developed market stocks. Investors will then have greater visibility into how the Brexit process will ultimately proceed. However, as part of our desire to reduce downside risk to client portfolio returns over the coming months, we will evaluate client international developed market holdings to determine if a reduction in exposure is warranted. Any reduction made to these assets will be reinvested back into less volatile assets until we have more confidence in the stability of equity returns going forward.

Emerging market stocks provide one of the most compelling investment opportunities over the long-term, but at the expense of much higher volatility compared to US and international developed market stocks. Reducing client holdings in emerging markets stocks, and also reducing direct investments in emerging markets smid cap stocks, makes sense given what we believe will much more turbulent equity markets over the remainder of this year and into 2020. We prefer to maintain a tactical emphasis on China and other Asian-Pacific stocks leveraged to China. While China remains embroiled in a trade war with the US, the central government has instituted a number of targeted fiscal and monetary stimulus programs over the course of the past twelve months. These measures have helped to offset declining manufacturing activity as result of US tariffs. Like the US, China has become a predominately consumption-based economy, and the trend in China consumer confidence readings has not shown any discernable breakout to the downside as a result of the US-China trade war. China is also further along in its business cycle as compared to the US. Specifically, the contraction phase of its business cycle appears to have bottomed out, which is typically when investor sentiment begins to improve in anticipation of the economy entering the beginning (early) phase of a new expansion cycle.

## Outlook for Real Assets, Tactical Opportunities, and Alternatives

Generally, we are reducing exposure to real asset positions to help reduce equity risk over the coming months. Within real assets, we are focusing on reducing exposure to real estate given the sector's exceptionally strong performance YTD and the potential that appreciation will slow as rent affordability declines. We are not eliminating exposure to real estate, due to its defensive attributes (relatively stable income streams that provide a hedge against an unanticipated spike in inflation expectations), but we think it is prudent to lock in some gains that can be redeployed into assets with lower correlation to the fluctuation in stock prices.

For most clients we are maintaining positions within midstream energy infrastructure assets. In addition to the valuation support provided by a 6%+ average yield, industry fundamentals remain strong. The continued buildout of the US pipeline/storage network supports a steady rise in oil/gas volumes, which in turns provides support to distributable cash flows to investors. Improved corporate governance and simplification of shareholder ownership structures within the master limited partnership ("MLP") subset of the midstream energy space has increased the appeal of these assets to a broader investor base. While the drone attacks on Saudi oil facilities last month are unfortunate and adds yet another source of geopolitical risk for the equity markets, they highlight the strategic importance of US shale in diversifying the global energy supply. The increase "drone warfare" on Middle East oil fields could potentially help fast track remaining North American pipeline permits thus pulling forward more oil/gas throughput and the potential for higher cash distributions to investors.

Generally, we continue to support a tactical emphasis on healthcare and consumer staples sector stocks. Since a large portion of companies within these industries sell "essential" products and services, they provide the opportunity to lower the overall sensitivity of client stock holdings to cyclical changes in the business cycle. Healthcare stocks are especially attractive given the YTD underperformance of this sector relative to the MSCI All Country World Index, a measure of global large cap companies. We continue to view universal health care coverage in the US as highly unlikely, especially in a gridlocked Congress. Furthermore, universal healthcare is not economically feasible as it is estimated to cost the US government $3 to 4 trillion to support.

We are generally reducing client holdings to technology/communication services while adjusting the mix of assets owned within these industries to include more higher yielding, less cyclical telecommunication stocks. The substantial outperformance of the technology sector relative to global large cap stocks YTD, provides an ideal opportunity to lock-in gains while decreasing the sensitivity of our client stock holdings to a downturn in economic conditions. We continue to advocate maintaining an emphasis, albeit lower, to the technology sector as a means to gain exposure to the major secular growth opportunities within technology, including 5G, big data, internet of things ("IOT"), machine learning, and artificial intelligence

We plan to reduce exposure to alternative assets and strategies ("alternatives") for clients whose weightings are meaningfully above their recommended strategic targets. Alternatives remain an important portfolio "diversifier" due to their relatively low relationship to traditional stocks and bonds over market cycles, but given our views on global interest rates, our clients will be better served rotating excess exposures to investment grade bonds over the coming months. We are comfortable with our clients assuming more interest rate risk given the global shift toward lower monetary policy rates. We will look to increase our clients' alternative asset holdings should macroeconomic growth trends begin to stabilize or if our view on the trajectory of interest rates meaningfully change.

## Outlook for Fixed Income

We are generally increasing weightings in investment grade bonds (i.e. "core bonds") to reduce portfolio volatility and downside risk over the remainder of this year. We will look to add to existing US core bond strategies that own diversified mixes of predominately investment grade bonds. US investment grade bonds tend to have higher yields, thus potential for higher principal appreciation, as compared to other international investment grade bond markets. The US core bond investments we use tend to have low-to-negative correlation to stocks thereby providing a ballast to portfolio returns should stock prices experience a correction within the next few months.

Within US core bonds we continue to avoid direct investments in corporate bonds since the US and most other international developed markets are in the late phases of their respective business cycle (typically the late phase of a business cycle ends with deteriorating credit conditions and higher bond default rates). We maintain an emphasis on domestic mortgage backed securities given the relatively healthy backdrop within the US real estate market. While these bonds have underperformed the broader investment grade bond space YTD, they have low sensitivity to interest rates due to their "floating" rate structures, which provides a hedge to bond investments should interest rates rise unexpectedly. We also continue to advocate holding a diversified mix of municipal bonds for clients in higher tax brackets.

We are maintaining US dollar-hedged international developed market investment grade bond weightings for clients that own these assets. These bonds help to further diversify the sensitivity of fixed income investments to US interest rate movements and credit conditions while offering lower-correlated return streams. Generally, these bonds have lower overall yields as compared to US investment grade bonds, but their relatively steep yield curves (the longer the maturity of a bond, the higher the yield), especially within Europe, provide attractive "roll-down" opportunities (the interest rate of longer maturity bonds decrease, while price increase, as they get closer to maturity). Exposure to emerging market bonds is still beneficial to many clients, as this asset class is one of the few areas within fixed income to offer attractive long-term, risk-adjusted, return opportunities supported by robust secular tailwinds.

## What Does This Mean for Your Portfolio?

The 24-hour news cycle means there is no escape from the constant barrage of macroeconomic issues and geopolitical events dominating the headlines. The US-China trade war, a “no-deal” Brexit, impeachment inquiries, inverted yield curve, drone strikes on Saudi Arabian oil fields, US withdrawal from Syria…..even the staunchest “bulls” (i.e. investors with the most positive outlook for the financial markets) may be pushed to consider medications to ease their anxiety.

We are becoming more cautious about the equity markets over the remainder of 2019 and into 2020. Numerous trade-related events are set to occur over the next three months that have the potential to increase the perceived risk of a US recession occurring over the next twelve months. Heightened geopolitical tensions will also weigh on investor sentiment towards stocks as appetite to take on more risk diminishes.

While we customize each of our client portfolio recommendations, we generally recommend caution at this stage of the decade long economic expansion here in the US. Normally we would be encouraged to increase equity allocation outside the US but multiple signs suggest caution would be wise during the near term.

Please be sure to let us know if you have any questions about your portfolio that are not addressed in your consolidated Quarterly Portfolio Report (QPR) and our recommendations.

We invite you to visit our new website at www.ginsburgadvisors.com. Here you will learn more about our services, value proposition, and our team. The site also has a useful “Resources” section where you can access our previous market commentaries, watch informative videos, download our latest staff contact list, and access useful financial calculators and web links. Please be sure to check the site periodically as we will be updating the functionality of the site to include a client portal and other useful applications.

As always, please contact us if you have any questions or concerns about your investment portfolio. We welcome the opportunity to discuss your goals and the most appropriate strategy to attain them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.

*This information is compiled by Ginsburg Financial Advisors.*

*Unless otherwise noted, financial data are as of September 30, 2019*

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