Economic & Market Commentary

Financial assets grudgingly moved higher during the third quarter. Equities, as measured by most indices, increased 1%-2%, except for small capitalization stocks which posted negative returns. The widely followed S&P 500 index produced a 1.7% total return, which was below each of the prior two quarters, resulting in a return of just over 20% for the nine months. It was a better period for equities than had been expected at the start of 2019, when a survey taken by the American Association of Individual Investors showed that only 25% of the respondents thought stocks would be up in six months. The pace of returns through the quarter was uneven, reflecting increasing uncertainty about the path of the U.S. economy, as well as concerns about domestic and international political risks. Returns alternated (positive-negative-positive) for the three months, reflecting a "glass half empty, glass half full" point of view, depending on the data reported and the prominence of the other risks. Interest rates continued their decline as the 10 year Treasury, which started the quarter at 2.00% ended at 1.69%, resulting in bond returns besting equity returns across most of the yield curve.

The character of the equity market has begun to show signs of change in recent months. Growth, which has been the dominant investment style for most of the past decade, has shown some signs of tiring and value, which has been a deep laggard, has shown some signs of revitalization. This has happened several times before, but inevitably reversed course, which has led to a ten year period of relative underperformance for value investors. Is this time different? We hope so! Along with value showing renewed signs of life, the breadth of the equity market improved over the period, five of the eleven S&P sectors outperformed the composite for the quarter, and six did so for the nine months. The defensive sectors, utilities and consumer staples, were stand-outs for the quarter, followed by information technology and financials. Year-to-date, industrials and consumer discretionary were also noteworthy contributors. The FAANGs (Facebook, Apple, Amazon, Netflix, Google) which have been so dominant in recent years lost some of their momentum in both the quarter and year-to-date. Only three of the FAANGs beat the index in both periods, and three were negative for the quarter.

Growth and momentum have been the dominant forces determining equity returns for the better part of the past decade. Over that time period, the Russell growth stock index has beaten the Russell value stock index by over 3% per year. A stunning difference for an unusually lengthy period, making life difficult for value investors as they have struggled during this decade long drought. While we don't consider ourselves to be deep value investors, our "Growth at a Reasonable Price" style clearly tilts in the value direction. Our investment philosophy strongly believes that what you pay for an asset plays a central role in the return you will achieve. Whether you reason a priori or a posteriori, valuation matters! Value investing traditionally has been defined as owning stocks that are priced low in relation to various financial metrics: book value, earnings, dividends, etc. In the world we invest in today, some of these metrics need to be revisited and we have made changes to our investment process to account for the impact of globalization, technology and the development of emerging economies on companies.

The U.S. economy has become a service-dominated economy and "bricks and mortar" (book value) matters less to service-oriented businesses than typical manufacturing businesses. Today's service companies tend to be more involved with technology and therefore intellectual property. Unlike other businesses which have permanent assets, the assets of today's service businesses walk out the door every night, and their balance sheets contain more "soft" assets such as goodwill and other intangibles. So, while net assets (book value) may be less important than in the past, earnings and cash flow still matter. After all, the reason one owns an investment is to earn a competitive return. With stocks that means participating in a growing stream of earnings and cash flow over a period of time. In general, there are two things that determine the value of a stock. First, the economic fundamentals that affect a company and the earnings and cash flow it can produce compared to what an investor can earn elsewhere (say a risk-free Treasury bond). Second, are the psychological factors which can positively or negatively impact the valuation investors attach to a company's underlying fundamentals. We find it easier studying and analyzing the economic fundamentals than anticipating the psychology of what will be in fashion in the future. The extended period of growth and momentum outperformance has encouraged some investors to pay excessive valuations on partially or unproven company concepts, most of which are likely to disappoint over time. We believe the market's shift to more value-oriented stocks provides us with a comparative advantage and should help client portfolios outperform over time.

On the macro front, pundits are presenting a confused picture of the U.S. economic outlook. We are hearing a lot of "on the one hand and on the other hand" from forecasters. Earlier in the month, the Institute for Supply Management (ISM) issued their monthly survey of 400 purchasing managers which provides an indication whether the economy is growing faster or slower than the prior month. The latest report pointed to a marked slowing of manufacturing activity for a second consecutive month. Economists view this metric as being a useful leading indicator of the future direction of the economy. Investors interpreted the release negatively and took more than 4% off the S&P 500 over the following 2 days. The ISM survey was followed by the release of the September jobs report, which was positive, and resulted in the S&P 500 increasing about 3%. This speaks to the skittishness of investors regarding the risks of an economic downturn. This confusion obviously increases the volatility in both the bond and stock markets.

We have been in the 2% real GDP growth camp for a long time and are inclined to remain. The U.S. economy is more domestically oriented than most of our global counterparts and, while global slowing is a reality, our economy has been able to withstand significant negative trends abroad. The Chinese trade issue will no doubt have a negative impact on us, (and probably did in the latest ISM report), and that will be accentuated by other tariff issues that may arise (i.e. the European Union). A recent visit by a Chinese delegation to the U.S. appears to have advanced trade negotiations. Whether anything of substance is ultimately contracted is yet to be seen. Most observers don't expect much other than a continuation of "kicking the can down the road". In the U.S., consumer spending (70% of our economy) has been the driver of economic growth. Consumers are spending, savings are more than adequate, and wages are growing modestly.

Business spending has been less than robust, and housing has been sufficiently strong to keep our overall growth in the 2% area. The pundits view of the third quarter is for growth just below 2%, after a strong first half. Forecasts for the final quarter are up in the air. A final round of tariffs on remaining Chinese imports is scheduled to begin in December, and the World Trade Organization has given its blessing on a series of tariffs on goods from the European Union (yes you may soon be paying 25% more for your next bottle of French Burgundy). These, of course, are an added tax on the U.S. consumer. If these, and other forces, result in a negative change in consumer sentiment, which leads to a slowdown in consumer spending, it would not be a good outcome. We, therefore, must watch consumer behavior closely to determine if a change in our viewpoint is called for.

As far as the stock market is concerned, clients are having a good 2019, with most measures of performance up in the high teens to low-20% through the nine months. However, it should be noted that the level of the market (S&P 500) is about where it was a year ago, just before the large downdraft in the final quarter of 2018. Most of this year's gain has come from an expansion in the price/earnings ratio (a psychological factor), not from earnings growth (a fundamental factor), which has been lackluster. As a result, stocks (S&P 500) are being valued at more than 18x current year's earnings. This is not exactly a compelling value, and as we have mentioned before is only "cheap" when compared to interest rates, which most believe are too low. As usual, when we write our quarterly outlook, we are in earnings reporting season. The expectation is for lackluster reports. Factset (a financial monitoring service) estimates aggregate S&P 500 earnings will be down 4%, as results are clouded by impacts from tariffs, global slowing, a strong dollar, wages and other cost increases as well as the adverse geopolitical environment. None of this inspires great confidence; however, we are more optimistic than the consensus and believe earnings results will come in ahead of expectations.

For some time, we have written about the well-known geopolitical risks on the horizon. In addition to China, Iran, North Korea, Brexit, and the mercurial nature of the current administration, we have added the increased potential of a trade war, impeachment, and a Presidential election next year. These are all potentially disruptive and, in our view, more in the forefront than six months ago. We have felt for some time that investors have become inured to these risks, and instead focused on the massive amount of global liquidity that has been sloshing around for the past decade. This leads to the belief that when an economic problem arises, the Federal Reserve and other central banks will come to the rescue providing more liquidity. Basically, the availability of liquidity searching for return has "trumped" the many risks. If this liquidity were to diminish, investors could well refocus on the seriousness of these many risks, which in turn could be negative for financial assets. For the past several periods, we have acceded to the dominance of liquidity in the equation, which has been the appropriate position given the results. With risks more heightened, however, it may be timely to revisit the premise. Our analysis, and discussions with economic consultants, lead us to conclude that liquidity will remain amply available for the near-term. After all, (according to JP Morgan) 16 central banks have reduced interest rates in the third quarter, and 24 are expected to do so in the fourth. Our

Federal Reserve is expected to reduce interest rates further into 2020, and also begin to again expand its balance sheet (adding reserves to the banking system). So, we conclude that we should remain invested at this time, particularly since what we own still has significant unrealized value. We think the markets can grudgingly grind higher, with increased volatility (witness the beginning of October). The risks we have mentioned are in the front of our mind, and we will watch for any changes in liquidity or in the real economy to determine if a change in direction is called for.

Fixed Income

As noted earlier, returns for U.S. fixed income securities were relatively strong for the third quarter. Interest rates continued to fall across the entire yield curve, which drove bond prices higher and fueled the robust returns for the quarter. Unlike the rally in the first half of this year, the Federal Reserve Open Market Committee (FOMC) lowered the benchmark Federal Funds rate twice, for a total of 50 basis points, to a target range of 1.75% - 2.0%. Escalation of the U.S. – China trade war, growing political concerns and weaker global growth continue to put more pressure on the Federal Reserve to lower short-term rates and become more dovish in its monetary approach.

The Bloomberg Barclays U.S. Aggregate Bond Index returned 2.27% for the quarter. The entire U.S. yield curve shifted down as rates declined. The two-year Treasury Note fell by 13 basis points (bps) to 1.62%. The ten-year Treasury fell by 35 bps to 1.66%. The thirty-year Treasury fell 42 bps to 2.11% and touched a historical low within the quarter, hitting 1.95% in August. The curve slightly flattened. The inversion between the two and ten year-Treasury dissipated, however an inversion remains between the six-month Bill and ten-year Treasury.

On September 18, the FOMC voted to lower the Federal Funds target rate by 25 bps. The Committee's vote was not unanimous: 7 members voted to cut 25 bps, 1 voted for a 50 bps reduction, while 2 members voted for no rate reduction. The Fed released a statement that noted weaker fixed business investment, lower exports and uncertainty in global economic growth. Inflation continues to remain lower than the Fed's target 2% rate.

During the quarter, the Federal Reserve started to intervene in the overnight lending market (Repo) market. The Repo market is a short-term lending market that financial institutions use to lend/borrow funds to each other. Repo rates are normally aligned with the Federal Funds target rate. During last month, the rate on these loans spiked for a few days, which required the Federal Reserve to intervene. The Federal Reserve has continued to intervene in this market and provide liquidity. While this liquidity squeeze is a concern, it's worth noting that the Federal Reserve intervened in this market regularly, using open market operations historically. While liquidity in the Repo market has improved, the Federal Reserve has reaffirmed its commitment to provide liquidity to this market when needed.

U.S.- China trade uncertainty has negatively influenced business confidence and investment. The U.S. consumer has been the main driver of growth as the consumer accounts for 2/3 of U.S. GDP and continues to propel the economy. There has been some weakness in manufacturing. The Chicago Purchasing Managers Index dropped to 47.1 and the ISM Manufacturing Index dropped to 47.8. These are the lowest levels since the 2008 financial crisis. The lower manufacturing numbers have increased the probability that the Federal Reserve will continue to lower the Fed Funds rate for the remainder of 2019.

We will continue to position our client portfolios to take advantage of lower absolute yields and a dovish monetary policy, however we are cautious on rates as our main goal is capital preservation for our fixed income strategies. We plan to continue overweighting the corporate bond exposure for our non-taxable clients. Strong balance sheets, good fundamentals and attractive risk adjusted returns continue to support the investment grade corporate credit sector. For our taxable clients, we continue to favor investment grade municipal bonds over other fixed income securities, as the municipal yield curve offers compelling risk/reward characteristics with favorable after-tax yields.