Mount Yale Market Commentary

3rd Quarter 2019

Summary

- Markets enter the historically volatile fourth quarter with high expectations that global growth and corporate earnings can rebound, neither of which have yet to materialize.
- Global stocks were pushed around by a nearly constant stream of Tweets from the U.S. President regarding trade with China but ended the quarter with little change. Overall, bonds performed well as yields declined precipitously.
- Mounting geopolitical stresses—Sino-American Trade War, Fed independence, protests in Hong Kong, Brexit and the Aramco Attacks—have all generally been dismissed by markets.
- It appears central banks can continue to commit to easy monetary policies even if inflation metrics move higher than stated targets.

Global Markets	*QTD*	*YTD*
MSCI ACWI	(0.03%)	16.20%
Barclays Global Aggregate	0.71%	6.32%

Source: Bloomberg

Overview

Asset prices were mixed in the third quarter as stocks saw-toothed sideways but made little forward progress. Without significant gains or losses, the quarter seemed relatively benign on the surface; however, the flurry (or fury) of tweets from the U.S. President regarding trade with China pushed markets around like Muhammed Ali in the boxing ring. The ever-escalating trade tensions dominated the headlines. Each round involved more telephone calls, meetings, cancelled trips and dozens of tweets – yet no real progress. By December, there may be a 21% tariff on over $300 billion in goods that China produces and the U.S. buys. In addition, by the end of the year, nearly 99% of all imports from China could have tariffs. This compares to roughly 69% in September.

It is especially concerning that trade tensions are increasing at the same time that the global economy is showing material signs of weakness. The global JPMorgan-Markit Manufacturing Purchasing Manager Indices (PMI) continued to signal outright contraction in September, and developed economies, such as Japan and Germany, were at or below their second-quarter levels. Emerging markets rebounded slightly due to a minor bounce in China.

The bout between the two largest economies in the world is starting to affect U.S. businesses. September's Institute for Supply Management (ISM) U.S. Manufacturing index fell even further below 50.0, hitting 47.8 and signaling an overall contraction. The services sector, which is a much larger portion of the U.S. economy, slowed significantly—falling to 52.6, according in the ISM Non-manufacturing index. Also in September, the Business Roundtable CEO Economic Outlook Index sank to the lowest level of the Trump presidency. The one-two punch of "potential trade war" and "slowing global economic growth" cited by respondents was clearly a factor.

Not all the news was terrible. In a recent Fortune interview, Blackstone CEO Steve Schwarzman summarized some of the lingering positives that have so far helped stave off recession:

> *Consumer buying is going up…If [consumers] continue spending that money, we'll have a longer run. But there's no doubt that 4 percent type growth, 3 percent growth would be very challenged now.*

Comments from Home Depot Executive Vice President of Merchandising, Ted Decker, spoke to the collateral damage, but also potential opportunity:

> *I'm not aware of a single supplier who is not moving some form of manufacturing outside China. So, we have suppliers moving production to Taiwan, to Vietnam, to Thailand, Indonesia and even back into the United States.*

To counter deteriorating fundamentals, central banks around the world continued to ease their monetary policies, which contributed to an epic decline in global yields. The 10-year U.S. Treasury yield started the quarter at 2.0% but ended at 1.68% after bottoming in early September at slightly below 1.5%. The two-year note moved from 1.75% to 1.63% during the

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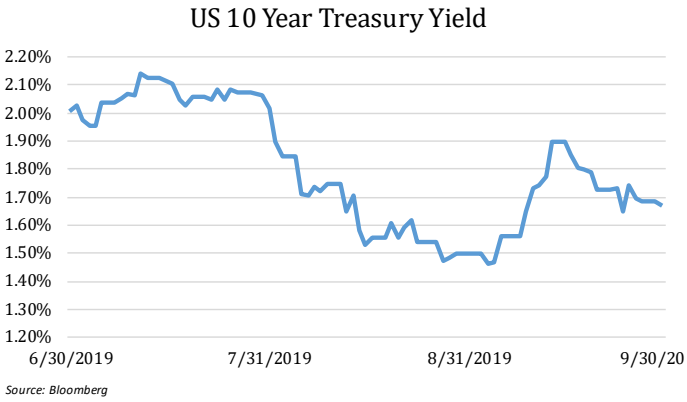
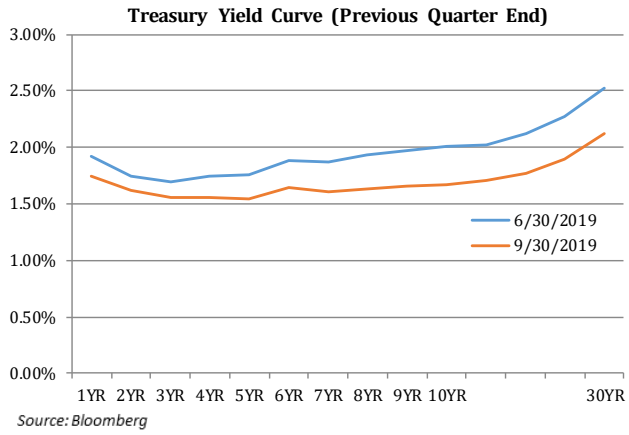
quarter after bottoming at the same level as did the 10-year, at 1.47%. The yield curve flattened by 20 basis points for the quarter after inverting for a few days at the end of August. Total negative-yielding debt hit $16 trillion globally by the end of the quarter—a substantial $3 trillion increase. In what seems to be a logical response to lower interest rates and additional quantitative easing, gold was the best performing asset for the quarter, up 5.4%. It has risen 16.1% during 2019.



If the trade war has generated any positives, it's that it may have given the Federal Open Market Committee (FOMC) cover to end quantitative tightening early and lower interest rates at its past two meetings. As Chairman Jerome Powell said in his prepared remarks at the FOMC September press conference:

> *As I mentioned, weakness in global growth and trade policy uncertainty have weighed on the economy and pose ongoing risks. These factors, in conjunction with muted inflation pressures, have led us to shift our views about appropriate monetary policy over time toward a lower path for the federal funds rate, and this shift has supported the outlook.*



The Fed's easing comes when the unemployment rate is at its lowest level, 3.5%, since the late 1960s. The Consumer Price Index (CPI) sits at 1.8%, and the U.S. stock market is within a few percent of all-time highs. Even high yield spreads were near cycle lows at 380 basis points over Treasuries when the FOMC lowered interest rates again in September. The FOMC risks contributing to a significant divergence between asset prices and economic fundamentals with this course of monetary policy.

Despite the Fed's maneuvers, the U.S. President wanted more. Indeed, more may be needed to arrest a slowing economy in time for the election next year. Nothing captured the president's frustration with the Fed more than an August 23rd tweet where Mr. Trump channeled his inner Ali—perhaps the greatest trash-talker of all time.

> *....My only question is, who is our bigger enemy, Jay Powell or Chairman XI?*

The Atlanta Fed currently expects third-quarter real gross domestic product (GDP) growth to be just 1.8%, which would represent a slight slowdown from the 2.0% growth of the previous quarter. Non-farm payroll growth averaged 157,000 over the past three months. Real personal consumption expenditures, a broad measure of consumer spending, slowed to a year-over-year growth rate of 2.3%, after previously topping out at 2.8% earlier in the year.

U.S. Markets

U.S. equities were mixed. Large cap stocks generated positive returns, and small cap stocks posted negative returns. The Russell 1000 Growth Index was higher by 1.5% in the quarter, outperforming the Russell 1000 Value Index by 10 basis points. Small cap value stocks, as measured by the Russell 2000 Value Index, lost 0.6%. The latter significantly outperformed small cap growth stocks, which lost 4.2%. Year-to-date, large cap growth is up 23.3%, large cap value is up 17.8%, small cap growth is up 15.3%, and small cap value is up 12.8%.

US Equity Markets	*QTD*	*YTD*
S&P 500	1.70%	20.55%
Russell 1000 Growth	1.49%	23.29%
Russell 1000 Value	1.36%	17.81%
Russell 2000	(2.41%)	14.15%
MSCI US REIT	7.38%	25.71%
Alerian MLP	(5.09%)	10.91%

Source: Bloomberg

Lower interest rates significantly influenced sector-level performance; those most sensitive to rates performed the best. For

the quarter, utilities returned 9.3%, real estate was up 7.7%, and consumer staples increased 6.1%. Materials, health care, and energy all posted negative returns for the quarter. Eight of eleven sectors in the S&P 500 have generated more than 20% on a year-to-date basis. Health care and energy have been the significant trailers for the year, generating returns of 6% or less.

S&P GICS Sectors	*QTD*	*YTD*
Consumer Staples	6.11%	23.28%
Health Care	(2.25%)	5.64%
Utilities	9.33%	25.40%
Communication Services	2.22%	21.74%
Consumer Discretionary	0.51%	22.46%
Energy	(6.30%)	6.00%
Financials	2.01%	19.60%
Industrials	0.99%	22.58%
Materials	(0.12%)	17.11%
Real Estate	7.71%	29.71%
Technology	3.34%	31.37%

Source: Bloomberg

First-quarter S&P 500 operating earnings posted year-over-year growth of 4.0%. This was consistent with the past two quarter's growth rate. Standard & Poor's estimate for 2019 operating earnings was lowered slightly during the quarter to $161 per share, an unremarkable 6% increase from 2018 levels. As 2020 comes into view, estimates for earnings next year are currently set at $180 per share.

Supply and demand dynamics within the U.S. Treasury market are starting to get interesting. Since the start of the trade tensions, official international holdings of U.S. Treasuries have been declining. Back in March 2018, non-U.S. holdings were above $3.1 trillion, but are now below $3 trillion. This is in the context of net new issuance increasing by over $1 trillion in the past eighteen months. The U.S. Treasury expects to issue nearly $400 billion in net new debt during the fourth quarter.

Amid the precipitous drop in interest rates, most fixed income asset classes produced attractive quarterly returns. The Bloomberg BarCap U.S. Aggregate Bond Index was up 2.3% in the quarter and is now up 8.5% for the year. The Bloomberg BarCap High Yield Corporate Index increased by 1.3% during the third quarter and is up 11.4% for the year. Hinting at growing stresses, the lower quality part of the high yield bond market (CCC-rated) is the only segment that has posted negative returns (-4%) over the past 12 months. The S&P/LTSA Leveraged Loan Index gained a modest 1.0% and is now up 6.8% for the year. Markets clearly expect low rates to persist: dedicated bank loan mutual funds have experienced more than 40 consecutive weeks of outflows.

US Fixed Income Markets	*QTD*	*YTD*
Barclays US High Yield	1.33%	11.41%
S&P/LSTA Leveraged Loan	0.99%	6.79%
Barclays US Aggregate	2.27%	8.52%
Barclays Municipal High Yield	2.84%	9.69%
Barclays Municipal	1.58%	6.75%

Source: Bloomberg

Municipal bonds, as measured by the S&P National Municipal Bond Index, gained 0.8%, leaving them up 4.7% so far in 2019. Emerging market bonds, as measured by the JP Morgan USD Emerging Markets Bond Index, were up 1.5% in the quarter, pushing that sector to a 13.0% return in 2019. International developed market bonds, which are saddled with negative yielding interest rates, declined by 70 basis points, leaving the asset class up 4.5% for the year.

Foreign Markets

The majority of countries, both developed and emerging, posted negative returns in the third quarter. Hong Kong was down nearly 12% as months of protests, known as the Anti-Extradition Law Amendment Bill Movement, continued into the fourth quarter. Germany, lower by 4.0%, remains mired in a manufacturing slump that has showed no signs of receding. The UK still has not resolved Brexit, and newly elected Prime Minister Boris Johnson has been adamant that the October 31 deadline will not be moved. The UK equity market was down 2.5% in the quarter. Japan was a notable positive performer, gaining 3.1% in the quarter.

In emerging markets, all countries but Turkey were negative in the quarter. China was down 4.7%, bringing its year-to-date return to just under 8%. China's GDP growth was just 6.2% last quarter, the slowest on record since 1992. In eastern Saudi Arabia, Aramco's oil processing plants came under attack one evening in September. This sent oil prices skyrocketing to the mid-$60s per barrel of West Texas Intermediate crude. As fears eased about how long production would be offline, oil settled back into the $50s by the end of the quarter.

Foreign Markets	*QTD*	*YTD*
MSCI EAFE	(1.00%)	13.39%
MSCI EAFE Small Cap	(0.34%)	12.46%
MSCI EM	(4.16%)	6.14%
MSCI EM Small Cap	(4.45%)	2.03%
S&P Global Ex-US REIT	3.19%	18.34%
JPM EMBI Global Diversified	(1.56%)	(10.27%)
S&P/Citigroup Int'l Trsy Ex-US	(0.75%)	4.52%

Source: Bloomberg

In dollar terms, the MSCI EAFE Index declined 1.0%, leaving it higher by 13.3% so far this year. The MSCI Emerging Markets Index was lower by 4.1% and is now up only 6.1% in 2019. In local currency terms, the MSCI EAFE Index was higher by 1.8% in the quarter and 16.2% for the year. For emerging markets, local returns were down 1.9% for the quarter and up 8.1% for the year.

Looking Ahead

Market expectations suggest that economic data and earnings should be picking up now and into 2020. Much of this will fall on the U.S. consumer, who enters this part of the economic cycle with a personal savings rate of 8.1%—a level not experienced much during this economic expansion. It is unclear at this point whether the consumer is pulling back spending in a structural or cyclical way. We will reserve judgement and watch the data, but the stakes are high and the main event—the 2020 U.S. presidential election—is fast approaching.

As we navigate markets, our focus remains on allocating capital to areas of the market that are attractively valued or represent an inefficiency that can be exploited. Well opportunities abound, we remain just as focused on the risk-side of the equation and seek to deemphasize or avoid overvalued and overcapitalized areas of the market. In some instances, the risks present the opportunity for potential future reward, and we will bring those to your attention as we uncover them.

Sincerely,

Mount Yale Research Team

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