Weekly Capital Market Comments

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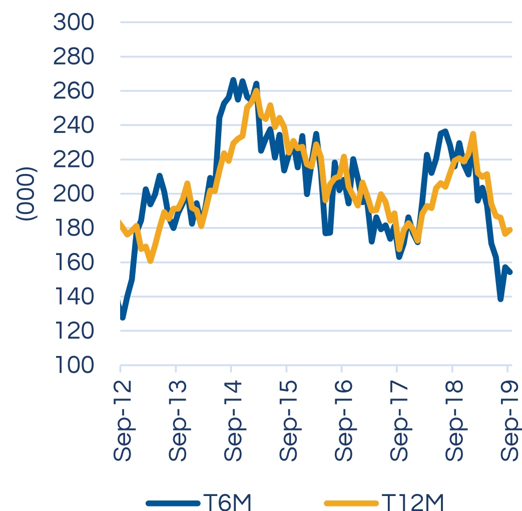
NORTHEAST SEQUOIA
PRIVATE CLIENT GROUP

Hope Is Not A Plan

Over the last several days, US capital markets encountered a flurry of bad economic news. On Monday, the Chicago PMI printed at 47.1, the second-lowest reading since December 2017, and well below the consensus of 50.1. On Tuesday, the ISM Manufacturing Survey printed at 47.8, the second straight reading below 50, and the lowest reading since December 2015. On Wednesday, the ADP Employment Survey showed that the US added 135,000 jobs in September, 5,000 below the consensus expectation, while August's reading was revised down by 38,000 to 157,000. Then, on Thursday, Initial Claims exhibited a modest uptick to 219,000 versus expectations of 215,000; while at the same time, the ISM Non-Manufacturing Survey printed at 52.6 (with the Employment Index slipping to 50.4 from 53.1 one month earlier), below the consensus expectation of 55.1, and the prior month's print of 56.4. Across the pond, things are not that much better. The Eurozone Manufacturing PMI is below 50, while German Manufacturing PMI is close to 40 (remember, readings above 50 suggest expansion, while readings below 50 indicate contraction). German consumers are waning, and Italy's GDP is expected to be close to flat for 2019, driving its debt/GDP ratio to about 132%, the second-highest in the Eurozone. Let's not forget about BREXIT; that clock is ticking with less than a month to get sorted out, and still relatively little chance of a smooth and orderly deal that includes an Irish Backstop. Moreover, if a Chinese trade war wasn't enough, reports are circulating the US will undoubtedly impose tariffs of up to 10% on European goods (from illegal aircraft subsidies to French wine, Scottish whiskeys, German tools, and British woolens). Now today, the September Non-Farm Payroll (NFP) report printed at 136,000, compared to the consensus of 145,000. While there were modest upward revisions to prior months, the 6-month and 12-month average moved to roughly 154,000 and 178,900, respectively, reinforcing a relatively stable, but declining trend. Still, today's report had something for Bulls and Bears alike. First, a 136,000 monthly print helps stave off any immediate recession concerns, and the Unemployment Rate did drop to 3.5%. Further, according to the Atlanta Fed's Job Calculator, to push the unemployment rate back to close to 4% over the next 12-months, the US labor market needs to grow at only 68,000 per month, suggesting a significant by attainable measure of job creation. So what are investors and clients to do with all this information?



Source: NEPCG and FactSet

Even before today's NFP report, US equities began to price in additional and more significant rates cuts by the Fed, to help resuscitate a slowing economy. About a half-hour after the open on Thursday, the S&P 500 bottomed at 2,855; then staged a 55pt (+1.9%) rally, to close the session at almost 2,911. We speculated that much if not all this rebound was fueled by hopes that the Federal Reserve would step in, providing additional stimulus via rate

cuts in **both** October (now 90 probability of a 25bps cut) and then again at the December 2019 meeting. In aggregate, this would bring the overnight lending rate down to 1.5%.

Now here is the rub; what happens if the Fed doesn't meet Mr. Market's expectations? What if the case emerges, that while the US economy is slowing, the FOMC shows restraint and prudence; saving the bluntest tool they have for a time when they really need it? Because as we pointed out above, even if job growth slows to about 65,000 per month, unemployment only moves to about 4.0% (1.75% below the long-term average of 5.75%). Alternatively, will it be too late by then? We have written on this topic extensively over the past 12 months (see, "*One And Done? Look Out Below*," August 30, 2019; "*The First Cut Is The Deepest*," July 19, 2019; "*Be Careful What You Wish For*," March 19, 2019; and "*Wait A Fed Minute, I Thought Things Were Good*," February 22, 2019), and our position remains unchanged. **We continue to believe the Fed is in a no-win situation.** If the Fed skips a rate cut at the upcoming October FOMC meeting, equity markets will sell off; and if they cut by another 25 bps (bringing the Fed Funds rate to 1.75%), markets and market pundits will suggest that Chairman Powell's "mid-cycle adjustment" is really the beginning of a rate-cutting cycle. So back to our last question, "what do investors do with these apparent and unavoidable and binary outcomes?"

Well, hope is not a plan or strategy. Therefore, we continue to recommend investors to de-risk; but this means different things to different individuals. For investors with taxable accounts, and short-term liabilities or goals, we believe that cash is king. Further, taxable accounts with long-term commitments or goals should also de-risk, but sitting in cash is not the answer. In our opinion, equity exposure for taxable accounts should, in most cases, be reduced by 20-30% in the near-term. For example, a 70/30 (equity/debt) portfolio should consider a shift down to a 50/50 position; and if an account is already conservative, given a lower risk tolerance, a 50/50 portfolio should consider a downshift to a 40/60 portfolio allocation. Retirement accounts with horizons of less than 10 years, should also consider to reduce risk exposure by at least 20% in the near-term; while retirement goals in excess of 10 years can take on a bit more risk, hedging against any upside surprises in trade-war rhetoric, better than expected economic trends or any positive resolution to any number of geopolitical headwinds we currently face. However, reallocating across asset classes and styles is also vital. In our view, growth and duration should be avoided in the near-term, unless balance sheets are solid and credit is sound. However, as with most things, everybody and every situation is different. Give us a call to discuss your specific solution.

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