Market Commentary

Third Quarter 2019

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The third quarter of 2019 was a volatile one for financial markets. Following the strong gains in the first half of the year, US equities moved in a narrow range for most of the three-month period, ending modestly higher with a gain of 1.9% for the S&P 500 benchmark index, bringing the year-to-date gain to 20.5%. Fixed income yields went on a roller coaster ride, as investors contemplated a series of interest rate cuts by the Federal Reserve. The benchmark 10-year Treasury ended the quarter at 1.67%, meaningfully below the 2.00% rate on June 30. The 10-year Treasury bottomed at 1.46% during early September, nearing the all-time low of 1.37% set in July 2016.

Volatility causes many investors to act in ways that are detrimental to their long-term returns. During the third quarter we saw many investors buying bonds at very low rates in anticipation of further interest rate declines which they hoped would generate capital gains. Conversely, in a hunt for current income, investors bid up the prices of high-yielding equities such as utilities, turning investment wisdom on its head. Fixed income investments should be held for current income and overall portfolio stability; equities for long-term capital appreciation.

Economic and Market Outlook

The US economy has slowed its growth rate over the past few quarters from the above-average growth rate in 2018. While concerns of a recession make headlines, we believe the economy will slow, rather than stall or contract. The recently released September ISM report which measures manufacturing activity showed a faster than expected decline in manufacturing activity. We attribute the slowing in manufacturing to concerns over trade issues which are causing executives to hold off on some capital expenditures. Other economic reports show continued growth for an economy in its 125th consecutive month of expansion. Growth in hiring and wages, along with low inflation continue to spur consumer spending.

The biggest oil-related news during the quarter was the bombing of Saudi oil facilities in early September which temporarily took 50% of Saudi capacity off-line. After a knee-jerk 15% spike in price, oil retreated when the affected capacity was quickly restored. After beginning the quarter at $58.47 for the West Texas Intermediate benchmark, oil ended the three-month period at $54.70, down 6% since the end of June. In the past several months, Iranian and Venezuelan exports have been cut significantly due to international sanctions as well as internal strife in Venezuela. Despite the cuts to supply, prices have been declining. We continue to believe the decline in oil prices is a function of overall global supply-demand issues, with estimates of demand declining due to expectations of slower global economic growth. We believe a range of $50-70 a barrel is fair value, barring any significant geopolitical events.

During the quarter, the Federal Reserve reduced the Federal Funds rate by a total of 50 basis points in two moves, six weeks apart. While the cuts were widely expected, future interest rate moves are less certain. With the official Fed Funds rate now below 2%, we do not think the Fed needs to cut rates

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further based on economic conditions. Investor expectations on the path of interest rates have swung 180% since the start of 2019. We entered the year with many expecting three interest rate hikes for a total of 75 basis points. Instead, the Fed has provided 50 basis points in cuts with expectations of another 25 basis points before year end. Interest rates in longer dated securities have seen even more dramatic moves. The benchmark 10-year note, which is used as a standard for many mortgage loans, has declined significantly during 2019. We remain convinced there is no fundamental reason for future rate cuts, except that markets will likely "demand" cuts or have the Fed risk a sharp market sell-off in response.

The trade spat with China intensified in early August with the announcement of additional tariffs on more Chinese imports. Looking at economic models, we believe the tariffs will have a negligible impact on end consumer spending as it affects GDP growth. The larger concern is how the uncertainty of tariffs affects the mindset of manufacturing companies, as stated above.

Finally, we must acknowledge the political climate in Washington which has gone from bad to worse in the past few months. Markets seem to have shrugged off any economic effects of a possible impeachment, with almost all convinced that the Senate would not come close to the 67 votes needed to remove the President from office. In our view, the main result of an impeachment effort would be the nearly complete stoppage of legislation for the remainder of this Congress. Nothing meaningful will have a chance of being enacted until after the 2020 elections. We note that almost all significant legislation over the past 25 years has taken place with a single party controlling both the Presidency and the legislative branches, which is not the current case.

Portfolio Positioning

With expectations of slowing economic growth over the next few quarters, we remain focused on those companies and industries with consistent growth in revenues and earnings in an economy showing uneven growth. While US equities look slightly expensive on simple P/E multiples, when compared to interest rates, inflation, and many international equity markets, valuations look more reasonable. Fixed income positions in portfolios serve to dampen volatility while providing a steady stream of income.

Conclusion

Looking out over the next 12 months, we believe economic fundamentals will remain positive. While GDP growth rates in 2019 are slowing from last year, we expect economic growth to remain positive through 2020, albeit at a slightly slower rate with few signs of inflationary pressures.

As always, we welcome feedback from our clients. Please call or email us if you have any comments or questions about your investment portfolio.

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