GLOBAL CENTRAL BANKS ACT AS DARK CLOUDS GATHER

In the third quarter, the global economy appeared to be facing several fundamental headwinds such as an ongoing global economic slowdown, escalating trade tensions (primarily between the U.S. and China, but also with other countries), a global manufacturing recession, growing geopolitical tensions which saw a brief spike in oil prices, and potentially a hard Brexit by October 31. In an attempt to prevent economic conditions from getting worse and ensure the continuation of this long economic expansion, central bankers around the world began to ease monetary conditions. The Federal Reserve cut interest rates twice during the quarter, while the European Central Bank cut rates and brought back quantitative easing. According to analysts at J.P. Morgan, sixteen central banks lowered rates in the third quarter, and they expect two dozen more to slash rates in the fourth quarter. As a result of these efforts to cut rates and ease monetary conditions, bonds outperformed stocks in third quarter of 2019.

STOCKS: MIXED RETURNS WITH INCREASING VOLATILITY

Global stock markets were mixed in the third quarter. U.S. large company stocks, represented by the Standard & Poor’s 500 index, gained 17 percent, while stocks of small companies and international markets all offered negative returns. Japan was the other bright spot, up 3.1 percent. U.S. large company stocks have outperformed stocks of small companies, represented by the Russell 2000 index, by 6.4 percent in 2019, suggesting that we are in the later stages of this expansion, and should anticipate more volatility in the upcoming months.

Volatility in equity markets is being driven by the trade dispute between the U.S. and China. Both countries have added significant tariffs on the other’s products. The trade dispute has also led to a recession in global manufacturing due to a slowdown in global trade, disruption in the supply chain, and uncertainty around capital expenditures. This has been particularly difficult for China and countries that rely on exporting to China, such as Germany and many emerging markets. This has added to market concerns that we are in the later stages of this economic expansion and the trade dispute could tip us into a recession. To counter these concerns, central bankers around the world eased monetary conditions as an insurance policy to prevent a recession. The U.S. Federal Reserve cut interest rates twice, the European Central Bank brought back quantitative easing, and many emerging markets have also reduced their policy rates. A consequence of this easing was that interest rates fell across the yield curve, and bond proxy sectors — utilities, consumer staples, and real estate — outperformed the
broader markets. Energy was the worst performing sector as a supply glut and slowing global growth hit oil prices.

Target Corporation was one of the best performing stocks in the Standard & Poor’s 500 index with a 24.4 percent return in the quarter. The company’s online and in-store traffic growth and margin improvements exceeded expectations. Other notable winners were Lam Research and Kellogg Company. Netflix was one of the worst performing stocks in the quarter because of fears of upcoming competition and sluggish subscriber trends. Other notable losers included retailers — Macy’s and Under Armor — facing tough competition. Value stocks reversed trend and outperformed growth stocks. This reversal was predicated by investor rotation from growth into value in September primarily searching for safety as trade tensions between the U.S. and China escalated.

**BONDS: LONG DURATION OUTPERFORMED AS RATES FELL**

Rates fell across the Treasury yield curve due to signs of slowing global growth, geopolitical tensions, and easing policies from global central banks. Longer duration sectors with positive convexity such as U.S. Treasurys and investment grade corporate bonds benefited the most. The mortgage sector had a positive return, but underperformed the broad market because falling interest rates drove many homeowners to refinance their mortgages. The high yield sector underperformed the broad market because of its lower duration. The Bloomberg Barclays U.S. Aggregate Bond index returned 2.3 percent for the third quarter.

The 3 month - 10 year portion of the yield curve remained inverted during the quarter, which has been a predictor of recessions in the past. To insure against a potential recession, the Federal Open Market Committee (FOMC) lowered the federal funds rate twice, to a range of 1.75 percent to 2.0 percent. The first rate cut occurred in July and the second in September. The European Central Bank cut interest rates below zero. The policy rate fell 10 basis points from -0.40 to -0.50 basis points, diving deeper into negative territory. The ECB also committed to a new round of asset purchases starting November 1, 2019, at a pace of 20 billion euros a month as long as necessary to hit its inflation target. Additionally, many central banks in emerging markets such as India also cut rates to support their slowing economies.

**OUTLOOK 2019: WILL MONETARY EASING EXTEND THE BUSINESS CYCLE?**

Economic growth is expected to slow in the second half of 2019 from the combined impact of the Federal Reserve hiking rates 250 basis points, fading impact of corporate tax cuts and simmering trade tensions. While global manufacturing is already in a recession, the much larger services sector appears to be still in expansion mode, but slowing. Fed officials downgraded their assessment of economic activity, further signaling that downside risks to the economy are rising. To prevent a recession and extend the business cycle, global central bankers are easing monetary policy. The Fed has cut rates twice this year and the market expects an additional cut by the end of the year. The European Central Bank not only cut rates but reintroduced quantitative easing. Additionally, central banks in sixteen other countries also cut rates in the quarter.
In this macro environment, we anticipate bonds, particularly longer duration U.S. Treasuries, to do well since they are most sensitive to falling rates. We maintain a neutral position to long U.S. Treasury bonds and portfolio duration. End-of-cycle risks are starting to build in credit, and valuations are stretched. We remain cautious of lower rated credits and will remain underweight to high yield. Rising leverage, weakening underwriting standards, and diminishing investor protections indicate growing risks, while credit spreads at the tight end of the historical range provide scant compensation for these risks, even with Fed support. We will look to trim our credit exposure if spreads tighten further. Securitized sectors continue to provide attractive risk-adjusted opportunities for high-quality, liquid returns with less potential downside than corporate credit. Non-agency residential mortgage-backed securities remain compelling amid a shrinking market.

Equities continue to benefit from the accommodative shift taken by the U.S. Federal Reserve. However, it remains unclear if deeper harm to corporate operations has already resulted from ongoing trade agreements and whether the expected slowdown in the second half will result in an economic, and hence, a severe earnings recession. Notably, unlike Europe and China, the U.S. economy has been far more resilient. Consumer demand remains healthy, the job market is strong, and inflation remains subdued. Thus far, equity valuations have been nearly immune to either macro or micro concerns as bullish sentiment prevails. In fact, current market valuations are a reflection that our longstanding economic resiliency will likely overcome any trade war setbacks. Given the lack of clarity, we are taking a neutral stance toward risk in client portfolios. In the interim, we continue to prefer domestic over international equities, and large capitalization stocks over small capitalization stocks. We are also fairly neutral to sector weightings except for a significant underweight to the energy sector. We continue to prefer individual companies with idiosyncratic catalysts or inflections.

We anticipate oil prices to be supported by OPEC production cuts, outages, and geopolitical risks. However, slowdown in global growth and increases in U.S. shale production will tend to put a cap on prices. We have no position in commodities, but maintain positions in material and energy stocks, and energy pipelines.

KEY RISKS:
- Political – potential Trump impeachment
- Rising recession risks in the U.S.
- Corporate earnings recession