TJIM QUARTERLY INSIGHT

Third Quarter 2019

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Entering the 4th quarter the enigmatic march of the stock market continues. Year to date the S&P 500 has returned over 20%. A number that would represent an exceptional year, let alone for only the first three quarters. With such lofty returns entering the 4th quarter, traditionally the best quarter of the year, the market would seemingly be set up for a strong finish.

However, we note the enigmatic path of the market and the economic fundamentals which underpin market valuations. Despite the stellar year-to-date performance, the market is only 1.6% above September 2018 levels. Despite the generally upward trajectory for asset prices in recent years, during the 4th quarter of 2018 market investors briefly traded in their exuberance for consternation. As investors took “stock” of mixed economic and political signals, the market sold off to the tune of (13.52%), good for the 8th worst quarter in the past 40 years.

The dichotomy of economic dynamism persists as some investors continue to dogmatically disregard derelict forces in favor of more positive economic indicators. There are ample reasons to remain positive regarding the prospects of both the real economy and of the stock market.

Real Gross Domestic Product (GDP) is currently running at a healthy near 2% annual rate. Growth in GDP usually translates to earnings growth for companies, which, roughly speaking, translates to better returns in equity markets. GDP is also a key indicator for policy makers at the Federal Reserve, along with unemployment, when deciding what should be the target Fed Funds Rate.

Despite this healthy growth, early warning indicators are starting to show, elevating the risks to future economic expansion. The Institute for Supply Management’s (ISM) factory index recently fell to 47.8, a level not seen since the 2008 financial crisis. This figure is important as a read out above 50 signifies manufacturing expansion, while a number below 50 signifies manufacturing contraction. As recently as November 2018 this figure was close to 60, well into expansion territory. Perhaps this decline is an effect of a continued strong dollar and slowing global growth. If the slowdown in the manufacturing sector starts to affect the consumer, a broader economic slowdown would become a near certainty.

Global contagion mentioned above notwithstanding, the consumer looks to be in pretty good shape. Personal income and consumption have notched solid gains, and with the unemployment rate at 3.7%, the labor market remains tight. With the consumer representing about two thirds of the economy, a strong consumer is necessary for continued economic growth. However, consumer inflation is still a bit below the Federal Reserve’s target.

While the consumer looks strong, the growth in consumer expenditures has begun to slow, creating trepidation with policy makers. Given this, and the delicate interactions between our domestic economy, driven by consumers, and international markets, where manufacturing is much more important, the Federal Reserve reversed course and cut their target interest rate twice in the quarter. Conversely, given the 3.7% unemployment rate and Real GDP at 2%, some have questioned the efficacy of cutting rates.

Nonetheless, interest rates around the world also remain extremely low and accommodative to asset prices. Low rates serve to spur economic and market growth by both: 1) reducing the cost to finance projects/acquisitions and 2) reduces the discount investors require and thereby lifting asset prices. At the end of September, the yield on the US 10-year treasury was a paltry 1.69%. This is a far cry from the 3.2% yield that investors could garner on the 10-year treasury just back in November 2018.

But, as nature abhors a vacuum, domestic rates here in the US do not tell the full story. Relative to the rest of the developed world, the US actually has fairly attractive domestic rates. In fact, only Iceland and Singapore have higher yielding sovereign 10-year bonds than the US and many developed nations' sovereign bonds currently have a negative yield. Astonishingly, there is something like $15 trillion in outstanding sovereign bonds with a negative yield. Obviously, a negative lending rate (aka yield) is not a natural thing. Absent massive deflation, exogenous forces like central banks have to be the orchestrators of such conditions. There are a few motivations for foreign banks to drive down their domestic rates: 1) fund deficits with cheap financing, 2) spur economic growth, and 3) devalue their currency relative to the dollar.

When a foreign currency is "devalued" relative to the US Dollar, that country's exports become more attractive to US consumers as the "cheaper" currency should translate to a cheaper product at the register. This devaluation is, at least in part, a reaction to increased trade pressure and the accompanying tariffs. As these barriers are raised global trade slows, which effects manufacturing abroad. The question is what happens here domestically when international manufacturing slows. Does domestic manufacturing increase due to the level playing field? Or does the slowdown abroad influence a domestic manufacturing decline (see IMS data above)?

In another troubling sign, the yield curve inverted in the 3rd quarter. An inverted yield curve occurs when interest rates on bonds that mature sooner yield more than bonds that mature farther in the future. For a number of reasons, this condition is abnormal and can prove to be problematic. An inverted yield curve is typically a sign of a slowing economy and a yield curve inversion has preceded every recession since 1970.

We think the market signals are not clear, and there is cause for both optimism and apprehension. On the one hand there is plenty of positive signals to continue to push this market forward, as Harry Truman said; "Can somebody bring me a one handed economist!" Unfortunately, I have two hands and neither one is holding a crystal ball.

As always, we believe a portfolio of attractively valued, high quality securities that is properly diversified across stocks and bonds with an asset mix that is appropriately matched to risk tolerance is the best strategy for meeting long term goals across volatile markets. We just want to thank you for your trust in our firm, and we will continue to diligently, and prudently manage the investments that you have placed in our care.

Sincerely
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