Private Ocean

OCTOBER 2019

Economic & Market Commentary

Prepared by the Private Ocean Investment Committee

Executive Summary

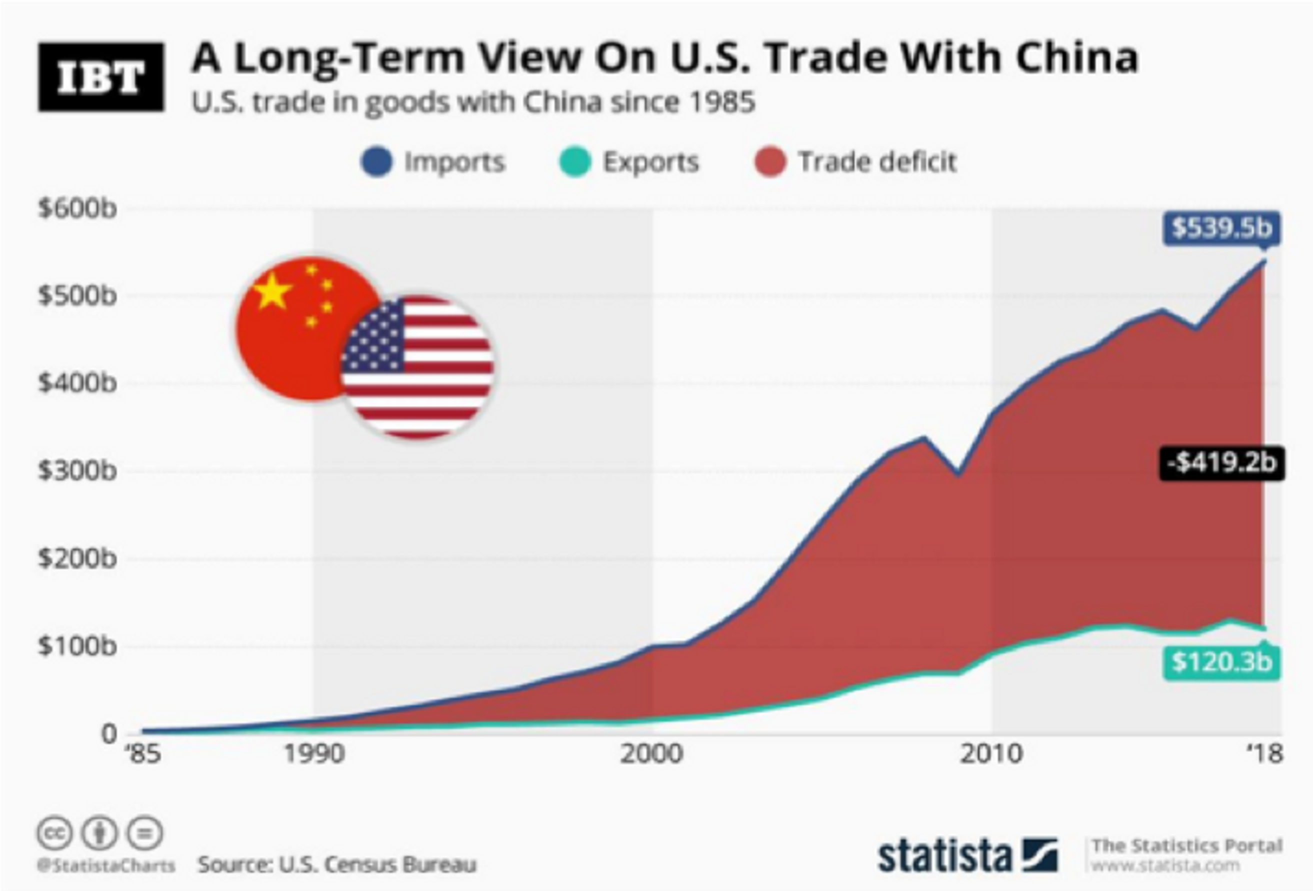
- Trade wars with China reached a peak in the third quarter with tensions lessening more recently amid news that trade talks would resume in October.
- The Federal Reserve in their monthly Beige Book reported positive news for employment markets, current interest rates, and economic growth.
- U.S. equity markets continued to outperform their international and emerging market peers. This was led by large gains in growth and tech-oriented companies.
- Real estate continued its positive run thanks to low interest rates. Industrial REITs have outpaced other sectors globally.
- Fixed income has performed well thus far in 2019, despite negative interest rates in many European government debt markets. Among the strongest performers year-to-date are emerging market sovereign debt and high yield corporate bonds.
- Alternatives, particularly managed futures, have responded positively to the recent market volatility as trends become more defined and opportunities across markets begin to surface.

Economic Environment

Major themes of the year include the continued trade tensions between the United States and China, Brexit, the European Central Bank's continuing move into negative interest rate territory, and political unrest in Hong Kong. The global economic environment has certainly provided many causes for recent market volatility in 2019. Through it all, many asset classes have performed positively year-to-date.

Trade Tensions

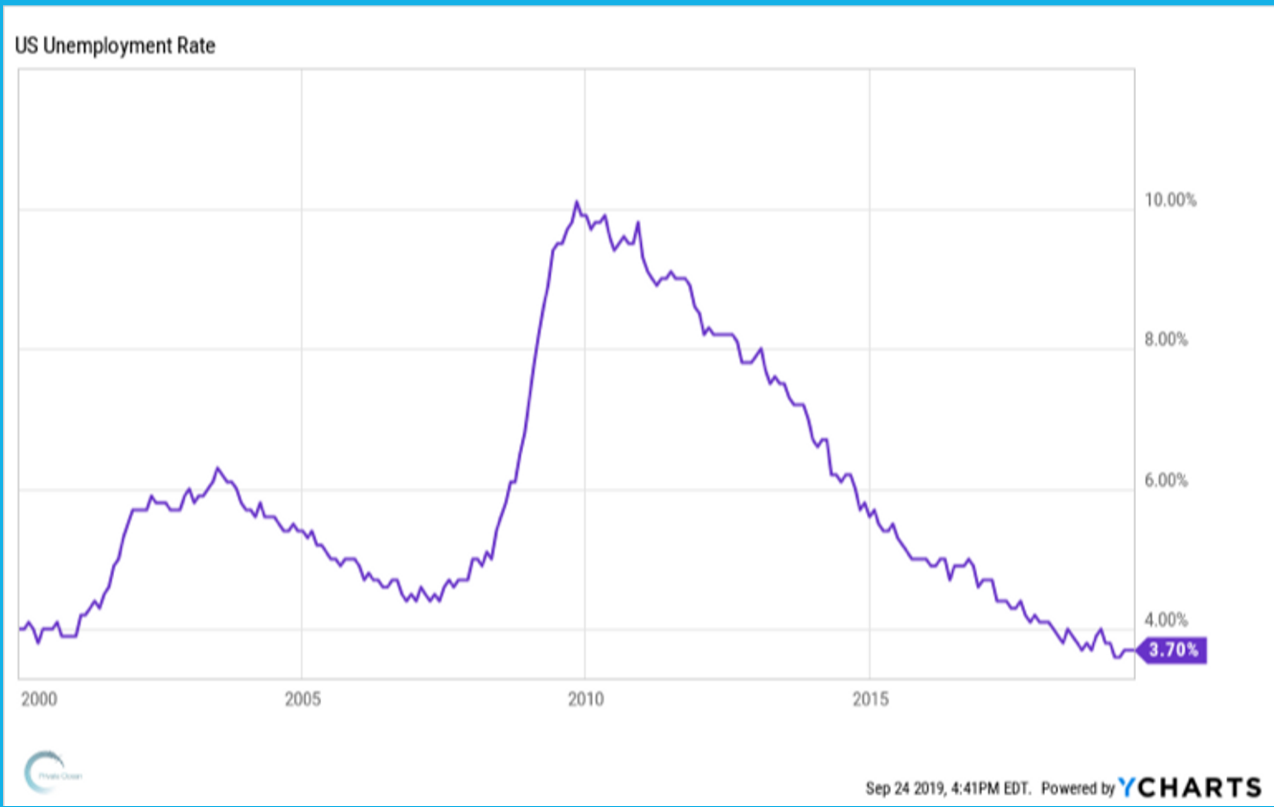
U.S. and China trade tensions can be traced back to the mid-1980's, when the trade deficit between the two countries began to widen. As of the end of 2018, the deficit between U.S. and Chinese trade was a staggering -$419.2B. In light of this, and due to continued issues around the preservation of intellectual property for domestic companies, there have been heightened tensions. One fiscal tool that has been used to try to close the gap has been tariffs. The tit-for-tat tariffs between the two countries have hurt both, and in the short-term, has had marginal impacts on the trade deficit. The protracted period of high trade tensions is slowing growth in China, which has further impacted other emerging market economies. In tandem with slowing industrial production, world trade growth has decelerated sharply over the past year. While markets have swung widely in both directions, they have remained positive year-to-date across the board.



Brexit

Brexit has far reaching implications for an independent United Kingdom and its subsequent trade with the European Union. The third quarter saw Theresa May resign from her post and her replacement, Boris Johnson, take major losses in Parliament as he tried for a "no deal" Brexit (a British exit without an agreement in place with the remaining EU countries). Given Britain's political turmoil, their currency, the Sterling, has continued to tumble from its 2016 high (just before the initial Brexit vote was passed). Recently, many UK based businesses have begun to relocate operations to Ireland or other European countries to continue taking advantage of trade agreements among EU countries. Tensions between the United Kingdom and the European Union have significantly impacted these markets, and there is continued uncertainty about what may happen in the long-term.

U.S. Employment Markets



The Federal Reserve has been given a dual mandate – maintain low unemployment through economic growth and keep inflation under control. With an additional 130,000 jobs added in August, the U.S. unemployment rate of 3.7% is at its lowest level since 1969. This is in stark contrast to the over 10% unemployment rate when the global financial crisis began in late 2008. Our strong labor markets are a product of an economic expansion that is now entering its 11thyear.

U.S. Inflation and Interest Rates

Inflation, the second component of the Federal Reserve's dual mandate, has remained at just below 2% for some time now. Inflation, as measured by the Consumer Price Index (CPI), currently sits at 1.8%. While the Fed just initiated another ¼ of a percent rate cut, there continues to be pressure on the Fed to cut the Fed Funds rate even further. As it stands now, the Fed Funds rate sits between a target of 1 ¾ and 2 percent. Many Fed watchers believe there is likely to be one more rate cut before year end.

U.S. Consumer Sentiment

Consumer sentiment is an important leading economic indicator because consumption is the largest component of GDP. Consumer and business confidence have continued to slip through August according to the Confidence Board’s Confidence Indices. Nonetheless, consumer confidence remains positive overall.

Equities

In general, equities have fared very well this year with most global equity markets generating positive returns year-to-date. While uncertainties remain surrounding U.S.-China trade tensions, Brexit, and further quantitative easing from the world’s central banks, equity markets have been rewarding to long-term, strategic investors.

Domestic Equities

U.S. equities have continued to outperform their international and emerging market peers through 2019. The U.S. economy has been bolstered by large cap and growth stocks, particularly in the technology sector. Large cap stocks, as measured by the Russell 1000 index, have risen 19.0% year-to-date. In comparison, small cap stocks, as measured by the Russell 2000 have experienced gains of 11.9% over the same period. Value has continued to struggle as investors continue to pour money into larger, growth-oriented stocks. This is not unprecedented. While we expect the value factor to generate greater performance over time, it will nonetheless experience periods of underperformance in some periods. Over the last decade, we have been in an environment that has been particularly rewarding to growth-oriented stocks and less favorable to value stocks. We fully believe this relationship will shift back in time and that over the longer-term, value will outperform growth.

Developed International Equities

As mentioned above, international equities performed well, though less so than U.S. equities. There are a variety of factors that have contributed to this, but the main factor is the slower economic growth in European markets. Regardless of the recent outperformance by U.S. equity markets, we believe it is still prudent to diversify across international markets. As measured by the MSCI EAFE Large Cap Index, international large cap stocks generated a positive return of 12.1%. Meanwhile, international small cap companies, as measured by the MSCI EAFE Small Cap Index, rose 12.0%.

Emerging Market Equities

A significant number of emerging market countries have initiated a series of interest rate cuts in an effort to aid economic growth and continue expanding with the rest of the global economy. 37 emerging market countries have initiated a total of 14 interest rate cuts in synchrony with developed markets. This aids their export markets. Emerging markets garnered positive returns year-to-date. According to the MSCI Emerging Markets Index, emerging market equities have risen 5.2% so far in 2019.

Fixed Income

Interest rates have been declining globally, but foreign debt markets have been particularly struck by negative interest rates. The European Central Bank (ECB) announced a further rate cut of 10 bps, pushing their interest rate on deposits to -50 bps. As of this writing more than $17 trillion worth of foreign notes have a negative yield. Fixed income markets are having a strong year from a total return perspective as lower yields push bond prices up. Among the highest performing bonds are high yield corporate bonds and emerging market sovereign bonds.

U.S. Treasuries

The U.S. bond market has been the go-to haven given the recent volatility. While negative interest rates plague European markets, U.S. treasuries continue to offer positive yields and strong total returns overall. The U.S. bond market, as measured by the Bloomberg Barclays Aggregate Bond Index, has returned 8.9% year-to-date.

U.S. Treasury Inflation Protected Services

Inflation protected securities have also generated positive returns so far in 2019. Treasury Inflation Protected Securities, or TIPS, continue to be a diversification tool and a way to protect a slice of the fixed income portfolio from unexpected jumps in U.S. inflation. TIPS returned 7.9% year-to-date, slightly beating out the return on U.S. treasuries by a half percent.

High Yield Corporate Bonds

The high yield corporate, or "junk", bond market has thrived in the current fixed income environment. Recently, there have been additional fund flows into high yield corporate bond ETFs and mutual funds. This suggests a degree of optimism about this sector. High yield bonds are bonds issued by companies with a weaker credit standing which exposes investors to higher levels of default risk. This is usually compensated with a higher expected return. High yield corporate bonds in the U.S. have gained 11.3% return thus far in 2019, per the Bloomberg Barclays U.S. Corporate High Yield Index.

Emerging Market Debt

Emerging market debt has been the strongest performing asset in our fixed income sleeve. As previously mentioned, many emerging market countries are lowering rates, thereby pushing up bond prices and benefiting total returns. Year-to-date performance for the JP Morgan Emerging Market Bond Index has topped 12.0%.

Real Estate

Both domestic and foreign real estate investment trusts (REITs) have had an outstanding year so far. A low interest environment and positive valuations across the board have helped many REITs thrive. This year, domestic REITs have outperformed international REITs. According to the Dow Jones U.S. Select REIT Index, U.S. based REITs have generated a 23.4% return year-to-date. In comparison, foreign REITs have returned 17.5% over the same period, according to the Dow Jones Global Ex U.S. Select REIT index.

Alternatives

Liquid alternatives play a key role in diversifying our overall portfolios. Liquid alternatives have a nearly zero correlation with both global equities and fixed income markets. In the currently volatile market, with its large market moves and fewer trend reversals, managed futures (a subset of the liquid alternatives universe) have thrived. Per the Société Générale CTA index, managed futures have returned 8.5% year-to-date. Other liquid alternative funds have fared better in prior years.

Conclusion

The ongoing U.S.-China trade dispute and other geopolitical uncertainty along with negative yields in large swaths of the European debt markets continue to contribute to market volatility. Economies around the global have begun to slow down and have showed some signs of weakened growth. Despite this, most asset classes have experienced positive returns year-to-date.

Sources

1. https://www.un.org/development/desa/dpad/publication/world-economic-situation-and-prospects-september-2019-briefing-no-130/

Additional Resources: Bloomberg, Morningstar Direct, YCharts, Bureau of Labor Statistics, Federal Open Market Committee, MSCI Inc., JP Morgan, Statista.

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