

## **Q3 2019 Market Commentary**

In this commentary we will discuss the economy and talk about why the Fed has reversed course on interest rates, and what it means for the U.S. and global economy. The risk-free interest rate is the rate of return of an investment with no risk. Most often, either the current Treasury, bill or long-term government bond yield is used as the proxy for the risk-free rate. Usually, it's the rate on a 3 month U.S. Treasury now at 2.18% (the long term average is 4.34%). The risk-free rate is the number one driver of stock price movements. Higher interest rates (i.e. a higher risk-free rate) lead to lower stock prices, and lower interest rates (i.e. a lower risk-free rate) lead to higher stock prices. The Federal Reserve determines the low end of the risk-free rate. In the fourth quarter of 2018, the Fed signaled that they were looking at four additional rate hikes in 2019. At that time, we commented that we believed the Fed was moving too far, too fast. The stock market quickly sold off, losing over 20% of its value in the fourth quarter of last year. The market rallied in 2019 once the Fed stated they would put new interest rate hikes on hold. Now, the Fed has become even more accommodative and is talking about potentially lowering interest rates one or more times over the remainder of 2019.

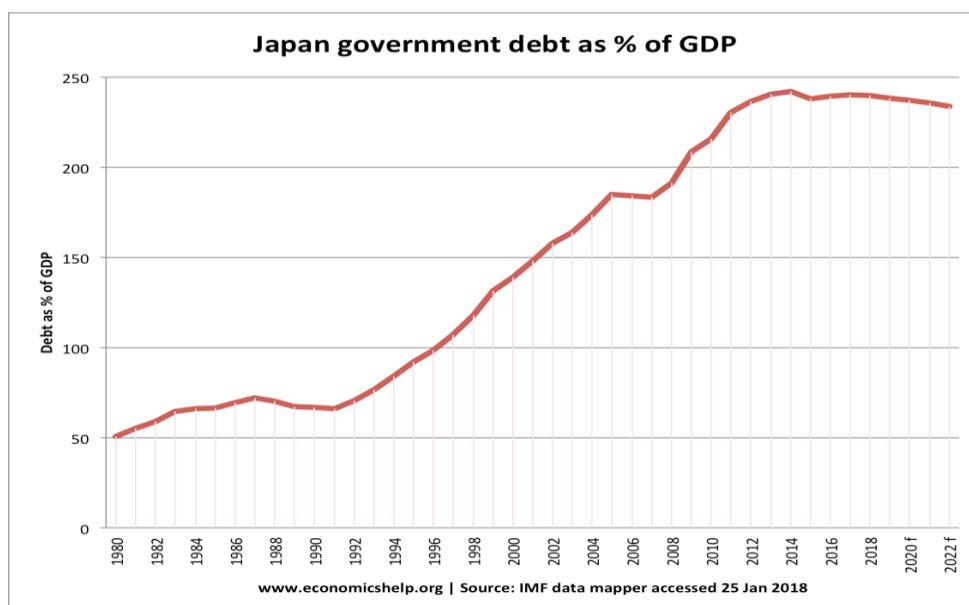
While the U.S. economy currently looks to be on solid ground, forward looking indicators for the U.S. economy are beginning to flash warning signs. International markets are already weak. This is not good because the average U.S. S&P 500 company receives roughly 50% of its earnings internationally, and since the U.S. dollar has been rising this year, it means that overseas corporate profits will be less for American firms after they repatriate their earnings.

That's because a high priced dollar versus lower priced foreign currencies leads to fewer dollars once a conversion has been completed.

At the end of June, Barron's reported a record \$13 trillion of (mainly) international government and corporate bonds were paying interest rates below zero percent. According to Deutsche Bank, the 10 year German Bund (the benchmark for European bonds) is trading at a record minus 25 basis points. This means that investors are willing to accept negative returns, implying that they are seeking protection from something worse.

In Europe, there are many problems. The continent is experiencing rising government debt loads, rigid tax structure, high government regulations, monetary union but no fiscal union with the Euro, shrinking and aging populations, Brexit, and the cost of integrating new arrivals.

In Asia, things don't look much better. The 10 year government Japanese bond yield is minus 0.15%. Japan's debt-to- GDP is the highest in the world (even worse than Greece), and the country faces a shrinking population and rising health care cost. Unlike Europe, Japan seems content to watch their population shrink in order to keep their homogenous society.



A high debt-to-GDP ratio is undesirable for a country as a higher ratio indicates a higher risk of default. In a study conducted by the World Bank, a ratio that exceeds 77% for an extended period of time may result in an adverse impact on economic growth. It was found that each additional percentage point of debt reduced annual real growth by 1.7%. For reference, the USA's debt-to-GDP (Gross Domestic Product) ratio was 105.40% in 2017. Thus, when the ratio is high (>80%), a country is likely to exhibit slower economic growth.

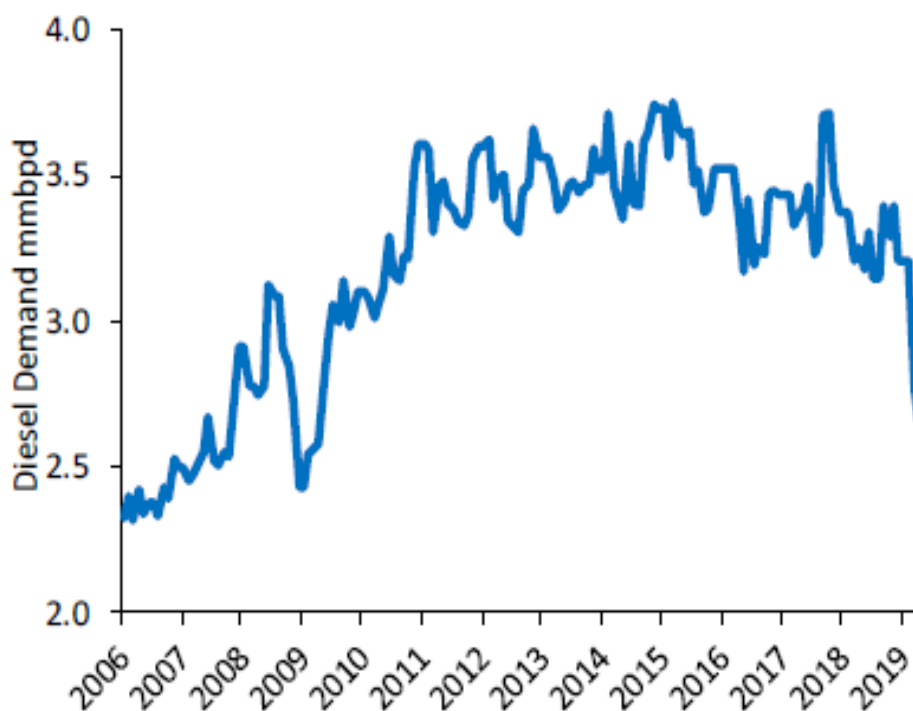
In China, the world's second largest economy, the official Chinese economic data points to strong continued growth. However, we find this to be very dubious. If you look at data provided by companies who operate in China, it paints a much different picture. Auto sales are an important indicator of consumer sentiment because autos tend to be big ticket items. If people fear for their job, or are uncertain about the direction of the economy, they hold onto their money. In China, data collected by the auto companies themselves, not the Chinese government, shows that auto sales have fallen almost 20 percent; a bigger drop than that experienced during the 2008-2009 financial crises.



Source: Bloomberg

Another important indicator of economic health is fuel consumption usage. In China, (as with the rest of the world) the vast majority of goods are still transported by diesel fuel. In time, this will change as the world electrifies their auto and truck fleets, but right now only a small fraction of China's trucks are electric. According to Wells Fargo, China's diesel fuel demand dropped 14% in April and 19% in May.

Besides auto sales and slumping fuel usage, Apple reported disappointing sales, and Starbucks reported negative same store sales growth in China. In our view, the official Chinese growth rate of 6% seems unrealistic given these other data points.



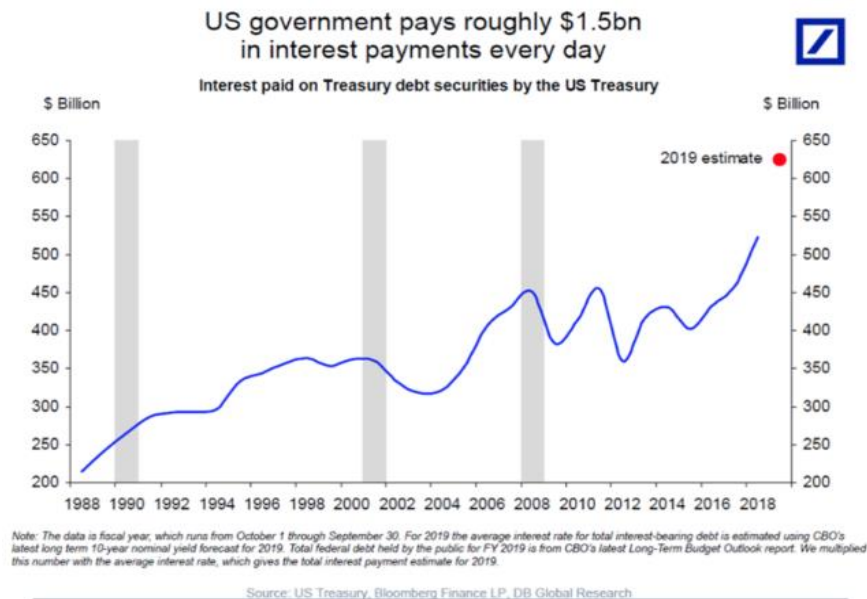
Source: Wells Fargo

In contrast, the United States looks much more solid than Europe or Asia. The U.S. currently hit record corporate profits and unemployment rates. However, these records are backward looking indicators, as the statistics have already been reported.

Looking forward, things appear more clouded. Record corporate profits came from large tax cuts. Future earnings growth will have to come from top line revenue growth and margin improvement, which is harder. In fact, Factset Corporation is stating that earnings guidance from companies within the S&P 500 is actually negative by -2.67% for the upcoming quarter, with 6 of the 11 S&P sectors expecting declines. Companies usually like to low ball their earnings estimates so that they can report upside surprises on earnings release dates, but even so, a negative quarterly earnings estimate is not bullish. Other smaller indicators like Recreational Vehicle (RV) sales are also flashing warning signs. Last year, U.S. RV (Recreational Vehicle) sales hit record highs, but they are off over 20% this year (RV Industry Association). RV sales have tended to precede economic recessions in the U.S., and while RV sales are still at healthy levels historically, the drop is concerning.

Other leading U.S. economic indicators such as housing and autos are starting to stall as well. Housing starts have recently moved below their three year moving average, falling 7.8% in May to a five month low (626K annualized units) and have remained below levels from before the financial crises.

Furthermore, the U.S. debt just hit over \$22 trillion, making future tax cuts unlikely. At the current high level of debt, every 1% increase in interest rates translates into \$220 billion in additional interest cost. This also puts pressure on the Fed to keep rates low. In fact, most of the increase in the budget deficit this year was due to increase interest cost from the Fed's rate hikes last year.



Bond investors have taken notice, and the U.S. yield curve recently inverted for the second time in roughly six months. An inverted yield curve is when the yield on the short end of the yield curve is higher than the longer end of the yield curve. Not all inverted yield curves lead to recessions, but since 1956, equities have peaked six times after the start of an inversion, with the economy falling into recession within seven to 24 months. As a reminder, interest rate inversions can lead to recessions because banks make less money in an inverted yield curve so they curb lending, which can create a recession. As of this writing, Fed funds futures are pointing to about an 80% chance for a July rate cut, which should help correct the interest rate inversion problem. Some economic slowdown was expected after the very high 4% economic growth that was experienced early last year. So now the concern is whether the economy is slipping into a recession or just slowing down to more sustainable growth? We hope that the economy is slowing to more sustainable growth, but we will be watching carefully.

In conclusion, the Federal Reserve has done a 180 degree turn from where they were just seven months ago. Instead of raising rates to slow the economy, the Fed is now

talking about cutting rates to prevent a recession. Although this has created a volatile market environment, given the weakness in Europe and Asia, as well as the slow-down in important U.S. indicators, we believe the Fed was correct to change course.

Furthermore, going forward, we believe that the Fed's current course of action will keep the economic expansion going (come the end of July this will be the longest U.S. expansion on record) and be positive for global economic growth. However, in the long run, in our opinion, to keep the economic expansion going the U.S. will have to rely less on monetary policy and more on Congress and the Executive Branch to control spending in order to develop a long term plan to bring down the nation's debt. In the meantime, we believe the United States is still the safest country to invest in. We are on the verge of being energy self-sufficient, we are the only super power that can feed itself, and we have a dominant military. So, we continue to like large capitalization, brand name companies that are returning cash back to investors from both dividends and share buybacks, and whose dividends are in line with or higher than the yield of a 10 year U.S. Treasury. Given the current parameter, we believe interest rates will continue to remain relatively low for an extended period of time, and thus provide a framework for both stability and future growth.

We hope you have a great summer and thank you for your continued support.

Sincerely,



William H. Schnieders  
Principal



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John C. Schnieders, CFA, CFP®  
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