Monthly Update

September 2019

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After a month in the markets that was dominated by trade and tariff news, September brought some hope, as the US and China put a few days in October on the calendar for high-level meetings in Washington, DC. As each day passes, it would seem more and more necessary that both sides want and need a détente. Economic growth is slowing globally, and after a data point seen on October 1st in the U.S., U.S. manufacturing has now contracted for the 2nd straight month[1]. We are hopeful that the $300b tranche of tariffs, which followed the implementation of tariffs on $250b worth of goods, will be removed as part of any substantive deal, and we'll work on removing the rest at some point. This would remove a lot of business uncertainty and would go a long way in helping economic activity.

Economic growth is slowing globally, and after a data point seen on October 1st in the US, US manufacturing has now contracted for the 2nd straight month[1].

At mid-month, we did get another 25 basis point rate cut from the Fed, which took the fed funds rate to a range of 1.75% - 2.0%, but what they do from here is more unclear[2]. A majority of voting Fed members view these rate cuts as 'insurance' against further slowing in economic growth, while a few don't believe we need any rate cuts at all. The internal dissent means that future rate cuts will likely only occur on firm evidence of economic weakness, rather than for 'insurance' purposes.

I don't want to get into a political discussion here, but just to highlight that the impeachment inquiry initiated by the Democrats in the House will most likely just be fodder for Washington, DC and have little to no impact on Main Street and Wall Street. This is because it would go nowhere in the Republican controlled Senate. This said, if come March and April it starts to impact the direction of the U.S. Presidential election, then the markets and the economy could reassess.

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The end result in terms of the market's reaction to the trade and Federal Reserve news was a 1.7% rally for the S&P 500 in September, which marked the 7th month this year with gains[3]. International markets bounced as well, with the MSCI ex U.S. equity index up by 2.7%[4]. With this rally in stocks, along with hopes for a trade deal and a shift in monetary policy led to a rise in global interest rates. The US 10 yr yield ended the month at 1.67% from 1.5% at the end of August which though is still below the 2% level at which it closed July[5].

1. ISM Manufacturing
2. Federal Reserve
3. – 5. Bloomberg

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The Global Economy

The U.S. economy remains the best of the developed economies, but even its growth has been moderating. Based on estimates from the Atlanta and NY Fed, GDP growth for the just ended 3rd quarter is expected to be between 1.75% - 2% vs 2% in Q2 and 3.1% in Q1[6]. The U.S. consumer remains a firm support to the economy, offsetting the slowdown in manufacturing, trade and capital spending. Thus, the key question from here is can the U.S. consumer continue to be the bulwark of economic activity. Much will depend on the state of the labor market from here.

The 2nd biggest economy, that being China, continues to moderate, as industrial production, fixed asset investment and retail sales all slowed[7]. Japan, the 3rd largest economy, has also seen a slowdown in manufacturing, but a jump in consumer spending ahead of the October 1st value added tax increase has been an offset[8]. It's likely we'll see a fall in consumer spending once the tax takes effect. Germany, the 4th biggest economy, saw no growth in Q2, and Q3 is expected to bring no growth too[9]. The UK economy, the 5th largest, is griped by Brexit ahead of the October 31st deadline.

Stocks

As stated, stocks continue to be predominantly impacted by macro news and events, but that is likely to change in the second half of October, and into November, as corporate earnings get released. I've talked about the state of the global economy, but earnings season gives us a chance to quantify the impact on company income statements and balance sheets. For all the worries and concerns about trade, tariffs, slowing growth, etc… it has been a pretty impressive year for stocks, with the best start to a year since 1997[10]. Yes, it does follow a tough fourth quarter of 2018, but the comeback has been pretty solid.

Where we go from here will most likely be influenced by the tenor and results from the upcoming trade discussions in DC and the direction of corporate earnings, where earnings per share growth is expected to decline by 3% in Q3[11].

Lastly on stocks, September was noteworthy in the land of valuations of initial public offerings. WeWork and Elevation Partners both postponed their IPO's, as investors pushed back on the valuations at which they both wanted to sell stock. This rethink on valuations actually started with the IPO's of Lyft and Uber.

6. Atlanta Fed, NY Fed
7. – 11. Bloomberg
15. Federal Reserve

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The bottom line to this is that investors are now more focused on profits, and suddenly, valuations matter.

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Bonds and Central Bankers

In August, we saw a plunge in global interest rates as the new batch of tariff news hit and markets anticipated further easing by the Fed, ECB and possibly the BoJ. In September, we did get that rate cut from the Fed and more policy initiatives from the ECB, but then things began to change. The Fed questioned the need for more cuts. The ECB only added to its monetary stimulus slightly, and the BoJ said they now want long term interest rates to rise, rather than fall. After 20 years of monetary easing, the BoJ, wanting higher long term rates in order to steepen the yield curve and create a lifeline for its banking system, is potentially a major sea change that we need to watch. This is because what might happen in Japanese markets won't stay in Japanese markets, as U.S. bond yields are tightly correlated to Japanese yields and European yields, which are themselves correlated to Japanese bond yields. As our investment focus is on shorter term durations, we are mostly immune from any disruptions in the longer end of the bond market yield curve.

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We live in an extraordinary moment in time with respect to the world's bond markets because of the introduction of negative interest rates. Never, in 4000 years of financial history, has it been seen before. I used to believe that higher inflation would end this grand experiment, but instead, it just might be the realization that damaging the profitability of one's banking system via negative rates and a flat yield curve is not a good idea and that would result in a rethink of current monetary policy.

The US dollar index continued to rally in September and is also up 7 of 9 months this year[12]. The index is at the highest level it has seen in about 2 ½ years[13].

Currencies

The U.S. dollar index continued to rally in September and was also up 7 months this year[12]. The index is at the highest level it has seen in about 2 ½ years[13]. On one hand this is a good thing, as in our consumer driven economy it enhances the purchasing power of our currency and helps to limit inflationary pressures. On the other hand, it clips the earnings of those companies that export to international markets. It also pressures those overseas companies and countries that have borrowed money in U.S. dollars, but generate local currency revenues and earnings. At the end of the day, what we want is not a strong dollar, nor a weak dollar, but a stable dollar.

12. Bloomberg
13. Bloomberg

Conclusion

I believe the conclusion I wrote in my August letter is so apropos, as of this writing as it was last month, so I'm just going to repeat it again here. To say we are living in interesting times is certainly an understatement. The news flow is dizzying, I know, and the headlines can be unsettling. Now, more than ever, it is important to have a long term perspective when it comes to investing. Trying to predict the short term is impossible, particularly now. Having a longer term view allows us to better maneuver through events in a diversified fashion that keeps us from getting distracted. 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. Lastly, we are also always looking to take advantage of opportunities that markets present because in times like this, they usually do.

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

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