NEWSLETTER

THE Miles Capital • Update 2019

THIRD QUARTER 2019 | VOLUME 19 | ISSUE 3

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ECONOMIC CROSS CURRENTS LEADING TO MURKY WATERS

ECONOMIC DATA REMAINED STRONG, YET NOT AS STRONG AS PREVIOUS QUARTERS

Concerns about global growth and trade took center stage to affect the outlook for the U. S. economy, which the Federal Reserve (Fed) has referred to as the "Cross Currents" of the economy.

Gross Domestic Product (GDP) growth for the second quarter of 2019 was 2.1 percent, lower than the first quarter report of 3.1 percent. However, the first quarter GDP was temporarily elevated due to higher inventory flows stemming from trade concerns. Even with the volatility, the consumer - responsible for approximately 70 percent of the economic growth - showed continued resilience in spending, propelling the economy. The consumer remains strong partially due to the continued low unemployment rate of 3.7 percent.

Some business forecasting surveys began to show declines, including the Institute of Supply Management (ISM) manufacturing survey. This survey has shown a decline below 50 which is indicative of the potential for recessionary activity. However, the ISM services survey has remained well above 50, demonstrating expansion in the services sector. The U.S. economy has shifted more to a service-based economy over the past decades. We believe that the moderation in growth continues through 2019 and into 2020.

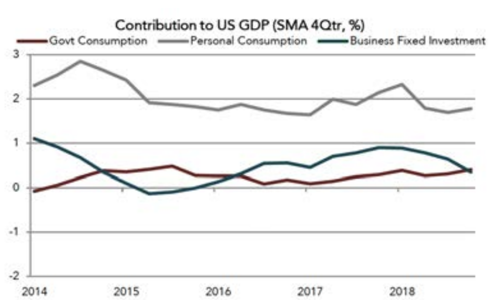
The Fed raised rates four times during 2018 then put the increases on "pause" in 2019 due to economic uncertainties around growth and trade, which they referred to as economic "cross currents". As the waters became murkier around growth and trade, the Fed adopted a more accommodative stature and lowered rates twice during the third quarter. Fed Fund Futures are showing a strong probability of another rate cut yet this year and perhaps one more in 2020, although the probabilities change quite frequently based on Fed tone and economic data.

Equity returns were generally positive for the third straight quarter although not as strong as the rest of 2019 as rhetoric had negative impacts on the markets and volatility increased. Miles Capital is forecasting a slower growth environment for the U.S. economy; however we do not see an immediate recession.

3RD QUARTER *snap shot*

+2.1%

GROSS DOMESTIC PRODUCT GROWTH FOR THE SECOND QUARTER



Source: Bloomberg

Source: Bloomberg

Fixed Income Market Update

IS LOWER FOR LONGER HERE TO STAY... AGAIN?

Since the early 1980s, the long downward trend in interest rates has been well documented. In the 1980s, there were unique factors producing upward pressure on yields, including global growth expansion, heavy government spending, and U.S. inflation over 10 percent. Fast forward to today and we find ourselves and the markets on the other end of this spectrum.

Today, interest rates are once again hovering near historic lows, growth across the globe is slowing, and inflation in the U.S. remains below 2 percent. While we don't necessarily expect rates to trend significantly or go to zero, falling interest rates has been a key theme of 2019 and we've seen zero rates in countries like Japan and much of Europe. Nearly 30 percent of the world's outstanding debt is trading at negative yields. A number of factors have contributed to these low and negative interest rates, but the themes of slow global growth and active global central banks are likely to keep interest rates lower for longer. However, we don't believe rates will be negative in the U.S.

Interest rates, as measured by the 10 year U.S Treasury Note, declined significantly over the quarter and ended at 1.67 percent. That level was 0.33 percent lower than where it ended the second quarter and over one percent lower from the beginning of the year. The decline of interest rates resulted in strong absolute performance for most fixed income sectors during the quarter. The Bloomberg Barclay's Aggregate Bond Index (Agg), a broad measure of the investment grade U.S. bond market, rose by 2.27 percent for the third quarter and is up over 8.5 percent year-to-date. That compares to an annual average return for the Agg of 3.8 percent over the past decade.

Few sectors of the investment grade fixed income markets managed to meaningfully outperform similar duration U.S. Treasuries for the quarter. Corporate and municipal bonds slightly underperformed while other sectors such as mortgage-backed securities and agency bonds slightly outperformed during the quarter. Within the corporate sector, lower quality and shorter duration slightly outperformed higher quality and longer duration segments of the sector.

The fixed income markets will have a number of factors to navigate over the coming months and quarters, including continued trade discussions, potential for additional central bank rate cuts, geopolitical risk, U.S. elections and global events such as Brexit. Give these and other factors, Miles Capital believes volatility will remain at heightened levels and the fixed income markets will have difficulty moving significantly in either direction until more clarity is achieved.

1.67%

YIELD OF 10 YEAR U.S. TREASURY NOTE AT QUARTER END

EQUITY

CLIMBING HIGHER, BUT THE ROAD IS BUMPY

For large U.S. equities, this is the strongest first nine months of the year since 1997. The first quarter saw the best start to the year since 1998. The second quarter also turned in positive performance to continue the streak. The third quarter finished up 1.70 percent, bringing the year-to-date performance for the S&P 500 to 20.55 percent.

Heightened volatility has accompanied the stock market for much of the past year. Concerns with trade and currency clashes between the U.S. and China, recession signals, and - most recently - political headwinds whipsawed investors throughout the quarter. On the other side, the Federal Reserve (Fed) attempted to allay some of these fears by cutting rates for the first time in more than a decade in July and then cut again in September.

Corporate earnings growth for the second quarter, reported during the third quarter, was fairly flat but still relatively solid. While this is a significant decline from the double digit positive growth experienced throughout 2018, those higher rates of growth are harder to maintain after the initial benefit of the fiscal tax stimulus. All sectors were positive for the quarter except for energy, health care, and materials. In a reversal, the defensive sectors (utilities, real estate, and consumer staples) were the top sectors for the quarter. With higher dividend yields, these sectors are attractive when bond yields are lower.

LARGE CAP STOCKS WERE UP 1.70% WHILE SMALL CAP STOCKS DECLINED 2.40% DURING THE QUARTER

Small caps fell 2.40 percent during the quarter and international stocks fell 1.07 percent. International stocks were impacted by slowing global growth, trade concerns, and other geopolitical risks.

China, while still a significant focus for market participants, is not the only factor investors are keeping an eye on. Third quarter U.S. corporate earnings projections have been have been trimmed, and headline news around Brexit, impeachment, and a global growth slowdown are all risks to 2019 market appreciation.

+1.70%

THE S&P 500 INCREASED 1.70 PERCENT FOR THE QUARTER

+20.55%

THE S&P 500 INCREASED 20.55 PERCENT YEAR-TO-DATE

ALTERNATIVES

POLITICAL RHETORIC PROVES
CHALLENGING

After laying the groundwork for a rate cut at their June meeting, the Fed lowered rates by 25 basis points in July, the first rate cut since 2008. The cut was labeled a "mid-cycle adjustment" and not the start of a rate cutting cycle. However, an escalation in the trade war between the U.S. and China created additional concerns over slowing global growth and led to another Fed rate cut in September. U.S. Treasury rates moved materially lower, with yields on longer dated maturities declining 30 - 40 basis points.

The trade situation continues to be quite volatile. The U.S. announced additional tariffs in August and China retaliated with new tariffs as well. But late in the quarter there was an effort by both sides to de-escalate the tensions in advance of a planned October meeting. While temporary progress has been made, skepticism remains around the potential for an agreement on key structural issues.

Hedge funds struggled during the quarter, particularly long/short equity strategies as sector volatility created challenges. Health care, a key sector exposure for funds, continued to be hurt by the "medicare for all" comments from presidential candidates. In addition, comments about rising drug prices impacted the pharmaceutical industry. And while U.S. large cap equities posted another positive quarter, U.S. small cap and international equities were negative.

Macro strategies produced the best return for the second straight quarter, but not without some volatility. These strategies have generally been positioned for lower interest rates, and therefore benefitted from the sharp decline in U.S. Treasury yields. Commodity positions also contributed, including being short energy (oil declined 7.5%) and being long precious metals (gold rose 4.5%).

Hedge funds will continue to be impacted by trade developments and central bank policy. While we expect a trade deal between the U.S. and China to ultimately be reached, there will likely continue to be volatiliy. Corporate earnings growth is expected to improve in 2020, but the longer the trade war continues, the greater the impact it will have on future earnings, which would lead to muted hedge fund returns as they would likely reduce market exposure.

3RD QUARTER
snap shot

+8.5%

THE BLOOMBERG BARCLAY'S AGGREGATE BOND INDEX (AGG) RETURNED 2.3 PERCENT FOR THE QUARTER AND IS UP OVER 8.5 PERCENT YEAR-TO-DATE

30%

NEARLY 30 PERCENT OF GLOBAL DEBT IS TRADING AT NEGATIVE YIELDS

Source: Bloomberg

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