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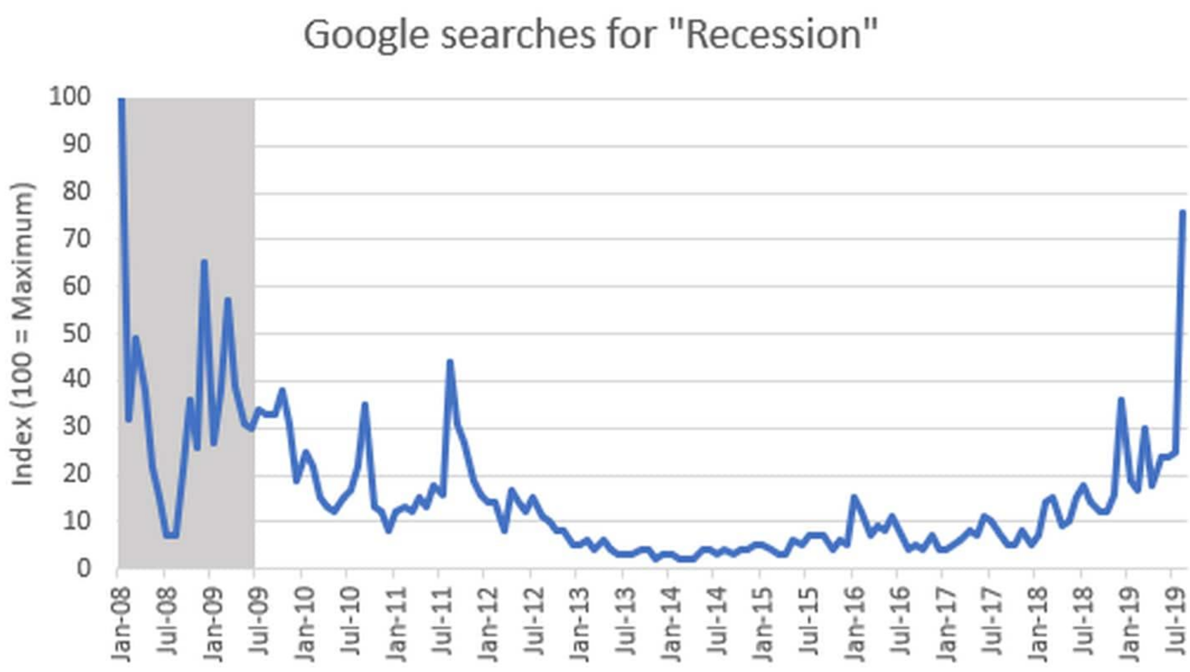
Fourth Quarter 2019 Market Commentary

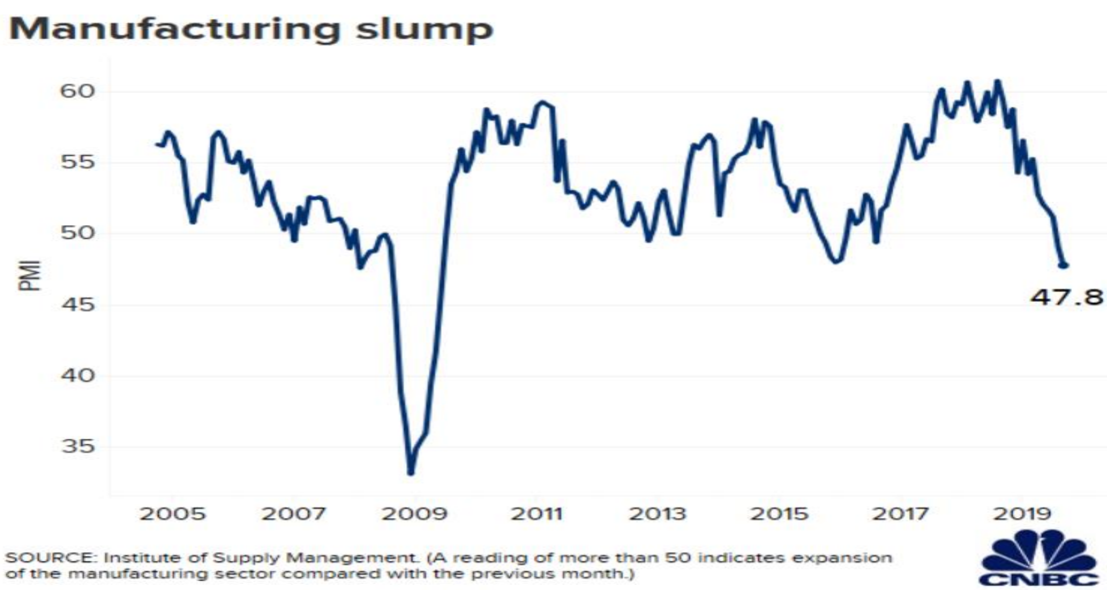
Throughout the past two years, in both 2017 and 2018, the domestic U.S. economy has been solid. Over the past few months, however, some economic headlines have turned negative as the industrial side of the economy has begun to stall. The consumer side of the economy, which accounts for over 70% of economic output, is still doing quite well. In this commentary, we will talk about why the industrial side of the economy is slowing, why the near term threat of a recession is bigger than the actual threat of recession, and how we believe this will affect the financial markets.

With international markets in the doldrums, the U.S. manufacturing sector of the economy has slowed down considerably from its fast growth of last year. The economy has also suffered from an inverted yield curve which has risen fears of a recession.



Source: Google Trends

As we have discussed in previous commentaries, an inverted yield curve restricts bank lending because banks cannot make money on loans when short term rates are higher than longer term rates. If this is not corrected by lowering short term interest rates, a recession usually follows. Fortunately, the Federal Reserve has been lowering rates. Manufacturing has been at the heart of the slowdown. The widely watched ISM (Institute of Supply Management) Index fell to 47.8 (numbers above 50 indicate expansion) in its most recent report. The ISM had been above 50 during most of 2017 and 2018 (see chart below). A drop in manufacturing activity in September took the market down, and put additional pressure on the Federal Reserve to lower rates further to support the economy.



Despite the drop in manufacturing, we believe the near term risk of recession is overblown. First, the manufacturing sector of the economy which accounts for 8.8% of total U.S. employment and 12.5% of U.S. Gross Domestic Product, is not large enough to throw the entire country into a recession (Economic Policy Institute 9/19). Manufacturing activity started the year strong, but has become progressively weaker all year, culminating in the weakest ISM manufacturing index report since the 2008-2009 Great Recession that was just reported in

September. As recently as last year, the index was showing the strongest manufacturing growth in over a decade. That said, there are a few things to remember when evaluating the most recent report. To begin, the ISM report is a survey, and can be impacted by sentiment (China trade concerns) as much as actual activity. Manufacturing also has much more international exposure than the service side of the economy, and so trade worries show up more in this report. Second, General Motors, the largest car manufacturer in the country, is on strike which is affecting car production throughout the country as parts suppliers begin to shut down. Furthermore, Boeing, the largest aerospace company in the world, and the largest exporter from the USA, as well as the country's largest manufacturer after General Motors has had its bestselling 737 Max product grounded since the start of the year. So with the nation's two largest manufacturers not operating, the ISM number was bound to be weak. We view both these conditions as temporary.

Third, even though the reading was weak, the index dipped below 50 earlier in this recovery, without derailing the expansion. In fact, in 2012, the index fell below 50 on three occasions, then again in 2013, and in 2015 the index fell into the 40's for five consecutive months. Each time, the economy kept growing. Also, it is worth noting that nine of eighteen industrial industries reported growth in September in the ISM report, while seven reported contraction (two reported no change).

In spite of the weakness in the manufacturing report, the primary reason we do not see a recession in the near term is because consumers are doing well, and as mentioned earlier consumer activity is 70% of the U.S. economy. In addition, the most recent unemployment report shows the lowest unemployment rate in 50 years. Back in 1969, when the jobless rate also was only 3.5%, the labor participation rate was 60.1%, which is lower than the 63.0% average so far this year. So arguably the unemployment picture is better now than it was then. Moreover, wage growth is the highest it has been in 10 years, and total U.S. retail sales are up a solid 4.1%

year over year (U.S. Census Bureau). In addition, one detail from the jobs report stood out; the share of voluntary job leavers (quitters) among the unemployed spiked up to 14.7%, the highest since 2000. This is an important number because it shows employees have enough confidence in the economy to find another job, and it also means they are more likely to spend. This report also coincides with the Paychex 2019 Human Resources Survey which states that 68% of employers find it difficult to find quality employees.

One analyst whom we respect as a good forecaster is Joseph Ellis. As an analyst, Ellis was known for his accuracy in predicting the growth rate of the economy. In his book titled *"Ahead of the Curve"*, he outlines how he would forecast gross domestic product growth by calculating the overall increase in employment (up over 1.1 million jobs this year), and multiply that number by wage growth (up just over 3.5% this year, which is a 10 year high). He then would have a minor adjustment for stock market growth since it affects spending for higher earning Americans, as well as the direction of interest rates to calculate potential buying power of consumers. Using his formula, the economy should be up over 2% this year. It would be up higher if the rest of the economy were doing better. We will monitor this throughout the year, but so far it's on track.

We feel the transportation indexes also support this +2% growth view. When looking at the transportation indexes, the ATA (American Trucking Association) is also reporting a solid year with tonnage up 4.3% year to date. This is important because trucks transport 71.4% of the products moved within the country (ATA). The Railroad Industry Association which transports most of the rest of the tonnage is reporting a -3.9% drop in loadings this year, but that is due mainly to a -6.9% drop in coal shipments. Coal is the number one item transported by railroads and accounts for 15% of all rail tonnage. As coal power plants are being replaced by natural gas, and to a lesser extent wind and solar, the rail tonnage is being reduced. So, the consumer and transportation indexes still suggest that the economy is growing nicely, despite the manufacturing data.

If the Federal Reserve Bank begins to cut interest rates again (the S&P future market is indicating one additional cut this year), then housing should begin to pick up, which will help U.S. manufacturing. Indeed, U.S. homeowners are among the unexpected beneficiaries as fears of a global slowdown lower mortgage rates. Mortgage rates have dropped more than 100 basis points since the peak late last year, and wages are now growing near the fastest pace in a decade, boosting affordability, and homeowners with higher rates can now refinance which should aid consumption. A pickup in housing should also aid manufacturing as homebuilding consumes a disproportionate share of U.S. industrial activity (windows, plumbing, wood, carpeting, wiring, heating/cooling systems, etc.)

Based on fundamentals – population growth and scrappage – some analysts believe that the U.S. needs about 1.5 million new housing units per year, but hasn't built at that pace since 2006 (First Trust Economic Research). So there is pent up demand for housing and the industries’ internal fundamentals are still solid. New home sales normally run around 70% of single-family housing starts. That said, sales have now exceeded that 70% threshold for each of the past six months, signaling plenty of appetite in the U.S. for new homes. This is another part of the reason we think the U.S. will not enter a recession soon.

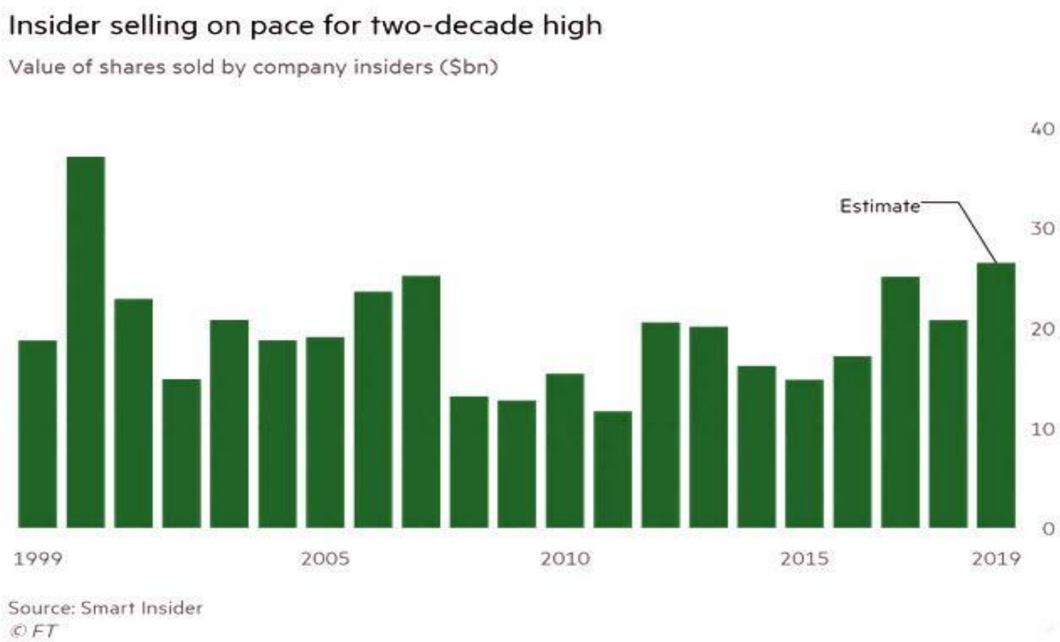
LEI Level in Flattish Upward Trend

Source: Charles Schwab, Bloomberg, The Conference Board, as of August 31, 2019.

Lastly, the Leading Economic Indicators index is also another reason that we do not see a recession in the immediate future. The index is still moving higher, although at a much slower rate. Historically, a recession does not occur on average until 13 months after the Leading Economic Indicators has started to turn down.

Thus, the economy may not go into a recession near term, but we do not think that necessarily means the market is in for smooth sailing. It is just a matter of time before the country encounters another recession, it's a natural part of the business cycle. Unfortunately, the normal tools to deal with a recession have already been tapped, mainly monetary and fiscal stimulus. Interest rates are already very low and the national debt at over $22 trillion, and has never been higher. NBER (National Bureau of Economic Research) has shown that high debt levels lead to slower future economic growth.

In addition, the current valuation on the S&P 500 is 16.82 times forward earnings, versus a 25-year average of 16.22 time's forward earnings (JP Morgan 9-30-19). So, valuations of the 500 largest companies in America are not expensive, but they are not cheap either. Coupled with a strong year in the market this year, a slowing economy, the uncertainty of the upcoming presidential election, and the uncertainty of which way the country will vote will likely cause volatility going forward in the market. Indeed, this has already started to happen as the Dow Jones Industrial average is roughly where it was trading back in April of this year even after all of the big up and down swings we have seen this year. We also see the high insider selling volume taking place right now as a measurement of the uncertainty that many business executives see in the market going forward, and the volatility that they are looking to avoid.



We do expect some more down swings in the future. These drops could be caused by political turmoil in Washington, or a weak economic report, but we think that any prolonged dips in the market will be met with buyers as there is not a lot of attractive investment options right now for savers.

One of the major long term trends that we see is the aging of the U.S. population and the 10,000 Americans who are turning age 65 every day. With the current yield on the 10 year government rate currently trading below the interest yield on stocks (as measured by the S&P 500), we think the market will rally from any sell offs as baby boomers continue to try to lock in income to fund their retirements.

In conclusion, we see a choppy financial market, but no recession for the near term. If the leading economic indicators peak, an inverted yield curve returns, or the consumer stalls, we would expect a recession in the late 2020 to early 2021 timeframe. Moreover, the next recession may be tough because the countries primarily tools with dealing with recession, fiscal stimulus and monetary easing, have already been deployed. Given the backdrop we have described of a high debt, slow growth, low interest rate world, we continue to favor companies who provide goods and services that consumers use on a daily basis, and who are returning cash back to investors from both dividends and share buybacks.

We thank you for your continued support.

Sincerely,

Bill

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