Q3 2019 MARKET RECAP

OCT 9, 2019

TRADE RESOLUTION STILL PENDING

The S&P 500 posted its third consecutive positive quarter in Q3 2019, bringing the year-to-date return to over 21%. However, the third quarter was a bit choppier as the economic cycle continues to mature and the data, both within the US and from around the globe, is showing more signs of slowing. It will be interesting to see how the fourth quarter plays out, as years when the S&P 500 is up over 20% through the first three quarters (7 of them since 1957) have seen an average Q4 return of +0.5% while Q4 is traditionally the most positive quarter of the year, posting an average gain of +3.6% across all years. Our year-end price target for the S&P 500 remains 3,000 (+1% from here).

The trade war between the US and China continues to be the biggest news headline. We believe this is costing around 1% of GDP based on 3% GDP potential from labor force growth and productivity gains. Meetings are planned for the second week of October and it seems as though any step towards a resolution could provide a solid boost to both markets and the global economy.

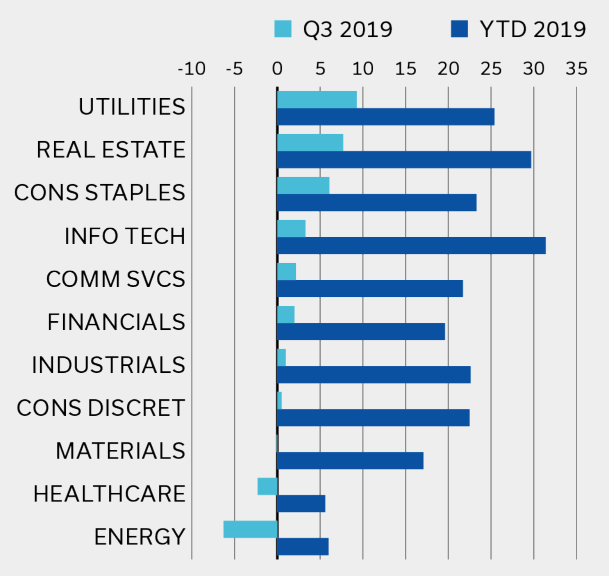
The weakening trend in Manufacturing PMI numbers continued as Europe in particular declined to deeper multi-year lows. The US saw its Manufacturing PMI fall to the lowest level since 2009, so this isn't just confined to Europe. Emerging Market economies have slowed as well but are holding up a bit better on this metric. In the US, Q2 GDP slowed significantly from Q1 to 2.0% and Q3 estimates are currently slightly below 2%. Germany and the UK posted negative Q2 GDP readings while the Eurozone came in at 1%. Japan and China continue to slow as well but remain positive, with China posting its slowest growth in roughly a decade. Estimates for global growth currently sit around 3% versus the long-term average of 3.75%.

Domestically, the labor market continues to be tight and job openings are still outnumbering unemployed persons. Consumer net worth moved to new highs in Q2 and productivity remains strong, rising +1.8% on average over the past four quarters, well above the expansion average of 1.1%. Headline Inflation remains low, although Core Inflation is starting to move a bit higher with rising medical costs outweighing the decline in energy costs. Much as it was in the second quarter, the US economy remains fundamentally sound but is showing signs of wear in places.

INTEREST RATE CUTS

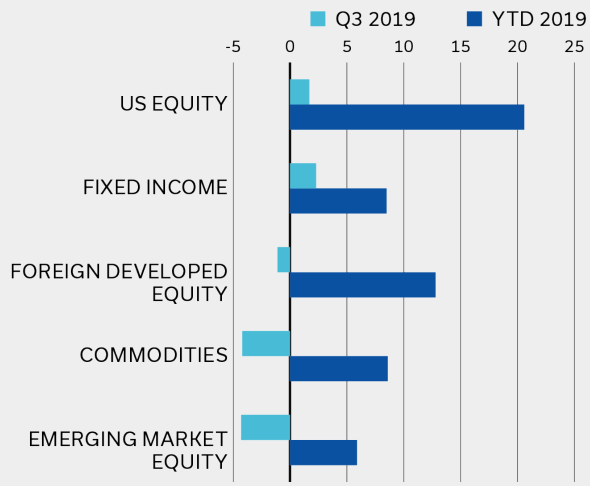
Other major developments in the third quarter included the Federal Open Market Committee cutting rates twice for the first time in 10 years, once in July and once in September. If they are done, this rate cut cycle would mirror other mid-cycle extensions like 1987, 1995, and 1998, all with low-to-mid single-digit GDP. Currently the market is pricing in another rate cut for 2019 and one for the first quarter of 2020. The Fed itself has forecasted zero additional cuts in 2019 and 2020. The 10year-3month Treasury yield has been consistently inverted since May but it is likely that negative rates around the world are anchoring the US 10year Treasury yield lower than it would normally be, so what has historically been a recession indicator may be less

Sector Returns, % return
As of 9/30/19



Source: Morningstar Direct

Asset Class Returns, % return
As of 9/30/19



Source: Morningstar Direct

predictionary this time around. Either way, inversions themselves are not great recession predictors with the average lead time between an inversion and a recession being 55 weeks, or the middle of 2020, and markets have historically risen during that time.

IMPEACHMENT?

In recent weeks, the possibility of impeachment has arisen as well. Looking back at past impeachments (1868, 1974, 1998), we have data for the more recent two and in those cases, the trend that the markets had been following (up or down) heading into the impeachment held throughout, so that could mean higher equities in this case.

GLOBAL UNCERTAINTY

Lower rates around the world are, at least in part, due to the continuing economic uncertainty and central banks taking measures to prevent a recession. These measures help but at some point we will reach the limits of monetary policy. As we said above, GDP in Europe, Japan, and China continues to slow. China's stimulus is showing green shoots despite slowing GDP, as its Manufacturing PMI rebounded back into expansion territory above 50 at the end of Q3.

Moving into the final quarter of 2019, uncertainty abounds. Data continues to slow but remains modestly expansionary for the time being. The Citi Economic Surprise Index has moved strongly higher in recent weeks indicating that recent data has been more positive than forecasts. Valuations in the US are slightly above historical levels. The US-China trade war remains at the forefront of potential global catalysts and central banks continue to battle slowing data with accommodative policy. We remain optimistic that the current slowdown is temporary and we may see improvement in the coming months.

Sincerely,

Kim David Arthur
CEO and Portfolio Manager