Monthly Update

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The two main catalysts that helped lift markets in September carried over into October: hopes for a US/China trade deal and a third rate cut from the Federal Reserve. This initial deal between the US and China, termed "Phase One," seemingly just needs I's dotted and T's crossed. This phase will include increases of Chinese purchases of US agricultural products to the levels seen in 2017, along with parameters on currency movements, and the further opening up of the Chinese financial industry. In return, the US will not follow through with the planned December 15th tariffs on $160b worth of Chinese imports. There is also a slight possibility, according to the news, that the September 1st tariffs on $110b worth of Chinese imported goods would get rolled back. Let's hope so. Phase Two will likely include the protection of US intellectual property, and addressing the worries of US businesses that are threatened to transfer their technology to Chinese partners. The latter part will be more difficult to come to terms with, but hopefully, we'll see some progress in that area.

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As largely expected, the Federal Reserve cut its federal funds rate by 25 basis points on October 30th to a range of 1.5-1.75%[1]. This marks the 3rd rate cut this year, in what Chairman Jay Powell has defined as a 'mid cycle adjustment' to policy. Rather than the beginning of a more pronounced rate cut cycle, this adjustment was put into place in order to address any sharp economic slowing. The US economy has moderated, hence the rate cuts, but Powell and his colleagues are hopeful that what they've done so far will be enough to, at minimum, stabilize growth at current levels.

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October also saw a flood of earnings releases, with Corporate America giving us their take on things during Q3 and guidance about what they are observing in Q4. As is typical, about 70% of companies have beat earnings expectations, with about 60% exceeding revenue estimates[2]. Notwithstanding the historical beat rate, earnings per share are still expected to decline about 2.5% in Q3, and Q4 earnings estimates have turned slightly negative versus a 2.4% expected increase predicted at the end of September[3]. After rallying by 1.7% in September, the S&P 500 was higher by 2% in October[4]. The US Treasury went the other way as yields rose. The 10 year yield closed the month at 1.69%, up 2.5 basis points, but as of this writing in early November, they are now up to 1.87% on those trade deal hopes and the subsequent belief that economic growth will stabilize[5].

1. Federal Reserve
2. – 5. Bloomberg

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That belief helped to lift commodity prices with the CRB index up by 1.7% in October[6]. After three months of gains, the US dollar ran out of steam and closed the month down 2%, as measured by the euro heavy dollar index[7].

The Federal Reserve and Interest Rates

As stated, the Fed cut rates for the 3rd time this year, but importantly signaled that this might be the last time for a while. The Fed regards the three rate cuts this year as 'insurance' against a deeper economic slowdown. Any future rate cuts would be due to the economic data softening further. Jay Powell said it would take a jump in inflation in order to reverse any of these cuts. They don't see that likelihood anytime soon. While the Fed directly controls short term rates, the market drives the direction of long term rates, and the rise in October is continuing into November.

In response to the Trump tariff threats, and in addition to anticipated further easing from the European Central Bank and the Fed, global bond yields plunged in August[8]. Since then, the global bond yields have steadily risen as the tariff threat has been scaled back. It is now the desire of the Bank of Japan for higher long term rates in order to steepen their yield curve. There was major push back against Mario Draghi for his last bout of monetary easing, as well as hopes that the global economy can start to improve from here. This trend up in rates has taken Japanese and European bond yields to their highest levels since July, and has left the yield on the US 10 year yield is just shy of its July high[9]. I expect this trend to continue and believe that the tight correlation between yields in Europe and Japan, with US yields, will continue.

The Global Economy

In the 3rd quarter, the US economy saw 1.9% growth following an increase of 2% in Q2 and 3.1% in Q1[10]. According to the NY Fed and the Atlanta Fed, GDP growth right now is estimated to be up around just 1%. Weakness in manufacturing, capital spending and trade are the main culprits for the softness in response to trade tensions and a moderation in the pace of Chinese growth. The US consumer remains the strength of the economy, as the unemployment rate is still near 50 year lows and wage growth has been the best in this expansion. Thus, continued health of the labor market is key to sustaining this economic expansion. Chinese growth continues to slow, with Q3 GDP coming in up 6%, the slowest rate of gain in at least 30 years of data[11]. The German economy likely contracted in Q3 with overall Eurozone growth of just 1.1% y/o/y in Q3[12].

6. – 12. Bloomberg

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Stocks

The US stock market is riding the hopes that a trade deal with China and the rate cuts from the Fed will help reverse the recent economic slowdown. In fact, the $64,000 question is, to what extent do we see improvement in coming quarters in response to both of these catalysts? The year to date gain in the S&P 500 through October is a solid 21%, but this followed the 14% decline in Q4[13]. With respect to valuations, the S&P 500 is now trading at 19 times expected 2019 earnings, and slightly more modestly at 17 times 2020 estimates[14]. Thus, going forward, an improvement in earnings is key for markets.

To this point, earnings are on pace to fall for the 3rd straight quarter in Q319 and the estimate is now for a slight decline in the fourth quarter, as mentioned earlier[15]. Revenue growth has slowed as global nominal GDP moderates and profit margins are now receding, largely in part to higher labor costs.

International markets have had a nice run recently, as the ACWI ex US All World Index rose 3.1% in October, after a 2.7% rise in September (in dollar terms)[16]. With such a dramatic underperformance of international markets over the past decade, compared to the US, we believe some reversion to the mean is likely in order.

As I mentioned in my September letter, there is an ongoing valuation rethink when it comes to some individual stocks, which continued in October. Investors now want profits, not market share. Or, at least they want a well thought out plan to a path that leads to profits. Value has begun to outperform growth and we expect this trend to continue as the spread between the two has been as wide as it was in the late 1990's[17].

Currencies

The US dollar index took a 2% breather in October after gains in 7 of the past 8 months[18]. The Pound saw a sharp rally against the Dollar in response to hopes that a final resolution to Brexit, which will include a deal, is finally upon us after Boris Johnson most likely gets elected in December[19]. The Yuan rallied against the US dollar on the positive early feel on the trade talks, and this helped to lift most other Asian currencies[20]. Versus our largest trading partners, Mexico and Canada, their currencies rose as well against the US dollar[21]. In turn, this dollar weakness has helped to lift emerging market stocks and bonds[22].

13. – 14. Bloomberg
15. Factset
16. - 22. Bloomberg

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Conclusion

The stock market has continued to rally on hope, rather than on the fundamental economic and earnings outlook. The hope is that a US deal with China will be of substance and with a rollback of some tariffs, which can lead to a resumption in global manufacturing, investment, capital spending, etc. The other hope is that the Fed can engineer a soft landing with its 'mid cycle adjustment' rate cuts, which may, in turn, spur more borrowing and an improvement in the consumer areas of the US economy. The fundamental outlook, as stated, is more mixed with modest economic growth and declining earnings. In 2020, hope will very likely need to become a reality.

As far as interest rates are concerned, while central banks still dominate in their influence, I believe we have reached an endgame in extreme monetary activism in Europe and Japan, the homes of negative interest rates. This has broad repercussions for US rates, as our movements are highly correlated to theirs. Also, if the stock market "hopes" do turn into a reality, we should expect higher interest rates as a result.

Either way, we try to construct portfolios for our clients that are well diversified, with a long-term time horizon in mind; an investor's two best friends. Of particular importance is making sure our clients have their liquidity needs met over the coming 24-36 month period, which then makes market gyrations much less relevant during this time frame.

Please never hesitate to reach out at any time with questions or for any discussion on the economy or markets.

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