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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

Inflection Points?

In many respects the third quarter may have represented a sea change for global economies, central bank monetary policies and equity valuations. While the World Bank estimates that global GDP will advance 2.5% in the second half of 2019, this figure belies the deceleration in economic growth that is happening in the economies of Europe, Japan and mainland China. The ongoing trade frictions are an important contributor to slowing economic growth; however, there are additional factors including aging demographics in Europe, the Brexit stalemate, an increase in the VAT tax in Japan and high debt levels in China. The U.S. economy remains resilient, but manufacturing activity has slowed noticeably over the last year, largely in response to a reduction in the growth rate of global trade.

Global central banks maintained a consistent policy of monetary easing during the quarter: the U.S. Federal Reserve reduced the federal funds rate by 0.25% to 2% at its September meeting. Likewise, in September, the European Central Bank lowered its policy rate 0.10% to *negative* 0.50% while restarting the bank's policy of open market purchases of debt securities. In Asia, the People's Bank of China lowered the reserve ratio requirement for members banks by 0.5%. Central bank actions have been in response to the softer global economic data. As we wrote last quarter, one of the side effects of aggressive central bank policies has been a significant increase in the amount of negative yielding debt. This figure stood at $13 trillion in July of 2019 and had grown to over $17 trillion by September, according *to Grant's Interest Rate Observer.*

Despite what can be characterized as extraordinary efforts on the part of central banks in recent years, the effectiveness of these policies appears to be declining. In Japan, where the central bank has employed negative interest rates since 2016, real GDP growth had averaged 1.2% over that time period. In Europe the story is similar, the European Central bank introduced negative interest rates in 2014 and real GDP in the eurozone has averaged less than 2% over that time period. More recently, in spite of historic levels of monetary stimulus, eurozone real GDP growth has decelerated from 2% in 2018 to 1% in the second quarter of 2019. As discussed above, there are a variety of factors contributing to the tepid economic growth. However, it is becoming increasingly clear that following several years of unconventional monetary stimulus, the incremental benefits of such policies are diminishing. Indeed, with over $17 trillion of negative yielding debt outstanding, it has been argued that the costs of unconventional monetary policies (in the form of foregone interest payments to savers) are beginning to outweigh the benefits.

The broad stock market, as measured by the S&P 500, returned 1.7% during the quarter. There were a number of diverging trends within the stock market: small and mid-cap stocks posted negative returns in the quarter and the Russell 2000 index (a broad measure of small company stocks) had a return of -2.4%. Another notable development in the quarter was the outperformance of value stocks vs. growth stocks; the S&P/Citigroup Value index gained 2.8% while the S&P/Citigroup Growth index returned 0.7%. Much has been written over the last several years about the privately financed growth companies that have become known as "unicorns." Prominent among these are Uber, Lyft, Pinterest and the shared workspace firm, WeWork. Although their business activities are varied, these firms share several common characteristics: rapid growth, significant financial losses and an extended period of private financings prior to becoming public companies. A notable development during the quarter was the withdrawal of the proposed initial public offering of WeWork. The reasons for the withdrawal included corporate governance issues, a lack of disclosure and recent management changes. It is worth noting that the proposed offering price for the company's shares would have been 50% lower than the previous round of private financing. Uber and Lyft, which held successful public offerings last spring, saw their stock prices decline 38% and 37% respectively during the quarter.

Reflecting upon developments during the third quarter, it would appear that we may have reached an inflection point in the global economy, whereby the global trade frictions that began in 2017 have started to take a meaningful toll on economic growth in 2019. Similarly, we appear to have likely reached an inflection point in the effectiveness of the aggressive, and unconventional, monetary policies of global central banks (especially the use of negative interest rates). And while we are reluctant to make definitive conclusions about stock market valuations, the recent evidence surrounding highly valued, loss-making "unicorns" point to an inflection point in the stock market's willingness to support elevated valuations for these businesses.

Challenges and Opportunities

The developments described above certainly present challenges for investors. Slowing global economic growth has reduced the demand for energy and industrial commodities and export-oriented industries in particular have been impacted. Increased tariffs have led to rising input costs for a variety of industries. The unconventional monetary policies are proving to be a double-edged sword: while ultra-low interest rates reduce the cost of capital for businesses and consumers, they also penalize savers and retirees. Many banks have also seen their profitability diminished due to a narrowing of their lending margins. Because interest rates are an important factor in establishing investment parameters in the stock market and the real world, i.e., in measuring the return on any new capital expenditure, it has been argued that ultra-low interest rates have distorted decision-making for both financial and corporate investors.

Yet, with challenge often comes opportunity. In the U.S., economic growth, while modest, continues to be steady and the unemployment rate in September was reported at 3.5% (a 50-year low); U.S. consumer spending has been resilient. An important underpinning of the U.S. economy is residential construction and recent evidence indicates that lower interest rates are having a beneficial effect on housing demand.

The impact of higher tariffs, and associated uncertainties, represent a serious challenge when contemplating economic growth for 2020. Over the last 12 months the costs of higher tariffs have been mitigated by their limited scope and the willingness of industry to bear some of the costs, thereby sparing the consumer "sticker shock." In the U.S., the stimulative impact of the 2017 tax law has also helped to offset the costs of tariffs. Looking forward, the Administration's proposed broadening of tariffs on China are estimated to cost the average U.S. family $1,000 in 2020, according to JP Morgan Chase. With negotiations ongoing, tariffs present both a risk and an opportunity as we think about the year ahead.

With over $17 trillion of negative yielding debt globally, and global economic growth subdued, central banks may experience diminishing utility of monetary policy in the current cycle. If this proves to be the case, it will likely present a challenge for long duration assets such as long-term bonds. Prices for these securities have risen dramatically over the last year. As an example, the 100-year Austrian government bond, which was issued in September of 2017, has risen over 100% in the last 12 months and today has a current yield of only 1%. If long term interest rates were to rise by 0.5%, this could translate into a 25%-30% loss on the principal value of this bond.

The recent reduction in the valuations of highly valued growth stocks, such as the "unicorns," presents a challenge for investors because of the "halo effect" these names have had on the broader universe of growth stocks, which often form the core of an equity portfolio. However, a correction in valuation excesses is, in many regards, a welcome development and helps to establish a stronger foundation for the stock market going forward.

Keeping Options Available

Flexibility and the ability to adapt to changing circumstances are two hallmarks of successful investors. The need for flexibility in managing investment portfolios is of paramount importance in the current environment. Global economic growth is slowing, yet an easing in the current tariff standoff could have a positive impact on global growth next year. While no one knows the future path for global central bank policies, the current risk reward for long term bonds appears unfavorable; the 10-year German government bond is currently yielding *negative* 0.6%. Conversely, 6-month U.S. Treasury notes yield 1.7% with minimal principal risk. Stock market valuations, as measured by the forward P/E multiple on the S&P 500, are about average given the current level of interest rates. However, value stocks continue to trade at a discount to growth stocks. The Russell 3000 Value Index is currently trading at the widest valuation discount to the Russell 3000 Growth Index in over a decade. With these considerations in mind, our portfolio positioning is as follows:

- Given what we perceive to be elevated risks to the economy, we have modestly reduced the equity weighting in balanced accounts, and have increased our holdings of cash and short term U.S. Treasury securities.
- Equity selection has emphasized established, profitable companies whose stocks are selling at a discount to their intrinsic value.
- We continue to emphasize high quality, short duration bonds in our fixed income portfolios
- Owing to the significant increase in negative-yielding debt and the potential implications for currency stability, we are maintaining an allocation to gold via the gold iShares ETF.

As always, we welcome your comments and questions.