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2019 – Third Quarter Review

Gaining some clarity?

Brexit: British Prime Minister, Boris Johnson, has forced the action regarding Brexit. The British Parliament stood up to his threat to remove the U.K. from the European Union (EU) without a deal. In turn, Mr. Johnson has struck a deal with Northern Ireland, the EU, and likely with Parliament to leave the EU with a documented arrangement. There is much to play out, but a disorderly exit has been taken off the table. That is a relief.

China: The trade negotiations with China seem to have reached an inflection point. The escalation of trade penalties from both sides appear to be giving way to an incremental approach to working through issues while gradually reducing tariffs and goods restrictions in the process.

Resolution soon? We are more hopeful on the timeliness of a Brexit solution. On the world stage, China has proven to have blinkered vision with regard to ethical business practices given their government's penchant for world dominance. This is making negotiation for elimination of forced technology transfer, elimination of technology theft, and open markets for foreign corporations in China very difficult. Will China feel the need and pressure to change?

Last quarter, we discussed the unlikely and simultaneous advance of stocks and bonds in 2019. Usually, stocks rise with the prospect of economic / corporate sales and earnings growth. Bonds rise with the prospect of trouble ahead. Yet both asset classes were providing above average returns.

A turn for the worse: During the second quarter, the Treasury yield curve inverted. In the third quarter, the yield curve inversion worsened to the point the 10-year Treasury yield was almost 0.5% lower than the 3-month Treasury rate by late August and early September. Historically, most yield curve inversions point towards a recession within a year or two.

A quick reversal: Along with the improvement in Brexit and USA – China negotiations, the 10-year Treasury is now yielding almost 0.5% higher than the 3-month Treasury. The change from an inverted yield curve to one with a positive slope is reflected in intermediate and long-term bond prices declining. Negative yielding bonds worldwide have declined $4.5 trillion to $12.5 trillion from the high-water mark in August. This is a signal that prospects are improving across the globe. The bond market has gone from flashing red to a much calmer state. Simultaneously, the stock market has re-gained ground lost during the time the Treasury curve was inverted.

Voting machine: The securities market is a short-term voting machine and a long-term weighing machine. The voting machine has gone from sending mixed signals (stock and bond prices rising) to being more decisive (stock prices up and bond prices down) over the last month. The voting machine is indicating comfort that the economy will continue in a positive direction. We believe this result is directly attributable to the improvement in the Brexit negotiations and the U.S. – China trade negotiations.

Contagion? Due to their strong export-based economies, Asia and Europe have been and are feeling the effects of the trade tariff tit for tat the most. But, in the USA, the consumer is still feeling strong with high employment, growing wages, and no threat of high inflation. Although some progress is being made regarding Brexit and the U.S. – China trade battle, uncertainty for corporate planners will remain until each are resolved. This uncertainty is directly restricting corporate investment.

Market Data

Through the third quarter, a 100% stock portfolio with 20% invested in international returned 21.63% with dividends reinvested. Intermediate term bonds were up 8.72% (Barclay's Aggregate Bond Index) and short-term bonds were up 3.32% (S&P Short Term Bond – Gov't/Corporate Index).

Growth stocks outgained value stocks in the first three quarters of the year by 5.32%. Therefore, value stocks trailed all stocks by 2.66%. This is an improvement of 0.64% from the 2nd quarter end.

At the third quarter end, price to book value of growth stocks was 8.14. This is 68.5% above the long-term average of 4.83. Price to book value of value stocks was 2.09. This is 3% above the long-term average of 2.03. Valuations for growth stocks and value stocks remain in stark contrast. In the month of September, value stocks outgained growth stocks by 3.74%. Is this the turning point for value investing? Let's hope so.

Evidence of tenuousness remains in this ten plus year bull market. In 2019, $500 billion has been added to cash accounts, $275 billion has been added to bonds, and the pool of equity investments has declined by $190 billion.

Macroeconomics / U.S. and World Economy

USA: First quarter, second quarter, and third quarter real GDP growth rates, 3.1%. 2.0%, and 1.9%, beat expectations. The slowdown from 2018 and first quarter real GDP growth rate of 3% down to about 2% in Q2 and Q3 this year is attributable to the reduction in corporate investment as a result of the U.S. – China trade dispute. Estimates by business groups, the Federal Reserve and the International Money Fund (IMF) for U.S. GDP growth for 2019 range between 2.4% and 2.1%, while estimates of economic growth for 2020 center around 2%. This year, corporate earnings comparisons are more difficult given the boost provided by tax reform in 2017 and 2018. That said, 75% of companies in the S&P 500 beat consensus earnings estimates in the 3rd quarter. This is an above average result. Sales were up 3% in Q3.

Euro area GDP slowed to 1.1% in the third quarter from 1.2% in the second quarter. This was the weakest growth since 2013. Euro area GDP growth forecast for 2020 is 1.1%.

Japan also slowed to 1.3% GDP growth in the 2nd quarter from 2.2% in the first quarter. Japan hasn't reported third quarter growth yet. The forecast for 2020 is 1%.

China's GDP growth rate continues to slow. Q1 was 6.4%, Q2 was 6.2%, and Q3 was 6.0%. 5.8% is projected for 2020. Will their growth rate trend be incentive to negotiate with the U.S. in earnest?

World: The IMF recently lowered their forecast for worldwide GDP growth from 3.3% to 3.0% this year. Although, they are projecting 3.4% worldwide GDP growth in 2020.

The impact of the U.S. – China trade negotiations is being felt in business investment numbers as well as Institute of Supply Management readings for manufacturing and to a lesser extent, the services industry. Numbers above 50 mean growth. Service numbers have gone from the upper 50's late last year to a three-year low in August of 52.6. The service number rose back up to 54.7 in September. The manufacturing sector had its first reading below 50 in August after averaging 56.5 over the previous 35 months. September and October readings were 47.8 and 48.3, respectively.

U.S. retail sales are up 5.1% through September, including a 0.3% decline that month. U.S. personal consumption for goods and services, which account for 67% of the U.S. economy, is up 2.46% from one year ago (3rd quarter end to 3rd quarter end). This is a slow-down from the 2nd quarter reading of 4.37%.

The U.S. consumer is being supported by continuing strength in employment. Initial claims for unemployment insurance remain at very low levels. This data points to continued growth in employment. The September slowdown in retail is not a trend. An uptick in retail is expected for October.

The headline rate of unemployment has ticked up to 3.6% in October from 3.5% at 3rd quarter end. The participation rate is rising, and the underemployment/unemployment rate is declining. Furthermore, the potential for gain in employment has dropped from 3% to 2.4% to date this year. That means **more people are rejoining the workforce**. The hiring rate in 2018 was 223,000 per month. In 2019, it is 173,000 per month through October.

Productivity rose in the first quarter this year to 3.5%, 2.3% in the 2nd quarter, and 3.5% in the 3rd quarter. This compares with 2.4% last year. Wages are continuing to grow at 3.1% to 3.2% this year.

Automotive sales and the housing market have very likely peaked. Automotive sales have been running in the 17 to 17.5 million range for the last three years and are projected to come in at 16.8 million vehicles this year.

At $1.294T, total construction spending is down 2.3% from the peak in May of 2018 of $1.324T, but it is up 2.3% from a revised last year end of $1.265T. According to the National Association of Realtors, the residential home supply is still a low 4.1 months. A six-month supply would be parity for buyers. According to Zillow, the median home price has risen 4.8% over the last year. They project the median price will rise 2.8% within the next year. The housing market remains hot, but it is limited by supply.

Since the end of 2015 through the end of 2018 the Federal Reserve raised interest rates by 0.25% nine times. The threat of economic slowdown has led the FED to lower rates three times this year. This recent FED action was subsequent to a precipitous drop in the 10-year Treasury rate at the hands of worry over a threat of a disorderly Brexit and the contentious U.S. – China Trade battle. The FED has a dual mandate of full employment and stable prices, which the FED has defined as symmetry around 2% inflation. The FED has indicated relative comfort with the present state of the economy given their dual mandate. They don't anticipate any further interest rate adjustments this year.

Conclusion

All said the economy in the USA is in decent shape, but beyond the peak of the economic cycle. Business decision makers are generally on hold for an outcome on U.S. – China trade negotiations and Brexit. Good results would release the animal spirits and a bad outcome or much extended negotiations would continue to slow the world economy. Recent news on both fronts has been welcome and reflected in the securities market.

Please feel free to contact us with any questions, or if you would like to schedule an in-person or phone meeting.

Thank you,

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