2019 Third Quarter Review of the Markets

Index	3rd Qtr Return	YTD Return
S&P 500	1.70%	20.55%
MSCI ACWI Ex USA	-1.72%	11.39%
Barclay's Bond Index	2.27%	8.52%
Consumer Price Index	0.41%	1.44%

Investment Commentary

U.S. stocks posted mixed results for the third quarter. Large cap stocks were up less than 2% while smaller stocks, as measured by the Russell 2000, were down 2.4%.

Internationally, developed market foreign stocks were up in line with the S&P 500 in local currency terms. However, for U.S. based investors, they were down about 1.1% due to the strengthening U.S. dollar. Emerging markets broadly underperformed amid heightened trade related tensions, ending the quarter down about 4.3%.

Bonds outperformed stocks during the bumpy quarter. The Bloomberg Barclays Aggregate Bond index increased 2.3%. This was driven by a sharp drop in interest rates at both the short and long end of the yield curve. The 10-year U.S. Treasury began the quarter hovering around 2% before falling below 1.5% in August, nearly approaching the historic lows set in July 2016. In Germany, the 10-year German Bund did set a new historic low yield of -0.74% in early September amidst a German manufacturing recession. Credit spreads in corporate bonds remained largely unchanged.

Economic Outlook

In our first quarter 2019 review, we wrote that the inversion of the yield curve between the 10 year Treasury and the 3 month Treasury was not a catalyst in itself for changing the level of risk in client portfolios. We believe that inversions between the 10 year Treasury yield and the 2 year Treasury yield ("10/2's") have more predictive power than the 10 year/3 month spread. However, during the third quarter the 10/2's also inverted. This prompted us to take another look at which economic indicators we should focus on to determine when a shift in risk across client portfolios may be appropriate. We looked at the reports issued by the National Bureau of Economic Research for the past five recessions. These reports are issued in hindsight (i.e. after each recession was well underway). The reports highlight the economic indicators the Business Cycle Dating Committee used to determine when the recession started. In each instance, the employment picture was a key indicator. The most recent reading for the unemployment rate from the Bureau of Labor Statistics showed unemployment declined further in September to 3.5% - the lowest reading in 50 years. As we have mentioned in the past, a large move upwards in unemployment would be of concern to us, but at the moment the labor market seems very robust.

In addition to unemployment, we and the committee look to key indicators such as real (inflation-adjusted) personal income and retail sales. Both of these indicators remain in positive uptrends and thus do not support the notion that recession is near. On the more concerning side, industrial production and manufacturing sales started to decline in late 2018/early 2019. In the past, these indicators alone have not signaled a recession without confirmation from the more consumer-centered measures listed above, but we believe it is still worth watching. We should also point out that this would be the second "manufacturing recession" in the post-crisis period, with the first one spanning the end of 2014 through the first quarter of 2016. It is notable that at this point the U.S. economy is driven much more by the services sector than manufacturing, which makes up only ~10% of U.S. GDP.

Given the global economic slowdown which continues to be exacerbated by concerns around global trade negotiations, the U.S. Federal Reserve ("The Fed") once again cut interest rates by 0.25% in September. This move was well telegraphed by the Fed and fully priced in by markets (hence the inversion referenced earlier on the short-end of the U.S. Treasury yield curve). The market is also pricing in an additional rate cut by the Fed in Q4, and a reasonable chance of two rate cuts prior to the end of the year.

We continue to believe that the economic landscape does not suggest that large changes to client portfolios are warranted.

Investment Strategy

We evaluated fixed income positions as interest rates declined during the quarter. In our opinion, instead of clients getting their Treasury exposure in the "belly" (7 to 10 year part) of the yield curve, there is better value to be had in owning a combination of longer term (10 – 30 year) Treasuries "bar belled" with short-term (1 – 3 year) Treasuries. This resulted in a marginally lower duration (sensitivity to changes in interest rates) in bond portfolios, but a higher yield.

We remain comfortable with our broadly diversified allocation to global stocks. As mentioned in our economic outlook, we do not foresee big changes in our equity allocation unless there are shifts in the economic data (employment, income, or retail sales) or in relative asset valuations. While current equity market valuations are perhaps slightly elevated relative to their own historical levels, we do not think stock market valuations are worrisome. Growth stocks continue to trade at lofty valuations relative to the more economically sensitive stocks that typically sit in the 'value' style box, reflecting concerns of continued economic sluggishness.

Do you read our Review of the Markets? If so, please drop us an email at advisors@finadvisors.com and let us know what you like and don't like about it.

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