Q3 2019

QUARTERLY MARKET & ECONOMIC PERSPECTIVE

Pursuit
PLANNING AND INVESTMENTS, LLC

INTRODUCTION

Central banks take center stage.

The Federal Reserve was two-for-two in their meetings during the third quarter, lowering rates by 25 bps at each, with global growth weakness, low inflation, and trade uncertainty (i.e. US/China) considered important factors in their decisions.

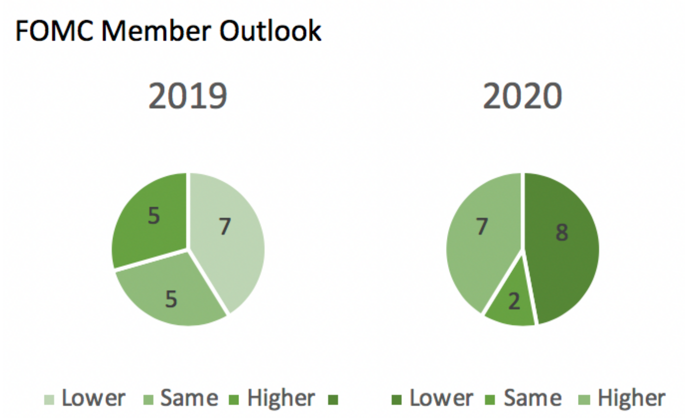
The first meeting occurred in late July and marked the first time in ten years the Fed cut rates. This rate cut effectively reversed the Fed's December 2018 rate increase of 25 bps. As a quick review, the most recent rate cut had occurred in December 2008 and was a 75-100 bps reduction to a level of 0-25 bps. At the time, the Dow Jones Industrial Average was around the 9,000 level and we were in the midst of a massive recession, a far cry from the relatively strong economy we are experiencing today. Chairman Powell referred to the cut as a "mid-cycle adjustment to policy" but expressed that he didn't think this cut would be the beginning of an extended cutting cycle.

The second Fed rate cut, one that was widely expected, came in mid-September. In his comments, Chairman Powell suggested the Fed was open to more future rate cuts but also pointed out that the Fed had no control over business decisions amid uncertainty stemming from US-China trade talks, which is likely having a negative impact on spending.

Remember, a major point of keeping short term rates low is to encourage borrowing, which leads to spending, which in turn leads to growth. However, businesses seem to be spending less on capital investments even with incredibly low rates.

If this continues, one needs to ask if there is much more the Fed can do with monetary policy. Similarly, the Fed needs to be concerned that if the economy actually does start to weaken, they will have fewer options to provide support with their primary tool already so low.

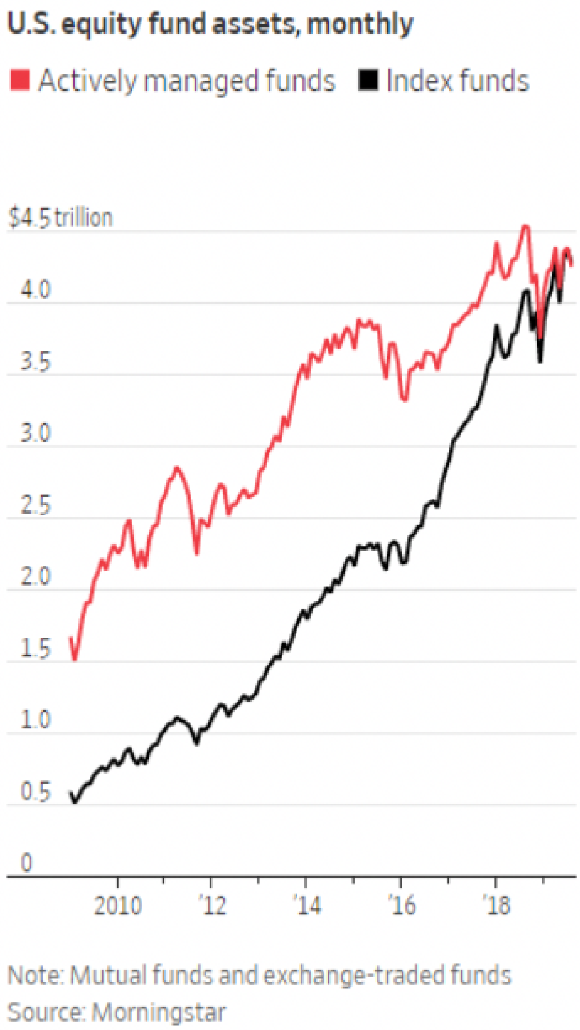
One very interesting point that came out of the September meeting was how divided FOMC (Federal Open Market Committee, the members that determine interest rate policy) members were regarding the future outlook. As the charts below show, fewer members expect rates to stay the same in 2020 vs. 2019 and almost as many members expect to see higher rates in 2020 vs. those that expect to see lower rates. Needless to say, there is little to no consensus of what comes next from the Fed as they disagree on the (intended or unintended) costs and benefits of cuts.



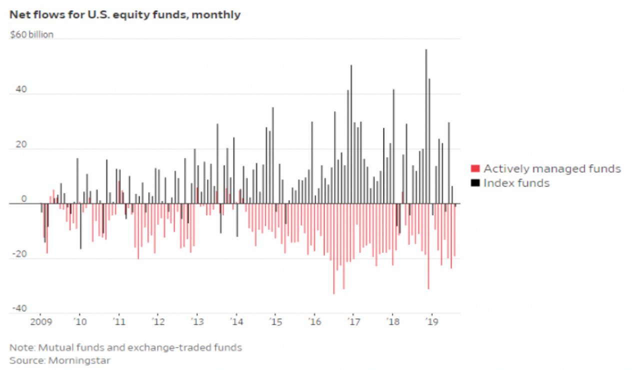
Meanwhile, elsewhere around the globe, the European Central Bank is contending with weakening manufacturing across the continent and is ready to be aggressive with monetary policies, suggesting both lowering rates and reigniting its bond purchase program. The rate cuts aren't just for the US and Europe, however. During the third quarter we saw many central banks lower their rates, including Australia, China, South Korea, and Brazil, just to name a few. Japan made no changes to its policy rate during the quarter, though it is limited in its ability to do so, as it has been negative since early 2016.

A MILESTONE FOR INDEX FUNDS

It is widely reported that the first index fund was launched in 1976 by John Bogle, the founder of Vanguard. At the time, the idea was derided for the idea that simply tracking an index could provide better results than a trained professional whose sole goal was to pick stocks. How far we have come since those days.

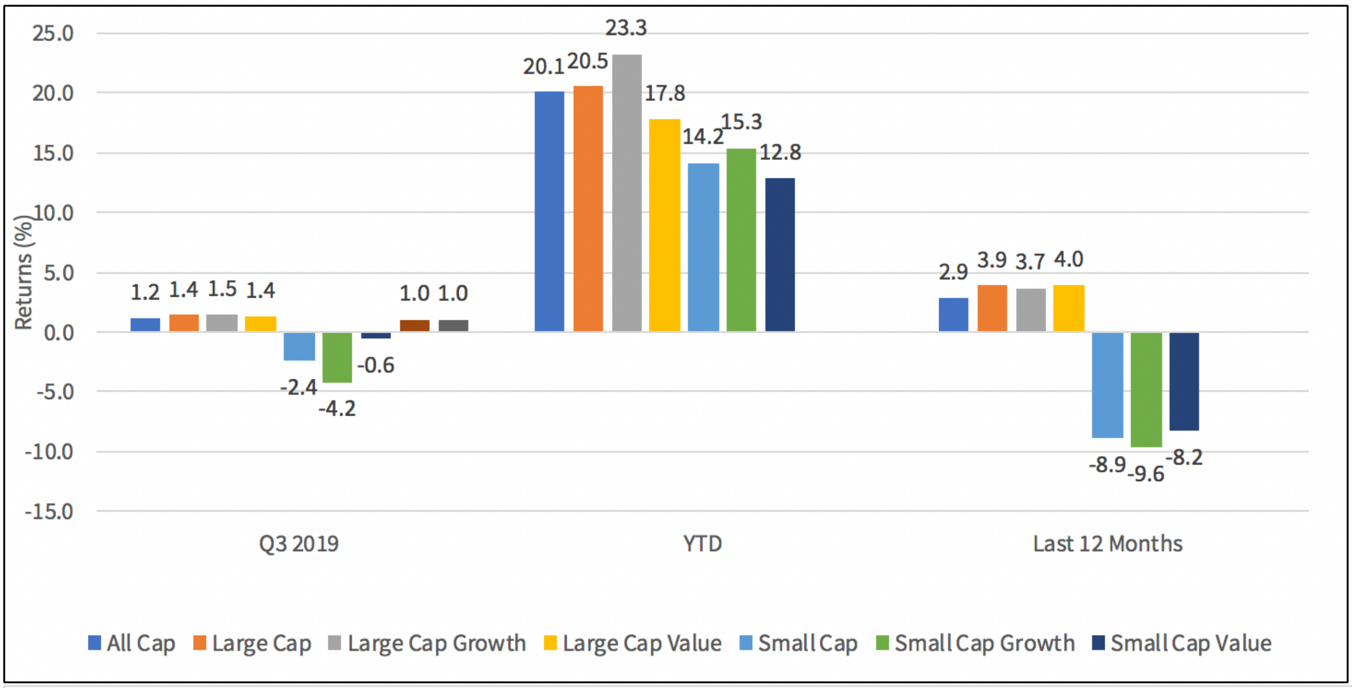


Morningstar, a firm known for its investment data and research, reported that for August 2019 month end, the amount of assets under management (AUM) that track broad US equity indexes ($4.27T) surpassed those of their actively managed counterparts ($4.25T).



One component of this increase in indexed product AUM that has been so interesting has been the consistency in which it has occurred. The chart above shows net flow data for US equity funds since 2009. The chart clearly shows that index funds (black lines) have consistently had positive flows over the last 10 years while their actively managed counterparts (red lines) have experienced consistent outflows over that same time period.

U.S. EQUITY



Source: Morningstar, Russell benchmarks shown, past performance is not indicative of future results

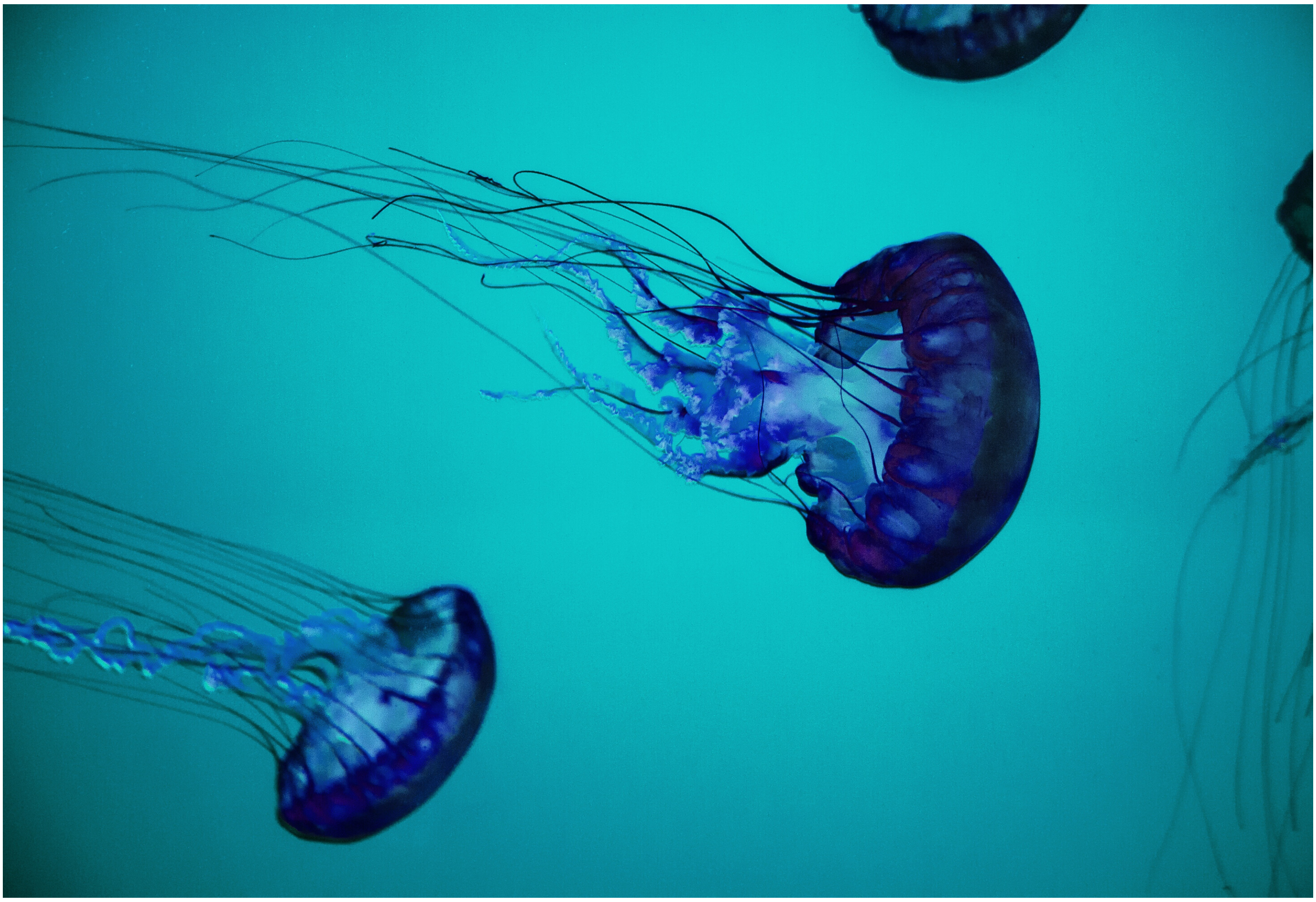
US equity markets continued their upward trajectory during the third quarter. In mid-July, after Fed Chairman Powell suggested they would cut rates, the S&P 500 rose above the 3,000 threshold for the first time ever and the Nasdaq closed at its highest level ever, 8202.53 (it has since beaten that mark multiple times).

In the third quarter, large cap stocks continued to outperform their smaller cap counterparts. In the large cap space, there was very little difference between growth and value whereas small cap value handily beat small cap growth over the quarter.

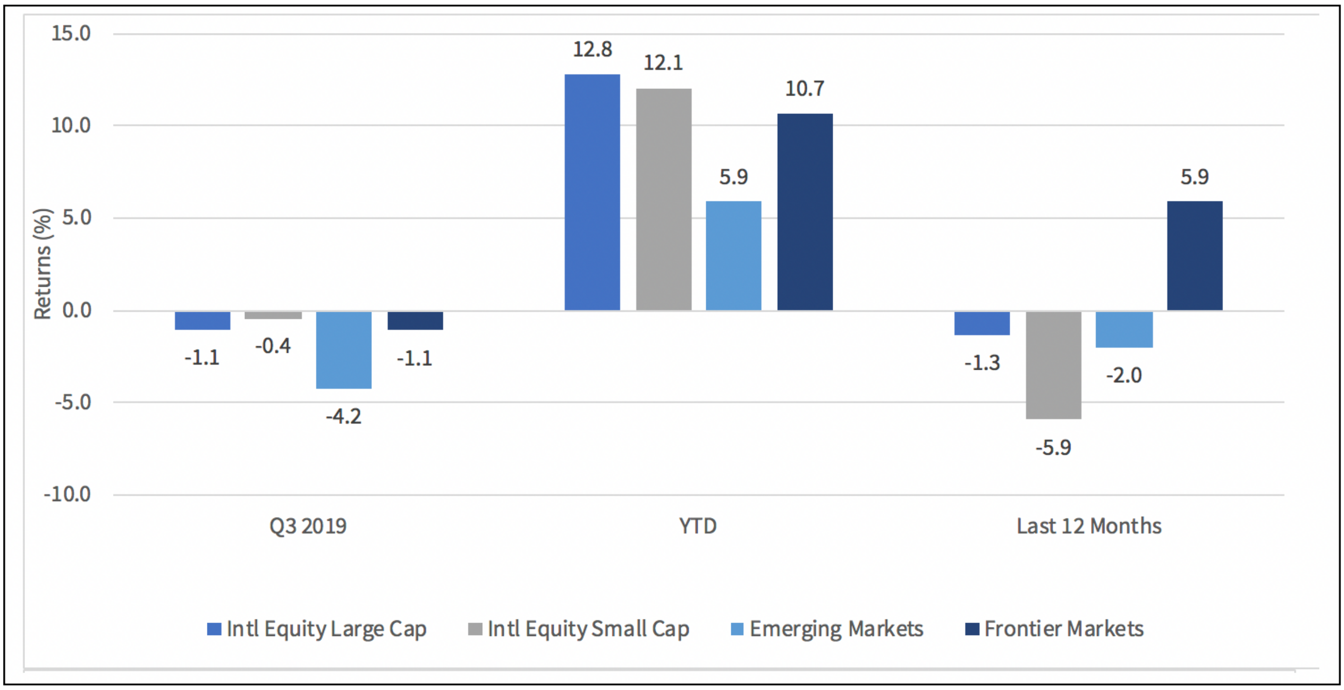
In September, specifically, we saw value stocks outperform growth stocks in pretty convincing fashion, in both the large and small cap categories. What makes this important is the fact that growth stocks have significantly outpaced their value counterparts over the last decade. Is this the start of a turnaround for value stocks? Of course, it's too soon to tell and we are not ones to prognosticate anyway. What we do know, however, is that growth stocks tend to do best when the prospect of significant growth is present. With the mixed economic data we are seeing, we may start to see more of a rotation to value stocks.

From a market cap perspective, smaller stocks should benefit from lower interest rates, all else equal, as they tend to rely more heavily on debt to fund their activities.

Another topic of heightened recent interest regarding stocks is their yield. As of September month end, the S&P 500 had a yield around 1.9%, which compared favorably to the 10-year US Treasury yield of 1.70%. However, this shouldn't be construed as a recommendation to trade in your fixed income investments for dividend paying stocks. Keep in mind that dividend yield is calculated as a stock's dividend divided by its price, so a higher dividend yield could be the result of a falling stock price. In addition, stocks have historically been much more volatile than fixed income. With both of those thoughts in mind, we would hesitate to push too far into equities simply for the increased yield vs. bonds.



NON-U.S. EQUITY



Source: Morningstar, MSCI benchmarks shown, past performance is not indicative of future results

International equity markets mostly fell across the board during the third quarter, with emerging markets taking the biggest hit.

Among developed markets, 3 of the 5 countries that comprise the largest weight in the index had negative returns for the quarter (Country, weight, Q3 return: UK, 16.4%, -2.3%; France, 11.3%,-1.8%; Germany, 8.5%, -4.1%; source: MSCI). For the UK, at least part of its issue is the continued uncertainty with Brexit and the fact that there is still no clarity on what comes next. For Germany, its Purchasing Managers Index score (PMI) fell to even lower levels for the third quarter, widely attributed to the US-China trade war's impact on its export-heavy economy. However, Germany is known for running a tight budget and therefore we shouldn't expect massive fiscal stimulus.

Emerging markets were hit particularly hard in August as the trade war escalated. Over the quarter, Chinese stocks fell 4.9%, South Korea dropped 5.3%, and India declined 6.0%, while Taiwan was one of the few countries that gained during the quarter, increasing 5.0%. (source: MSCI).

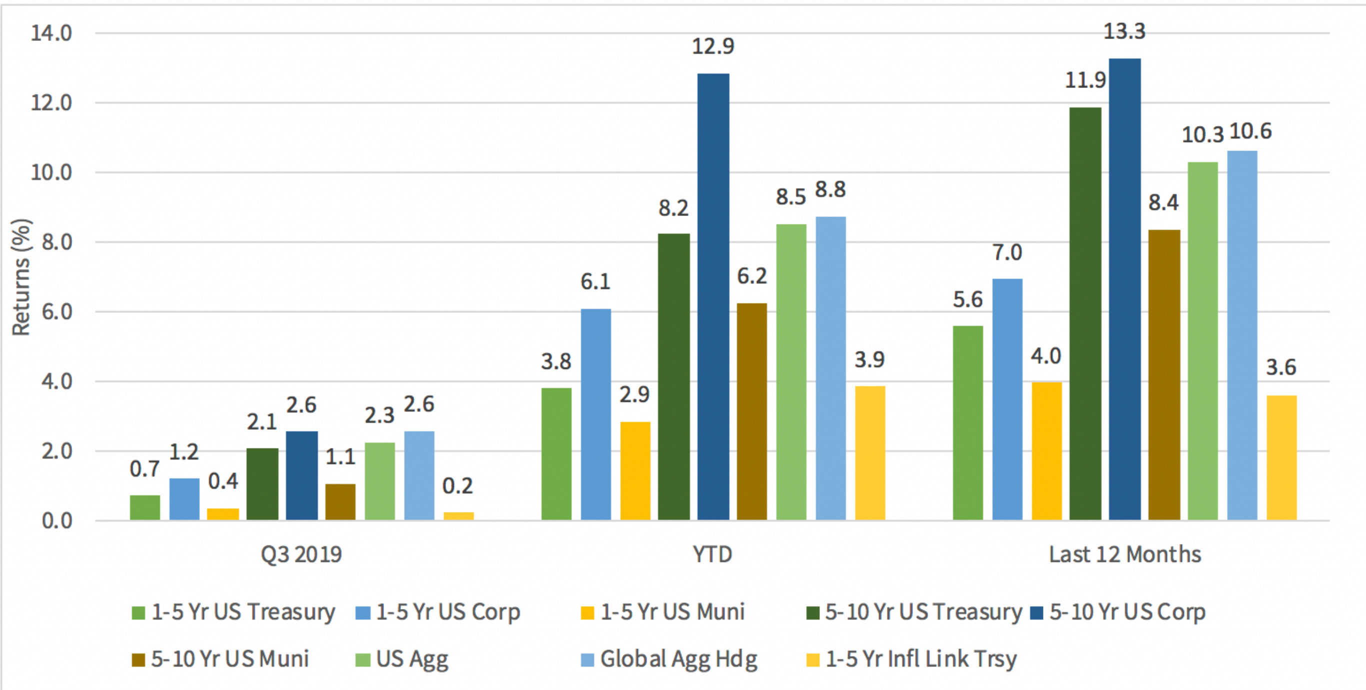
China represents roughly 32% of the MSCI Emerging Market Index (as of September month end) so when China suffers, it has an impact on the overall index. In addition, the trade war is having a slowing impact on global growth, which leaves emerging market economies and their currencies particularly vulnerable.

Something else to pay attention to in the US-China trade war is the ramifications it has in other developing countries. For those US companies that have global supply chains that currently include China, any increased uncertainty in their ability to stay with China in the long term may force them to determine it's best to build new processes in other markets, likely benefiting other developing markets.

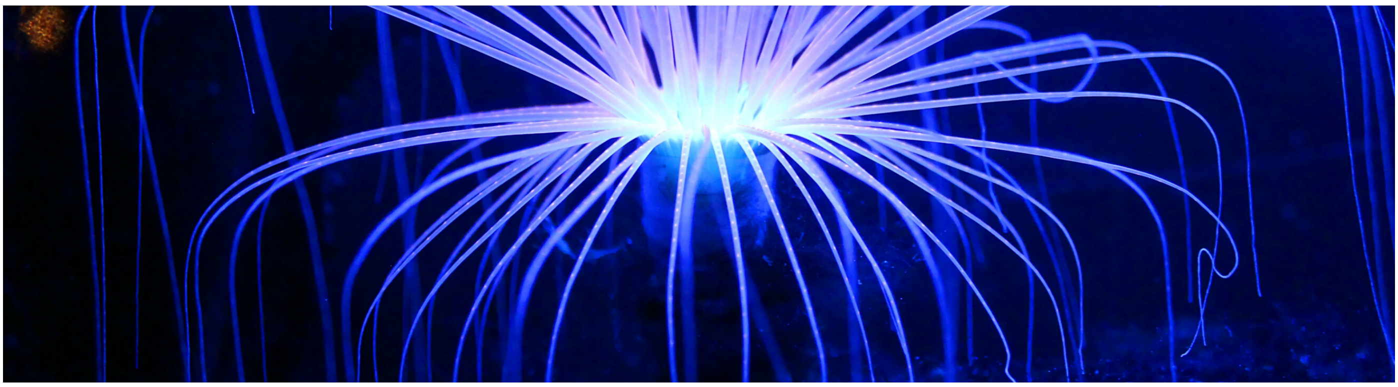
International equities remain undervalued, even if just slightly, relative to both historical norms and current US valuations. Our portfolios generally have a sizable allocation to non-US equities, both developed and developing, and would therefore benefit from a recognition by investors of the attractive valuations and/or a reversal in the dollar's continued rise (the Wall Street Journal Dollar Index ended the quarter higher).

GLOBAL REITS

Global REITs, as represented by the Dow Jones Global Select REIT, was one of the highest returning indexes over the quarter, gaining 5.7%. Non-US REITs grew by 3.5% while their US counterparts gained 6.8%. On a YTD basis, global REITs have gained over 22%. Some of this gain is likely due to the higher yields available in REITs, making them more attractive relative to other lower-yielding investments.



Source: Morningstar, Bloomberg Barclays and ICE BoA ML benchmarks shown, past performance is not indicative of future results



GLOBAL FIXED INCOME

Fixed income (aka "bond") markets saw a "risk-off' environment that was beneficial for fixed income in August while September saw a mild reversal as recession fears faded slightly.

Some of the angst in fixed income markets started in early August, when President Trump threatened new tariffs on China, upping the ante on the trade war. This was of course followed by China devaluing their currency, which led the US to designate China as a currency manipulator. Without getting into too much detail, the rising tenor of the trade war brought with it more uncertainty, lower business confidence and spending, which in turn brought longer dated bond yields lower (which move inversely with prices). This all led to August 27th when we had 10-year US Treasury yields close lower than 2-year US Treasury yields, a situation we have mentioned before that is referred to as an inverted yield curve. Interestingly, the negative difference between the 10's and 2's only lasted for 3 days at the end of August (the curve did not experience an inversion like this during September).

Source: www.Treasury.gov

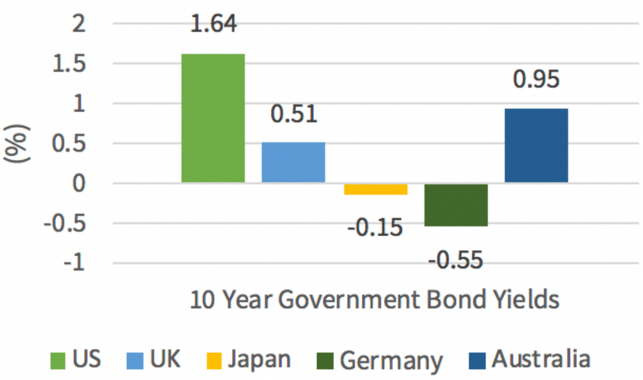
By subtracting the shorter term bond yield from the longer term and looking for the negative observations, the chart above shows that the curve inverted, briefly, with 10-year vs. 2-year US Treasury yields (orange line), but was consistently inverted using 10-year minus 3-month US Treasuries (blue line) during the third quarter.

As a quick reminder, inverted yield curves have been a good, though imperfect, predictor of future recessions. Equally important, inverted yield curves are correlated with recessions, they don't cause them!

Our portfolio's focus will continue to be on high quality bonds with an emphasis on short to intermediate duration Treasury and corporate bonds, where default risk is relatively low. For some investors, muni bonds are attractive for their tax-free income.

Even with the concern of low yields in the US, the opportunity is still considered greater than in most other nations. The challenges across the globe of slowing global growth (e.g. manufacturing) and policy uncertainty stemming from trade are having broad impact across fixed income markets. According to the Financial Times, close to $15T worth of debt globally had a negative yield as of September 30, which is roughly 25% of all investment grade securities.

Negative rates really started with various non-US central banks as they attempted to jumpstart their flagging economies after the Great Recession. The idea went something like this: central banks would penalize banks for holding their deposit (i.e. setting negative deposit rates); banks would lend out the money rather than be charged; the borrowers would spend the money; leading to economic growth and inflation. The reality, however, has been different as negative policy rates have not created the expected pickup in economic activity (could their economies be worse off without the negative rates?). The chart below displays 10-year government bond yields across several major countries, as of October 1, 2019 (source: tradingeconomics.com). Even with rates as low as they are in the US, they are still better than other developed nations.



Can rates in the US go negative? Right now, there aren't many economists or analysts predicting negative rates in the US. Even Fed Chairman Powell has previously shot down the idea of using negative rates as a policy tool. However, at the same time we can't say the scenario is outside the realm of possibility. While unlikely and improbable, let's just say we aren't convinced it can't happen here.

From an investment standpoint, one might wonder whether we should own negative-yielding assets. Our short answer is "yes." The long answer has to do with the total return after accounting for currency hedging, which can turn the negative into a positive.