Investment Commentary

October 14, 2019

3rd Quarter Recap

The stock market was volatile during the 3rd quarter and is currently about 3% below the high reached in early July. Large cap stocks continue to outperform small and mid-cap stocks. Value stocks outperformed growth stocks for the quarter but that occurred primarily over the past few weeks. And U.S stocks have continued to outperform international stocks.

Interest rates moved down during the 3rd quarter. The 10 year U.S. Treasury Note started the quarter at a rate of 2.03% and dropped to 1.67% by the end. Rates have recently moved back up and the current rate is 1.73%. Short term rates on bank savings accounts and certificates of deposit moved down due to rate decreases by the Fed.

The Current Economic and Investment Environment

The economy continues to hold up despite a broader global slowdown. And the recent job report shows a jobless rate of 3.5%, the lowest since December of 1969.

Manufacturing production improved in August after consecutive declines in the first and second quarters. But in September there were warnings beneath the surface as growth is slowing again. The weakness in manufacturing is mirroring the overall global trend.

Geopolitical Risks

The big geopolitical risks threatening the world economy are:

- The U.K.'s potentially messy exit from the European Union
- A crackdown on democracy demonstrations in Hong Kong
- Tensions in the middle east

Any of these risks could cause a sharp sell-off in global stock markets.

Trade Issues
The trade war with China continues to be on again/off again. Currently a “truce” has been declared and the stock market rallied in response. The tariff hikes scheduled for October 15th on $250 billion on Chinese goods will be suspended and in exchange China will buy $50 billion of American farm products.

But China does not appear to be willing to negotiate issues such as their technology policies, cyber spying and the protection of patents and other intellectual property. Another stumbling block is how to enforce any agreement.

A tariff hike on $160 billion of smartphones and other products is scheduled for December 15th. This leaves a black cloud over Apple and other technology companies with factories or customers in China.

Trade negotiations with China will likely continue for a period of years. And there may never be a complete resolution of all issues.

The End of Globalization
Globalization has peaked and there is significant risk as the world continues to de-globalize over coming years.

The latest wave of globalization occurred over the last 30 years and has boosted economic growth and lowered both inflation and interest rates. It has also had an effect on how the proceeds of growth have been distributed. Labor’s share of income has been pushed down while the share flowing to corporate profits has been pushed up. This has been an underlying cause of the current wave of populism across the globe.

There are many scenarios on how de-globalization plays out. At one end of the spectrum we could see “regionalization” in which trade is clustered in neighboring countries rather than globalized. At the other end of the spectrum the world could split into competing “blocs” (for example one led by the U.S. and the other led by China).

In most scenarios the effects on the world economy as a whole would be negative but manageable. De-globalization will certainly impact the profits of the multi-national companies that make up the bulk of the S&P 500 stock index along with companies in Europe and Asia.

Recession Watch
The economy continues to grow at a slow pace. As long as consumer spending continues to hold up a recession will be avoided. But the effects of the trade war are seeping into the economy and are starting to have an effect on corporate profits.

The economy could continue to muddle along with a recession pushed further out into the future. But the risk of a recession is elevated and growth will continue to soften.

Review of Asset Classes

Domestic Stocks
Year to date the overall U.S. stock market is up 15.7%, nearly erasing the 20% drop late last year. The stock market appears to be on a “sugar high” trading at levels not justified by the fundamentals. And third quarter earnings reports over coming weeks will likely show the trade war is crimping corporate profits. Earnings of S&P 500 companies are expected to decline for a third consecutive quarter.

While the stock market typically performs well in the fourth quarter due to holiday spending, this year any upside could be limited. However, we could see a rally on good news concerning the trade war or if the Fed lowers interest rates.

International Stocks
Slowing global growth continues to effect international stocks along with Brexit, negative interest rates and trade tensions. There does not appear to be much upside in international stocks unless there is a favorable resolution to Brexit and a pickup in growth.

Investment Grade Bonds
The overall bond market is up 8.2% year to date due to the decline in interest rates. Rates could be in a trading range in the near term, with overall returns in bonds very low. We are looking at 2.0% to 3.0% overall returns for the foreseeable future.

Going Forward
Investment returns will be low for the foreseeable future with an elevated level of risk. We are getting close to a point where a focus on downside risk and volatility should take precedence over higher investment returns.