3Q 2019
Market Commentary

With the lack of apparent progress in U.S./China negotiations, trade woes continue to weaken economic growth around the world. Add to this the fear surrounding uprisings in Hong Kong, China's conduit to world financial markets, and world growth becomes all the more negatively impacted. Rising world trade has been such an important part of the secular improvement in world GDP and income per capita, any slowing of trade growth is a concern. Current uncertainties have dampened capital spending plans, cross-border investment, and even U.S. domestic investment. As a result, weakness in numerous economic indicators has resulted in reduced world GDP growth forecasts and rising fears of recession in the U.S and Europe.

At the same time, some easing of tensions has occurred. Devastation of hog herds due to the swine flu recently caused China to agree to remove tariffs and to buy U.S. pork and soybeans again. In addition, the newly announced trade agreement with Japan (that does not require Congressional approval) should benefit U.S. agricultural exports. Finally, passage of the USMCA replacement for NAFTA would reduce uncertainty and rekindle growth in North America. While it appears to maintain bipartisan support, the decision by the House to investigate impeachment of President Trump may make it politically impossible for the USMCA to come to the House floor for approval. Failure to approve the USMCA would be a huge disappointment. Our recommendation to the President would be: avoid launching any other trade battles, focus on passing the USMCA, and commit to arriving at a more modest agreement with China.

Even in the face of these trade and other challenges, U.S. economy has so far remained resilient due to the combination of reduced corporate and personal tax rates and the reduction in federal regulations (partly from the Executive Order to remove two existing regulations for every new one added). Low unemployment claims (leading indicator), continued growth in jobs (lagging indicator), and strong consumer income and spending growth so far support GDP growth of 2-2.5%. However, the $64,000 question remains: will withering U.S. investment finally dampen consumer optimism, taking growth down with it? The jury is still out on this one.

In contrast, Europe appears caught in a slow moving downward spiral from the trade uncertainty (with falling orders from China) and the sort-of renewed "Battle of Britain" over Brexit. Exiting the E.U. trade sphere is a momentous decision, and although it may once again be delayed from the current October 31st deadline, the complete lack of consensus in Parliament has led to intra and inter-party warfare. Recapturing its sovereignty over trade and immigration will come at a great cost to U.K. citizens and business, but once a decision is finalized, everyone will work to make the transition work. The problem that hinders U.K. growth now is as much the uncertainty as the eventual outcome.

As forecasts of recession risk in the U.S. have risen, the pressure on the Federal Reserve Board to significantly cut the Fed Funds rate continues to build. The inversion of the short-end of the Treasury yield curve already forecasts more cuts to come to support the return to a positively-sloped yield curve. With 30-year Treasury yields already at historically low levels, further cuts in the Fed Funds rate are unlikely to provide stimulation to the economy. Housing starts and auto sales may be helped from such cuts, but only the resolution of trade disputes would likely lead to reacceleration of economic growth. The European Central Bank's decision to drive down interest rates with bond buying and to sustain negative real and nominal interest rates will not help the European economy. Such policies so disrupt the normal functioning of credit markets that they

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hurt more than they help. For the Fed, stability in currency exchange rates is an admirable goal, but distorting credit markets to cause the U.S. dollar to weaken is not a good idea.

Naturally, the financial markets remain schizophrenic regarding this uncertainty, rallying or plunging on short-term news flows. Bond yields plunged in August as trade news and economic reports appeared to be disappointing and then rose in September as economic indicators improved or at least created positive surprises. The stock market reacted in the opposite direction, falling as bond prices rose (yields down) and vice versa. After the strong market gains in the 1st half of 2019, major stock market averages on balance treaded water in the 3rd quarter.

The relative sluggishness in the U.S. economy (slowing real GDP growth) combined with the continuation of the monetary easing cycle prolonged the recent drought of value investing underperformance relative to growth investing. Although, in the long run (40 years ended 2018), each investing style had equal chances of outperforming the other (20 years for each), though in the last 10 years, growth outperformed in seven calendar years compared to only three for value. Subdued price inflation and low interest rates greatly benefited growth-stock valuations during this period, while subpar real growth hurt economically-sensitive sectors (e.g. energy, materials, and industrials). Using FAANG stocks as an example (Facebook, Apple, Amazon, Netflix, and Google but also including Microsoft), valuations have reached extremes that appear unlikely to be sustained. While the jury is out on such concerns over privacy, governments around the world have begun to step up their attacks, taxes and regulations on the use of such information to exclude competitors from markets.

In this light, it is interesting to see the dramatic turnaround in September in the fortunes of value stocks relative to growth stocks, where the S&P 500 Value outperformed the S&P 500 by nearly 2%. The difference in valuations between growth and value stocks hasn't been this large since the dot-com bubble burst in early 2000. Improving relative performance doesn't require an improving economy, but in combination with even a modest trade agreement with China, value stocks could shine once again.

The analysis and opinion expressed in this report are subject to change without notice.

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