October 1, 2019

"If at first you don't succeed, try, try again" - Frederick Maryat

Dear Clients and Friends,

The arrival of fall reminds us of vacations winding down and kids heading back to school. With this in mind, we thought of the quote above, which encourages schoolchildren to do their homework. However, judging from financial news headlines this year, the quote might also apply to central bankers and trade negotiators as they attempt to pass their own economic tests.

A theme of "try, try again" continued to play out in the third quarter as the Fed cut interest rates twice and as U.S. ~ China bilateral trade talks ebbed and flowed, moving markets up and down along the way. We believe that policy makers will keep trying to meet their interest rate and trade policy goals as we close out 2019, likely driving additional market volatility.

Down and back again

As we wrote in our August 6th letter, investors hoping for a quiet summer got a rude awakening as the Fed and Chinese trade policies rattled markets. In early August, broader markets declined ~6% from a late July peak on a double whammy of bad news. First, the Fed in late July cut interest rates by a quarter point, but investor frustration grew as the Fed signaled a cautious stance toward future rate cuts. Second, the White House added new Chinese tariffs and labeled China a currency manipulator.

Despite the bad news early in the third quarter, markets rallied to a nearly 2% total return for the three-month period on improving investor sentiment. In September, the Fed cut rates another quarter point and the White House both delayed tariffs and announced plans for additional negotiations with China.

Defensive positioning

During the quarter, two economic warning signs prompted us to continue our move toward more defensive portfolio positioning. Slowing trade volumes depressed demand for product exports and drove manufacturers to anticipate declining production for the first time in three years. What's more, the bond market grew cautious as 10-year Treasury bond yields fell well below 3-month Treasury yields in late August. This so-called yield curve inversion can suggest slower economic growth ahead.

Speaking of the bond market, we've also seen some unexpected choppiness in a corner of the market that rarely draws investor attention. In mid-September, investor concerns rose amid a shortage of cash and surging interest rates on short-term loans banks make to each other overnight. The Fed quickly added temporary funding for these overnight repurchase (or repo) agreements, reducing volatility. Still, we continue to watch the repo market for any spillover effects to other asset classes.

Amid these new warning signs, we reduced our exposure to stocks that could decline if interest rates continue to fall and if tariffs keep rising. During the quarter, we exited Charles Schwab & Co. (SCHW) because lower interest rates may pressure the company's earnings. We also sold an auto parts retailer

Genuine Parts (GPC) and a semiconductor company Microchip Technology (MCHP) as both could see volatile trade policies and slowing global growth impact their own earnings growth.

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Weighing risk and reward

As we look ahead to upside and downside scenarios for markets, we see both risks and potential rewards. On one hand, rising risk factors suggest a defensive stance. However, on the other hand, slow and steady economic growth suggests becoming more fully invested.

Our sense is policy makers will continue to "try, try again" as they take on tough economic problems, often with one hand tied behind their backs. The Fed is working with a very limited toolbox as it tries to juice up economic growth by taking interest rates from low to really low. Central banks in Europe and Japan keep trying (*to date unsuccessfully)* to use low or negative rates to spark economic growth, suggesting a tough road ahead for the Federal Reserve.

On the trade front, economic theory tells us that tariffs often create more losers than winners. The economic reality is that rising U.S. and China tariff barriers have led to a cooling off in global trade. Within this challenging framework, new policy decisions by the Fed and among trade officials could create additional market volatility.

However, when looking at broader economic measures, such as employment, wages, consumption and stock valuations, we come away a bit more cautiously optimistic that companies will continue to grow earnings and stocks will chase those higher profits. The non-manufacturing services sector continues to grow, as low interest rates encourage consumption and as trade-related pressures remain minimal.

Specifically, we expect the U.S. economy to grow around 2% this year and next, while profits (and stocks) likely increase in the mid-single digits or more. While we remain vigilant that a recession could throw off our base case assumptions for growth, at this point we see few near term warning signs of an impending slowdown. A view of slow, but durable growth is leading us to consider redeploying some of our defensive cash toward high quality defensive equities offering attractive valuations and rising dividend yields.

As central bankers and trade officials continue to 'try, try again', we anticipate additional market volatility ahead. However, our broader view of the economy, earnings and valuations suggests cautious optimism as we see opportunities to own attractive stocks, bonds and other securities. As we enter the final stretch of the year, we remain committed to our core investment principles while being ever mindful of your goals and objectives.

With Warm Wishes for Fall,

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