HIGHTOWER
WESTCHESTER

Q3 2019 Market Commentary

A dizzying third quarter is in the books and much like last quarter, it was full of ups and downs in the markets. Stock and bond values moved in response to the rhetoric from the participants in the trade war between the United States and China. The Federal Reserve ("Fed") embarked on a new easing cycle with two rate cuts, but the initial reductions in July were received as being more hawkish than many were expecting. More new jobs were added, but at a reduced rate, while wage growth has continued its strong pace. Manufacturing and industrial production remain muted, influenced, in part, by the waning global economy. To the dismay of President Trump, the dollar saw broad strength vs. most other currencies. Brent and WTI crude declined 8.5% and 5.8%, respectively, despite a wave of drone and missile attacks against Saudi Arabia's energy infrastructure.[1] Nevertheless, consumers were unphased by economic developments, spending at a steady rate throughout the quarter.

July kicked off the third quarter in a somewhat lackluster manner, as the benchmark indexes listed here posted gains over June's respective closing values. The Nasdaq gained over 2.0% for the month, followed by the S&P 500, which rose 1.31%.[1] The Dow Jones Industrial Index ("Dow") and the Russell 2000 inched ahead by less than 1%, while the Global Dow dipped by almost half a percent.[1] The Federal Open Market Committee ("FOMC") reduced short-term interest rates 0.25%, which sent stocks falling.[1] However, strong corporate earnings reports, low unemployment, and higher wages helped ease investors' concerns by the end of the month.

August started with President Trump's threat to impose additional tariffs on Chinese imports, which sent stocks plummeting. Throughout the month, each of the benchmark indexes listed above continued to lose value. Even a final-week push couldn't save stocks from posting month-over-month losses. Oil and gas prices at the pump fell in August, while long-term bond yields plunged as prices soared.

September saw many of the benchmark indexes post solid gains. Value outperformed growth by 3.60% in September but still unclear if this is a lasting trend. The FOMC once again lowered interest rates 0.25% during the month following July's 0.25% cut (the FOMC did not meet in August). By the close of trading on September 30th, the price of crude oil (WTI) was $54.37 per barrel, down from the August 30th price of $55.16 per barrel.[1] The price of gold dropped by the end of the month, falling to $1,479.30 by close of business, off from $1,529.20 at the end of August.[1]

Market/Index	*2018 Close*	*As of Sept 30*	*Month Change*	*Quarter Change*	*YTD Change*
DJIA	***23327.46***	***26916.83***	***1.95%***	***1.19%***	***15.39%***
NASDAQ	***6635.28***	***7999.34***	***0.46%***	***-0.09%***	***20.56%***
S&P 500	***2506.85***	***2976.74***	***1.72%***	***1.19%***	***18.74%***
Russell 2000	***1348.56***	***1523.37***	***1.91%***	***-2.76%***	***12.96%***
Global Dow	***2736.74***	***3021.34***	***2.31%***	***-1.73%***	***10.40%***
Fed. Funds	***2.25%2.50%***	***1.75%-2.00%***	***-25bps***	***-50 bps***	***-50 bps***
10-year Treasuries	***2.68%***	***1.67%***	***17 bps***	***-33 bps***	***-101 bps***

Source: FactSet[1]

Value stocks have lagged growth stocks for some time, so it is of particular interest that we note a small turnabout as value stocks did just a bit better than growth stocks in the third quarter – not nearly enough to make much of a dent in the large outperformance of growth over value in the year's first six months, but this still gives some hope of the market's long-anticipated return to rationality. However, international stocks still lag domestic stocks, and many think a reversion to the mean in that regard could be in the cards at some point in the future.

Valuation for U.S. stocks remains high by some of the most historically accurate measures but appear reasonable when compared to historically low bond rates. Long-run returns appear likely to be below the stock market's long-run historical average, but ahead of the returns currently offered by bonds or cash. The priciest and most popular growth stocks are much more expensive than the market overall, and therefore riskier. We will continue to regularly rebalance and widely diversify to help mitigate risk as we have always done.

According to FactSet, Q3 earnings for S&P 500 companies are currently expected to decline by 3.7%, the third straight quarter of year-over-year ("y/y") declines and the first time since Q4 2015 - Q2 2016 that earnings have declined three quarters in a row.[1] For the quarter, five sectors are predicted to report y/y earnings growth, led by the Utilities and Real Estate sectors. Six sectors are projected to report y/y declines, led by Energy, Information Technology, and Materials. This is why it makes sense to maintain an allocation to actively traded funds. They have the ability to navigate the investment landscape by scouting out companies in their respective sectors that have and are showing strong earnings growth.

Looking ahead, analysts are projecting earnings growth of 2.9% and revenue growth of 3.6% for Q4.[1] Earnings growth in January for Q4 was expected to be 11.1% so the trend of lowered expectations continues. Still, if estimates fall into place as expected, the full-year earnings growth

The bond market was the big story in the third quarter, with the Fed embarking on its first rate cut cycle in over ten years by reducing the overnight fed funds rate 0.25% at both the July and September FOMC meetings. The initial cut in July was proceeded by historic declines in the 10-year and 30-year yields, a temporary inversion of the 10-year – 2-year spread, and a new all-time low for the 30-year yield. In late August the entire curve was trading below the overnight funds rate. In early September many short-term funding rates ballooned higher including the overnight fed funds rate reaching 3%, despite the Fed's then 2% - 2.25% target range. The Fed has since been forced to implement daily repo operations for the first time since emerging from the financial crisis. A more permanent fix to the liquidity crunch could be announced at the October meeting. Some "plumbers" are expecting a permanent repo facility while others see the need for a more impactful QE-like response.

The broad U.S. bond market, as measured by the Bloomberg Barclays US Agg Index, returned 2.3% to investors as risk sentiment continued on its roller coaster.[1] Demand for U.S. Treasuries pushed rates to levels not seen since 2016. Investment grade and high yield corporates delivered solid returns in Q3, gaining 3.1% and 1.2%, respectively.[1] Given the downward trend in rates, U.S. Treasuries, which come with a hefty duration profile, returned 2.4%.[1]

Municipal bonds rose 1.6% in Q3, underperforming its taxable peers by 0.69%.[1] Strong technicals and encouraging fundamentals supported the positive performance. Taxable municipal bonds were the top performing sector increasing 3.4%, while pre-refunded municipal bonds suffered, only up 0.4%.[1]

Precious metals such as gold and silver gained +4.5% and +4.9%, respectively, in Q3, but each closed out the quarter on a sour note with declines of 3.2% and 8.7% in September.[1]

As we look across the pond, British Prime Minister Boris Johnson attempted to shut down Parliament for several weeks as part of his effort to push through a "no deal" Brexit by October 31. However, the United Kingdom's Supreme Court ruled the move was unlawful. How this affects Brexit moving forward remains unclear. Household spending helped push the eurozone gross domestic product ahead in the second quarter. The eurozone economy has grown 1.2% year-over-year.[1]

Emerging market equities were down as U.S.-China trade tensions escalated and concerns over global growth continued to mount. The MSCI Emerging Markets Index decreased in value and underperformed the MSCI World.[1] China underperformed by a more modest margin. The U.S. announced 10% trade tariffs on $300 billion of goods imported from China, some of which took effect in September. Following the announcement, the renminbi weakened beyond the symbolic seven-per-dollar threshold, and in response the U.S. Treasury labelled the country a currency manipulator. The U.S. also announced plans to increase existing tariffs of $250 billion of Chinese goods from 25% to 30% in October. China responded by announcing tariffs on $75 billion of U.S. goods.

Hong Kong SAR was the weakest index market, as demonstrations continued, despite the authority's efforts to resolve social unrest.

Impeachment, trade war with China, Iranian aggressions, looming Brexit, an inverted "yield curve" that might signal recession, ballooning debt – investors have plenty of concerns today. Yet the economy has so far kept powering on, interest rates and inflation each remain low, and this year through 9/30, the stock market has been unusually strong. However, that strength is basically recovering from weakness in last year's 4th quarter, and the stock market is still hovering near the high it made just over a year ago.

Can we talk ourselves into a recession, sure we could. A further downward spiral in sentiment would spell trouble. It could start a self-fulfilling cycle of layoffs, puny wage growth, anemic consumer spending, and lousy profits. With that said, past U.S. recessions have mostly begun after a shock or imbalance in the economy, which then impacts sentiment.

Looking ahead to the fourth and final quarter of 2019, stocks are often weak in October and finish the year stronger in November and December. We'll see if that pattern persists this year. Escalating trade conflicts and tariffs in August did affect attitudes and likely delayed further economic recovery. So where could the economy go from here? We think there will be growth in the U.S. this year and expect modest fading late next year. Better growth suggests equity markets could rebound from any summer relapse and long-term interest rates might bounce from their current super-low levels, along with stocks, for a while.

Overall, the global economy faces several binary and highly unpredictable risks. Until we have more clarity on the answers to these questions, we continue to believe that maintaining a diversified portfolio, rebalancing and owning uncorrelated assets such as alternatives, real assets and the like makes sense. In addition, not overreacting to market and geopolitical noise, while focusing on the fundamentals remains critical.

To discuss this commentary further, please contact us at 914-825-8630.
Hightowerwestchester.com

[1] *FactSet financial data and analytics. www.factset.com*