Stegent Equity Advisors Investment Letter

Market Review

October 2019

After an impressive move higher during the first half of 2019, risk assets saw little movement to the upside in the third quarter. The S&P 500 did reach a record high of 3,025 on July 26th, only to slide back six percent over the following six trading days as, once again, investors had to digest trade war concerns. The trade war has become a familiar distraction for the market over the last two years, and we do not anticipate an imminent resolution.

The uncertainty surrounding global trade tensions did induce investors to continue investing in lower-risk assets. The ten-year treasury bond price rose as yields fell from a peak slightly above 2% to a low of 1.45%, and then climbed slightly at quarter-end to yield 1.70%. Rate sensitive equity sectors, like Utilities and Real Estate, produced solid returns of 7-8%. Meanwhile gold continued to move higher, finishing the quarter around $1500 per ounce, for a near double digit gain.

As the quarter ended, the S&P 500 was able to regain some ground, and finished very close to where it started at 2,971. International stocks in developed nations were also unchanged, while emerging markets, led by China, finished a few percentage points lower.

Clearly, high levels of uncertainty have driven much of the price volatility domestic markets experienced for the last few months.

Trade War Offsets Rate Cuts

The strong upward move for equity markets in June and July was largely due to investors anticipating the start of a new easing cycle by the U.S. Central Bank. The Federal Reserve was barely able to meet those expectations, cutting the Federal Funds rate by 0.25%. The committee referenced "global developments for the economic outlook as well as muted inflation pressures" as the basis for their decision, but acknowledged there was both sustained expansion in economic activity and strong labor market growth. Further, Chairman Powell described the action as a mid-cycle adjustment, which was interpreted by investors as the Fed only doing one rate cut. Many investors were hoping for the start of a major easing cycle, which would imply many more cuts in 2019 and into next year. Investor disappointment in the Fed statement was reflected in market behavior.

On August 1st the president tweeted that the tariffs already placed on $300 billion worth of Chinese goods would be raised by 10%. An already disappointed market dropped 4.5% over the next three days, and remained there through August. September, historically the worst performing month for the S&P500, bucked its historical tendencies and moved higher, as Fed Chairman Powell recognized the apparent policy mistake and signaled that more easing was probably appropriate.

In a bit of 3rd quarter Deja-vu, the Federal Reserve met on September 18th and cut interest rates by another 0.25%, citing concerns regarding the global economy and muted inflation. Unfortunately, the rate cut was promptly followed by disappointing trade news. Chinese officials cancelled a planned visit to the U.S. to meet with farmers in Montana, while the president told reporters he was under no pressure to complete a deal.

In September, a significant and highly anticipated central bank stimulus program was initiated by the European Central Bank, including the announcement of a significant rate easing package. ECB president Mario Draghi announced that the bank would: 1) cut interest rates; 2) restart a continuous quantitative easing program beginning in November that includes 20 billion euros of bond purchases per month, and 3) make eurozone refinancing operations more favorable. The bond market responded with cautious optimism following the announcement. Clearly, global regulatory and monetary policy, along with trade policy uncertainty, was another major driver of volatility during the quarter.

The cavalry, in the form of global policy makers, has certainly showed up to support slowing global growth. In the third quarter, 13 major central banks cut rates while only one raised them. It is our opinion that a major, globally-coordinated easing cycle should be seen by investors as supportive of risk assets, even if some economists are questioning whether lower interest rates can solve the problems faced by the global economy. A sustained move above 3000 in the S&P500 would be a good first step toward making that a reality.

What Exactly are the Global Developments?

While most recessionary models do indicate that risks have risen, we don't immediately foresee a U.S. recession. The domestic consumer market is healthy, and for a service-based economy like that in the United States, the strength of consumer spending is vitally important. Additionally, consumer confidence is high, wages continue to tick upward as measured by year-over-year changes in average hourly earnings, and household debt service and financial obligation ratios continue to appear very low. Housing, a trailing indicator to economic growth, is improving, according to the National Association of Home Builders. These factors, in concert, continue to bolster domestic economic optimism.

On the downside, international markets are experiencing a protracted manufacturing recession that has started to effect business confidence. Investors are questioning whether a service-based economy like ours can avoid the global manufacturing slowdown, or if the U.S. is next on the list and could fall into recession. Two recent broad-based U.S. manufacturing reports illustrate this point: The September ISM Manufacturing index reported contraction (a reading below 50) in the U.S., driven by trade war uncertainty and strength in the U.S Dollar, while the Markit Manufacturing Index (MMI), which is more domestically focused, continues to point to expansionary activity. If the trade war and the subsequent global economic slowdown escalates further, there is a risk that business confidence in the U.S. could erode to the extent that the domestically focused MMI will contract as well.

Maybe the Rest of the Globe Needs Rescuing

Globally, economies are more oriented towards manufacturing, and recent economic data reflect this orientation. Fleeting signs of stabilization earlier in the year have evaporated, leaving serious recession concerns among global powers. In Germany, industrial manufacturing has been in contraction since the beginning of this year. In the second quarter, the German GDP went negative at -0.1% and there are fears that the 3rd quarter could provide another negative reading. Similarly, South Korean exports are especially sensitive to trade and they have fallen by 22% year over year. Japan exports are down 10%, Swedish PMIs have been falling, Taiwan exports are falling… we could go on.

Finally, political noise is certainly heating up around the world:

- Brexit is an ongoing saga with the October 31 deadline approaching.
- Middle East tensions are up after the latest attack on two major oil processing facilities inside Saudi Arabia.
- The U.S.-China trade war continues, with little hope for a quick resolution.
- A separate trade war between South Korea and Japan has the potential to escalate into something much more dangerous.
- An impeachment inquiry into President Trump has been opened.

Is the Cavalry Too Late?

As we enter the 4th quarter, we believe central banks will continue to support stocks with easing measures. The banking system started to show signs that more liquidity is needed from the Fed, with rates on overnight repurchase agreements (short-term money market lending rates) soaring to almost 10%. In reaction, the Fed stepped in and

provided liquidity to relieve the pressure. Some market participants are suggesting that permanent operations, like Quantitative Easing (QE) programs, are needed. If the Fed did restart QE programs, it would be another policy decision that would be supportive of risk assets for the near-term. Whether or not this comes to pass, it is safe to say that the market is actively telling the Federal Reserve that more attention is needed. Investors are pricing in a 93% chance of another rate cut by December.

The question then becomes: Will it be too late and/or will it be enough? During the manufacturing recession of 2015/16, central bank actions in coordination with fiscal stimulus provided the spark to reignite global growth. We believe a similar coordinated response could be the key to avoiding recession this time. Will Germany pass a fiscal stimulus plan in response to recessionary conditions? Will Chinese data start to improve after a massive stimulus push throughout the year? Or have they done enough already, and it will just take time to filter through to spur real growth?

Our Positioning: A Small Step Below Benchmark Risk

We believe that the prudent stance is to be slightly below bench mark risk. Last quarter, our stated goal was to move to neutral. In light of heightened risks due to the factors we've outlined here, our portfolios remain at 95% of benchmark risk. Our U.S. equity positioning is overweight in defensive sectors, like consumer staples, and also overweight in early cyclical sectors, like technology. Alternatively, we are positioned underweight in late cycle sectors (industrials and energy) and international equities.

In fixed income, we also remain slightly defensive. Treasury holdings are above benchmark weight, while corporate bond exposure is below benchmark weight. Additionally, precious metals have been slightly over-weighted in portfolios.

The battle between a slowing economy and global central banks will continue into the 4th quarter. If global economic data starts to improve, we will not hesitate to move back to benchmark levels of risk (or slightly higher). At the same time, if the situation continues to deteriorate, we will position more defensively.

As always, we are grateful for the opportunity to continue to serve as your trusted advisor. Please reach out with any questions or concerns.

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