Quarterly Missive

It's not the *wind*. It's the set of the *sails*.

THIRD QUARTER 2019

BY JAMES H. DRYDEN

As the summer days shorten and we begin the turn into fall, it's once again time to update our clients on our latest thinking and positioning. We thought about simply changing the date on last quarter's missive and sending it out again. While much has happened in the last three months, we find ourselves in much the same position, seemingly going nowhere fast. The economy still grinds along slowly and the capital markets remain positive on the year. However if we dig a little deeper we see nuances in the details and some gathering clouds. Last quarter we postured that the current economic expansion – already the longest in the post-war period – appeared to be at risk of winding down, and we see very little today to change that thinking.

To be fair, the positives are abundant and it takes very little digging to find them. Most key economic measures - GDP growth, unemployment, and consumer confidence - remain healthy. Corporate profits growth, one of the underpinnings of the financial markets, has admittedly slowed, however 75% of S&P 500 companies reported second quarter earnings in excess of estimates and we still expect +6.5% profits growth for the full year. Perhaps these numbers aren't as robust as those from 2018, but as we wrote last quarter, we've been expecting this.

Beyond the macroeconomic backdrop, U.S. equities have been remarkably resilient. As of this writing (9/21/2019), the S&P 500 index is up +21% on the year. Putting this performance within the context of trade wars, yield curve inversions and recession worries, it's almost striking how kind stocks have been to investors. Yes we've had pullbacks and bouts of volatility along the way - and August was particularly challenging - but the recent six-percent decline is very little when we compare it to the average intra-year drawdown of 14% in the S&P 500 since 1950.

But about those trade wars, yield curve inversions and recession worries…

As we've recently written, the escalating U.S.–China trade war continues to pose risks to the durability of the economic expansion and bull market in stocks. Although tensions have softened somewhat in recent weeks, the manufacturing side of the economy shows few signs of improving. Global trade has stalled as concerns over rising trade barriers have taken hold, resulting in weakening capital spending and a real threat to global corporate earnings growth. We're not hopeless though. Both U.S and Chinese negotiators have asserted that the bulk of a trade deal has already been framed and we've seen both sides appear more conciliatory. Beijing is once again purchasing agricultural products from the U.S and has offered concessions while President Trump has delayed the imposition of some tariffs. While we still believe a deal is quite possible by winter, we're not yet ready to hang our hats on it – this is a story line that seems to change by the week.

We would also be fair to point out that the manufacturing side of the economy – that piece most acutely impacted by the ongoing trade war- is relatively small, representing only 12% of total domestic output. On the flip side, consumer spending represents about 70% of total output and continues to impress, powering the economy along. Real personal consumption expenditures rose at a 4.7% annual rate in the second quarter, the

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largest increase in 4 ½ years. And it's no wonder: the unemployment rate is hovering near a half-century low. Wages are increasing. Asset values are buoyant. Consumer confidence readings from August were the highest readings of the year. So absolutely, the consumer side of the economy remains healthy. The big question is whether the malaise we're experiencing in manufacturing will eventually bleed into the larger segment of the economy, stalling economic growth altogether. This is something that bears watching closely in the coming weeks and months.

There has also been a lot of chatter surrounding the inverted yield curve and its proficiency for forecasting recessions. For starters, the yield curve is the graphical comparison between 2-year and 10-year U.S. Treasury Notes. In a normal environment, shorter-dated Treasuries yield less than their longer-term counterparts, which makes sense: as bond investors, we expect to be paid more for taking on the additional risk of owning longer-dated maturities. However from time to time this relationship "inverts" whereby short-dated Treasuries actually yield more, typically the result of an overly–aggressive Fed pushing short-term rates too high. Importantly, inverted yield curves do not cause recessions; they're merely the effect of an imbalance. What has investors on edge however is their predictive ability: over the last 50 years, inverted curves have preceded recessions every time and have rarely given a false signal. What is critical for us to remember as investors – and something we don't hear much about - the historic time lag between yield curve inversions and actual recessions is so wide (17 months on average) and so varied (between 10 and 24 months), that anything can happen during that time, for better or for worse, making the predictive benefits of inverted curves essentially useless. We know that recessions are an inevitable component of every economic cycle. We know we'll encounter one sooner or later. To us it seems pointless to get caught up in yield curve inversions as the catalyst.

Our bottom line - the economy continues its upward path, albeit with a shallower trajectory than that of a year ago. Manufacturing has slowed and business confidence remains challenged by continued trade uncertainties, although to-date the consumer has been a champion at offsetting the weakness. Some traditional recession indicators are flashing warning signs, although this deep in the business cycle we need to view recession risk as elevated anyway and plan accordingly. We also need to remember that stocks have advanced quite nicely during the month of September, largely we believe because of expectations for a trade resolution which may or may not materialize as soon as investors hope. Stocks will likely applaud if it is, but if it is not, we should expect a bumpy ride.

For portfolio positioning in our discretionary accounts, we are doing several key things: first and foremost, we are staying true to the process that has served us and our clients well over the years. We are staying true to our preference for owning companies with proven histories of paying, and growing their dividends. We are maintaining exposure to those asset classes whose fortunes tend to be less correlated to the stock or bond markets – namely real estate and alternative investments. And finally, we are remaining broadly diversified and remembering that for every asset class that zigs, another zags and that one of the greatest benefits of portfolio diversification is in the proven, long-term mitigation of volatility that it offers. We are making these very same recommendations to our traditional brokerage clients as well.

Most importantly, we once again remind our clients that our financial outcomes are unlikely to be influenced one way or another by this week's tweet or last week's trade announcement. They will moreover be determined by our long-term behavior, discipline and patience, and by our understanding that a bumpy ride from time to time is what we signed up for. We also remind our clients that we are here for them, anytime, to walk them through it all.

As always, we remain so very greatly appreciate the continued trust and confidence you have placed in us.

S&P 500 Index: The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value. Bloomberg Barclays U.S. Aggregate Bond Index: Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

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SOURCES: Wells Fargo Investment Institute, LSA Portfolio Analytics, BNY Mellon, MarketWatch, Schwab Capital Markets, Forbes.com

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