Market Commentary

September 30, 2019

Despite US political uncertainty, the China trade wars, and mixed economic data, stocks remain near all-time highs. The US consumer is generally upbeat and continues to spend at a healthy pace. However, the specter of recession looms as interest rates remain depressed and yield curves are quite flat throughout the world. In the US, we are witnessing a conflict between "soft" manufacturing surveys which signal slowing, and strong "hard" factory data indicating that the manufacturing sector is on solid footing. But there is little doubt that tariffs are weighing on the manufacturing sector. The ISM manufacturing report surprised to the downside in September, and has now fallen in each of the past 6 months, representing the largest 6-month decline since 2009. Keep in mind, however, that manufacturing represents only 10% of the US economy. While US employment data continues to be quite good, it is generally considered a "lagging" indicator and not a good predictor of where the economy is heading. Lower interest rates have also given a boost to the housing sector, which is a major driver of US growth.

US stocks eked out another gain in Q3, propelling stocks to the best performance in the first three quarters of a year since 1997. The S&P 500 was up a modest 1.7% in Q3, but YTD stocks have returned 20.6%. Small Cap stocks once again had a rough quarter (-2.4%), trailing Large Caps (1.8%) by a wide margin. Growth (1.1%) and Value stocks (1.2%) performed similarly. The two best performing sectors were those that generally benefit from low interest rates: Utilities (9.3%) and Real Estate (7.7%). Energy stocks (-6.3% in Q3) continue to be the ugly step child of the market. The Energy sector is down 19% over the past year. International equities struggled in Q3. Emerging Markets (-4.2%) lagged both Developed International Markets (-1.1%) and US domestic stocks.

Interest rates continued to tumble in Q3, leading to equity-like returns in fixed income. It was only a few months ago that world central banks had declared "mission accomplished" and promised to transition from aggressive easing into a period of "normalization" of interest rates. However, it was soon apparent that much of the world remains addicted to easy money, with many countries exhibiting QE withdrawal symptoms. Germany, historically the economic engine of Europe, is probably already in the midst of recession with recent manufacturing data plummeting to the levels last seen in 2009. So world central banks have once again fired up the printing presses and jumped into easing mode. As of late September, 55% of world central banks were easing monetary policy, the highest number since the financial crisis. The 10-year US Treasury yield fell 0.3%, ending the quarter at 1.67%. The Barclays Aggregate returned a robust 2.3% in Q3, and is up 8.5% YTD.

The financial market conundrum continues: stocks continue their upward march, as if all is right in the world, while interest rates fall and the US Treasury yield curve is inverted, signaling an imminent recession. This mystery is partly explained by the fact that US economic data is relatively strong (good for stocks), while much of the rest of the world is teetering on the brink of recession (lower yields). Among developed countries, the US currently has the highest real GDP, highest core inflation, and highest consumer confidence for first time since 1965. Thus, higher rates in the US are justified. But there is currently $14 trillion in negative-yielding international debt, and US rates remain quite high relative to the rest of the world. Despite decent economic strength at home, the Fed lowered the federal funds rate twice in Q3, bringing US rates more in line.

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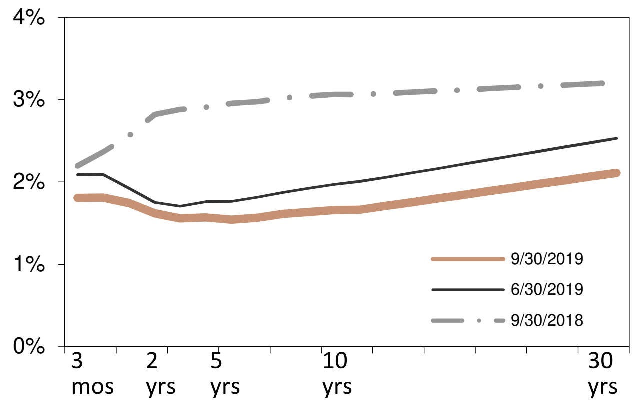
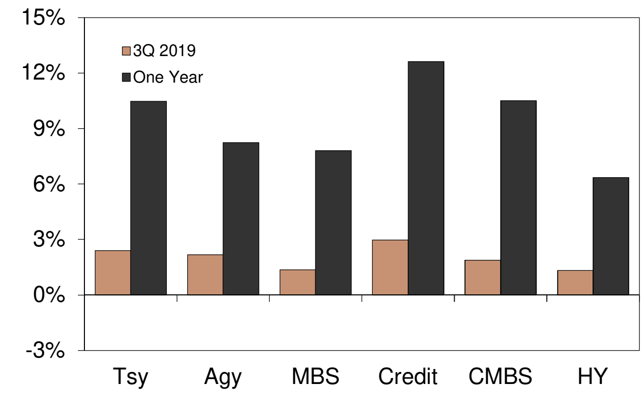
US Treasury Yield Curves



Sector Index Returns



Market volatility has picked up in recent months in both stocks and bonds. The MOV and the VIX are two market indices that measure volatility, or "fear," in bonds and stocks, respectively. These indices are currently sitting at elevated levels and appear to be moving higher. Most market watchers agree that artificial intelligence and machine trading are amplifying market movements. Gone are the days when price changes were determined by human beings reading company financial statements and press releases. Today, machines "scrape" millions of data elements such as prices and even phrases from the web and other private data sets. Markets can jump in milliseconds after the release of an economic report or a company press release. The challenge for investors is to maintain discipline, focus on fundamentals, and avoid chasing irrational market price moves.

With world central banks once again unanimous in their desire for stimulative policy, look for the monetary spigots to be turned wide open and for financial assets to benefit. "Don't fight the Fed" is sage advice in this climate, and, despite their lofty valuations, stocks are likely to be well bid. In our fixed income portfolios, we continue to tactically adjust portfolio durations to take advantage of anticipated interest rate changes. Currently, our client portfolios have average maturities comparable to their respective benchmarks. We continue to believe that the US economy is on solid footing, but interest rates should remain low in the near term due to loose Fed policy. However, long-term rates are likely to eventually drift higher as inflation pressures build. Given the massive rally in risky assets, we do not believe investors are receiving adequate compensation for holding lower-rated corporate bonds. Thus, we are underweight exposure to BBB-rated bonds, the lowest rated debt in the investment grade credit sector.