WEALTH MANAGEMENT MADE SIMPLE

nine points investment management

Third-Quarter 2019
Nine Points Investment Management (NPIM) Market Commentary
by CIO Clifford T. Walsh, CFA

THE S&P 500 index grew yet again in the third quarter with a 1.7 percent gain, following the gain of 4.3 percent in the first quarter. However, from a risk perspective, performance was much more mixed compared to the broad strength experienced in the first half of 2019. U.S. small cap stocks were down 2.4 percent in the third quarter while developed international and emerging market stocks declined roughly 1.1 percent and 4.3 percent, respectively. What's more, even with the indices generating positive returns, the drivers of performance shifted to more defensive sectors like consumer staples and utilities, which in our view is not a bullish sign.

On the fixed income side, the U.S. Aggregate Bond index returned roughly 2.3 percent. Long-duration bonds were the big winners of the quarter with Fed rate cuts, lower inflation and defensive posturing, while most other subsectors of the fixed income markets were pretty status quo relative to the broader index.

The Federal Reserve's (the Fed) dovish pivot continues to be the main driver behind the rally this year, in addition to a decline in economic activity, which appears to be accelerating to the downside as of late.

We continue to believe the markets are at an interesting crossroad. Macro and geopolitical uncertainty are rising, asset levels are at or near all-time highs, while the Fed and other central banks have been proactive in cutting rates and providing liquidity to short-term funding markets.

DESPITE MARKET EXPANSION, THE ECONOMY IS SLOWING

While S&P 500 corporate earnings have contracted for three straight quarters and GDP growth is slowing amid a manufacturing slowdown (see Institute for Supply Management [ISM] Index comments below), the S&P 500 is still just shy of its highs, causing us to be concerned that pricing is not consistent with the current macro environment.

The ISM recently reported that September's manufacturing activity fell to a 10-year low, due to weakening economic growth both in the U.S. and abroad. ISM contractions do not automatically lead to recessions and bear markets, and certainly some of the issues driving the poor performance are temporary (Boeing 737 issues, auto industry strike), but the decline was severe enough to take note. We think rising trade tensions and the ongoing earnings contraction have led to a pullback in business expansion and a focus on inventory management.

While manufacturing is a relatively small piece of the economy when compared to services, concerns are also mounting in this sector. The ISM's non-manufacturing index remains in expansionary territory, but new orders dropped precipitously from 60.3 to 53.7 last month. This was a three-year low. We are watching it closely to see if the trend persists.

As we look ahead, in our view, downside risks exist for corporate earnings expectations in Q4 and 2020; we see little catalyst for earnings to grow in Q4. Despite easier comparisons, growth has clearly slowed across the economy. What's more, 10 percent growth for 2020 appears aggressive with capex spending declining. The uncertainty about the economic outlook and foreign trade policy is likely to continue weighing on investment spending in the near future and is not indicative of a quick economic turnaround.

Our expectation for real GDP growth in 2020 is to come in below the current consensus forecast of 1.9 percent, perhaps as low as 1.25 - 1.5 percent. This would be a significant pullback from the 2018 peak of 3.2 percent and 2019's consensus view of 2.3 percent.

We think the economy and markets are on a tight rope. It will be interesting to see if the Fed has done enough to stabilize the economy and stave off a recession.

RATE CUTS, CURVE INVERSION AND INFLATION

The futures market for short-term U.S. interest rates is 80 percent, priced for one more rate cut by year end. We expect an additional 25 bps cut in the Fed Funds rate at the end of October. In September, the committee did appear to be divided, with two members opposing the previous cut and another three participants suggesting dissent via the dot plot. Beyond this year, the futures markets appear to be pricing in another two to three cuts. We are concerned that the market expectations are too aggressive on rate cuts heading into 2020 and will ultimately prove to be disappointed, which we believe could adversely affect both the equity and fixed-income markets.

As we have discussed in the past, the 10-year, three-month U.S. Treasury yield curve inverted in May and has stayed inverted since then, an ominous sign for the economy. Not only has this inversion preceded the past seven U.S. recessions, it has never triggered a false signal. While this is certainly concerning, we note that recessions typically lag this indicator by anywhere from six to 18 months, and the Fed has acted to cut rates much sooner in the cycle than previously, perhaps pushing out the timeline to the next recession. We also do not believe this inversion causes recessions, but summarizes sentiment about the future of the economy, which is certainly subject to change.

As far as inflation is concerned, labor is tight, as evidenced by the historically-low unemployment rate, typically a driver of inflation. However, automation and other technological advancements are keeping a lid on wages. This, coupled with excess manufacturing capacity around the globe, cause us to believe that global deflation is a much more serious concern at this point than inflation. As such, we would expect to see interest rates around the world continue to decline in an effort to stave off slowing growth.

QE OR NOT QE … THAT IS THE QUESTION.

The Fed recently announced an increase in its purchases of short-term Treasury securities. Fed Chairman Powell emphasized that the move will be to maintain control of very short-term lending rates. If you recall, repo rates spiked in mid-September, a result of the Fed's shrinking balance sheet and tightening liquidity in the banking system. This spurred the Fed to step in and provide funding to the short-term borrowing market. While not unprecedented, it is certainly not a positive sign, especially after the Fed expanded the funding offer from days to weeks. Given that the Fed's offerings have been routinely oversubscribed, we are concerned that liquidity is too tight in the banking system and that the Fed will need to expand the program. The repo market is an important market, the disfunction of which was a major trigger of the Great Financial Crisis because banks did not want to take counterparty risk for fear of exposure to subprime loans. Certainly, we do not see a similar crisis underway, but we are watching the repo market closely.

Many have argued that despite the Fed stating that its planned funding is not to be considered quantitative easing, the expansion of the Fed balance sheet suggests otherwise; we believe the truth is somewhere in the middle. While the funding is certainly providing liquidity to the markets as quantitative easing does, the focus on short-term lending rates as opposed to the 2008-2014 period, during which the Fed purchased longer-dated Treasury and mortgage securities, will not have the same effect on the financial markets. We believe the Fed's intentions are to ensure orderly short-term markets, avoiding the counterparty fiasco of the Great Financial Crisis, rather than pump massive liquidity into the markets.

BEHAVIOR SHIFTS AND DIVERGENCES WORTH NOTING

Investor sentiment is always worth keeping track of, but we find it most useful at possible inflection points and during periods of wide divergence between the economy and financial markets, both of which we believe are present at the current time.

In addition to the happenings in the repo market, the corporate credit markets are worthy of significant attention, in our view, particularly the high yield/junk market. Yields of corporate credits varying from BBB to CCC typically move in sync. Since April, this has not been the case, with the lowest quality of credit (CCC) deviating from the broader junk market with its rates rising, signaling to us a subtle shift in risk aversion. We are watching this closely to see if adjacent junk tranches follow.

We've also seen significant leadership changes in the equity markets. Growth-oriented sectors like technology have given way to more defensive sectors like utilities and consumer staples. We believe that both concerns about slowing growth and lower interest rates have driven the success of the latter sectors.

We also find it worth noting that insider selling among CEOs and CFOs in U.S. companies reached $14 billion in September, a 10-year high, and the sixth month this year in which more than $10 billion worth of stock had been sold. This is not exactly a solid vote of confidence for earnings as we look toward 2020.

While any one of these issues may not mean much, the combination of such changes in sentiment is certainly worthy of continued tracking.

GEOPOLITICAL RISKS ABOUND

Trade disputes and geopolitical frictions have become important drivers of the economy and markets in the past two years, and have seemingly escalated as of late. The trade war with China, coupled with the attack on Saudi oil infrastructure and tensions between Turkey and the Kurds, has increased geopolitical uncertainty in recent months.

Trade tensions between the U.S. and China have ebbed and flowed, so far without resolution. We believe there are strong economic and political incentives to come to an agreement, given how intertwined the two economies have become. That being said, each side wants to appear as the “winner,” which may mean a longer runway to a deal, and perhaps even a weaker deal. While we believe China has more to lose, given its slowing economy and heavy debt load, the timing around the 2020 elections may force the current administration to capitulate in an effort to claim some sort of victory. We have pushed out our timeline for the trade war between the U.S. and China to cease, and reduced our expectations related to the economic boost we expect such a deal to provide.

If a deal gets done, we think the likelihood is growing that it will come up short on protecting intellectual property for U.S. corporations, but with the elimination of tariffs, we would expect to see a modest tailwind for the U.S. markets. It should be a more sizable catalyst overseas, particularly the emerging markets.

WHAT’S NEXT?

While unemployment is low and the U.S. financial markets keep making new highs, it is our view that investors are largely ignoring a variety of concerns, which include declining bond yields; slowing growth; negative earnings trends; waning market participation and leadership changes; and other weakening technicals.

We think the markets are poised for heightened volatility as we approach year end. We believe the market is factoring in significant Fed easing, which may not come to pass. On the positive side, we are in new territory with the Fed cutting rates just after a yield-curve inverted, as the Fed is typically late to the party. In past cycles, the Fed hike rates well after a yield curve inversion, meaning the potential results are difficult to handicap. We could see a softer landing than history would indicate. The Fed is certainly navigating a slippery slope and we doubt it will do so without significant volatility.

Despite some optimism that the Fed has learned from history, with the inversion of the yield curve, significant insider selling, anti-growth policies like tariffs and high geopolitical uncertainty, we continue to believe a cautious stance is warranted.

We forecast a low-growth environment that will persist and, during such, believe the markets and economy are much more vulnerable to adverse shocks. We will wait for more clarity and take advantage of opportunities as they develop.

QUESTIONS AND COMMENTS

Clifford T. Walsh, CFA
Chief Investment Officer
American Portfolios Financial Services, Inc.
631.439.4600, ext. 277
ctwalsh@americanportfolios.com

Disclosure

The opinions expressed in this document are those of the NinePoints Investment Management (NPIM) research department at the time of this writing and are subject to change at any time without notice. This document is provided for information purposes only. It does not constitute an offer or a recommendation to buy or sell securities or other financial instruments mentioned and it does not release the reader from exercising his or her own judgment. Every investment involves risk, especially with regard to fluctuations in risk and return. The investment mentioned in this document may not be suitable for all types of investors. Past performance does not guarantee future results.

Information has been obtained from sources believed to be reliable and are subject to change without notification. Investors must make their own determination as to the appropriateness of an investment or strategy based on their specific investment objectives, financial status and risk tolerance. Investments involve risk and the possible loss of principal.

Securities offered through American Portfolios Financial Services, Inc. (APFS).
Member FINRA /SIPC.

Investment Advisory Services offered through American Portfolios Advisors, Inc. (APA), an SEC Registered Investment Advisor.

Sources:

[i]All index returns are total return figures accessed using Morningstar Direct on October 1, 2019. You cannot invest directly in an index. Index returns do not include trading or other investment costs.
[ii]FactSet Research
[iii]https://www.instituteforsupplymanagement.org/ismreport/mfgrob.cfm?SSO=1
[iv]FactSet Research
[v]https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html/
[vi]https://fred.stlouisfed.org/series/T10Y3M
[vii]FactSet Research
[viii]FactSet Research