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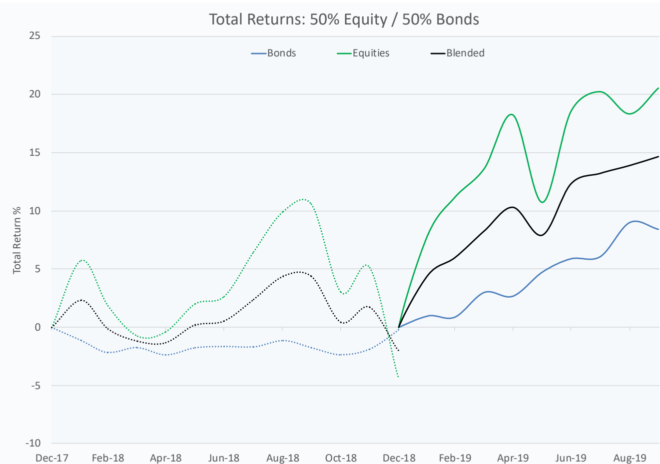
WHERE WE STAND – Q3 2019

The S&P 500 Total Return Index was up 1.8% (including dividends) in Q3 2019. See the solid green line to the right in the chart below. The Aggregate Investment Grade Bond Index (including interest) was up 2.4% for the quarter (blue line). If your portfolio comprised 50% S&P 500 and 50% Bonds, your YTD return would be 14.6% (black line). Data for 2018 is shown, broken lines, to the left.

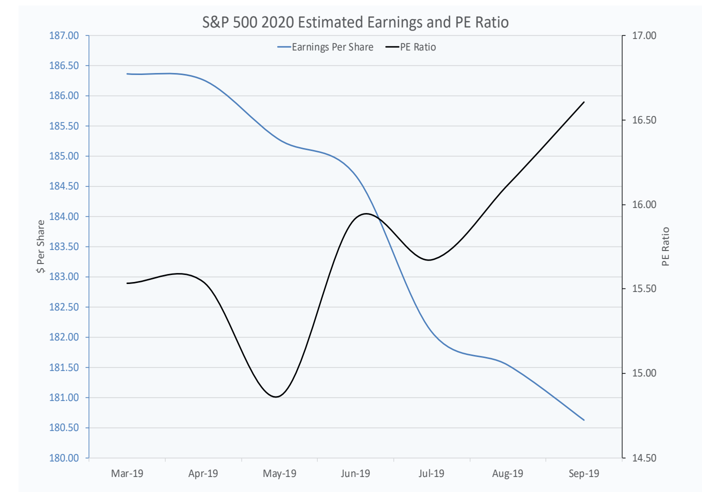


Overview

The S&P 500 index was up marginally in Q3 2019, recovering, in September, from a 6% correction in August. See the shaded blue area in the chart above. The index ended the quarter at 2,981, the high end of the broad range it has traded in for 2 years.

A convincing breakout from this trading range remains ellusive. On the one hand, reduced expectations for S&P 500 earnings weigh on the index. On the other, a more accomodative Fed and falling bond yields are acting as support.

As we approach the end of 2019, focus is shifting to expected corporate earnings for 2020. Over the last year, expectations for 2020 earnings have eroded from $186.35 per share to now $180.50 per share (still 12% higher than 2019 earnings) as shown in the blue line in the chart below. Therefore, the S&P 500 multiple (a measure of investor sentiment) has risen from a relatively pessimistic 14.75x to the somewhat more positive 16.75x earnings today (black line). However, these 2020



estimates are vulnerable to downward revision to single digit growth (or worse in the event of a recession), which implies that the forward PE ratio may be, in reality, over 18x earnings, a very optimistic valuation in light of current global economic uncertainty.

As noted above, global central banks continue to push liquidity into the world's financial system as economic indicators continue to deteriorate. For now investors are betting that these liquidity measures will stave off recession and continue to extend the business cycle.

Other important equity measures, like the Russell 2000 (a measure of domestic US companies) and Non-US All

World equities, remain challenged and perhaps reflect a softer fundamental underpinning to equity markets than the S&P 500 Index does. See the two charts below showing 2 year history.

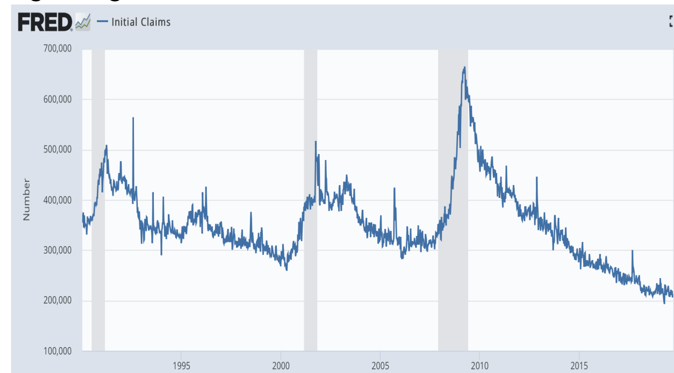
IWM [NYSE]
iShares Russell 2000 ETF

VEU [NYSE]
Vanguard FTSE All-World ex-US Index Fund ETF Shares

Politics continued to play a volatility inducing influence on financial markets during the quarter. In particular, the effect that China is having on existing world order, in terms of the current trade talks, its own economic slowdown, its internal political strife, and its threat to US global hegemony, is a developing story that will be with us for a while to come.

In the US, the prospect of impeachment of a US President has consequences that are hard to predict. And the rise in the polls of a left leaning Democratic presidential canditate (Elizabeth Warren), and the now, 25% chance of her being the next president, is an outcome that corporate America, and hence investors, may have to deal with as distribution-of-income and wealth issues come to the forefront of domestic policy.

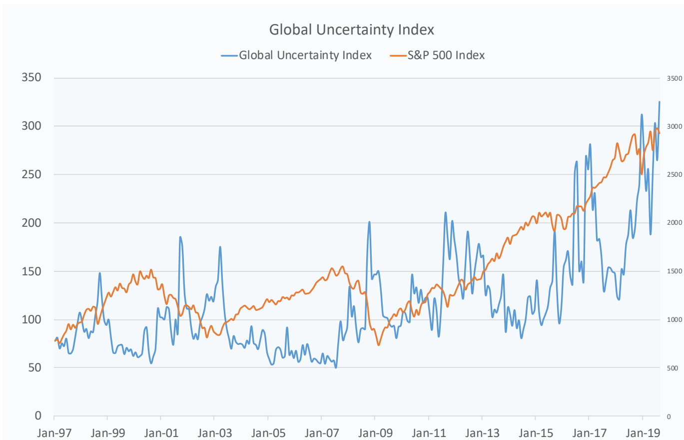
On the economic front, there are strong signs of a global slowdown in manufacturing and a lack of business investment. In many countries, manufacturing is in recession. On the other hand, in the US in particular, because of low unemployment, steady wages and availability of credit, consumer spending is relatively bouyant. The net effect is that the economy is growing, albeit at a relatively contained ~2%, as it has for most of this cycle. Consumer confidence, like the stock market, is strong, although both of these are lagging indicators of economic conditions. Importantly, for now, leading indicators like unemployment claims are not overtly signalling economic slowdown from these levels. This is



comforting, in a sense. But in another it is not, for from these levels, it is only a matter of time before unemployment claims turn up followed by recession as shown in the chart above. Grey shaded areas are recessions.

Some measures of global economic policy uncertainty have risen substantially. One study we follow measures this uncertainty: gleaning information from newspapers, CBO reports on tax code changes and the Philly Fed survey of professional forecasters. As one would expect, the uncertainty index has risen to unprecedented levels as shown in the chart below (blue line).

Usually, when uncertainty is high, asset prices (in this case



indicated by the S&P 500, orange line) have gone through a period of correction and are in sync, so to speak, with uncertainty levels. In this cycle, this is not the case. We suspect that this is to do with monetary policy since the great recession: where unprecedented amounts of global liquidity have been pushed into the system, distorting it in the process (for example negative bond yields throughout the globe) and preventing normal market clearing mechanisms from running their course…for now. Similarly, the not unrelated build up of corporate debt has played a part in this disconnect, especially so via the bloated and unsustainable level of

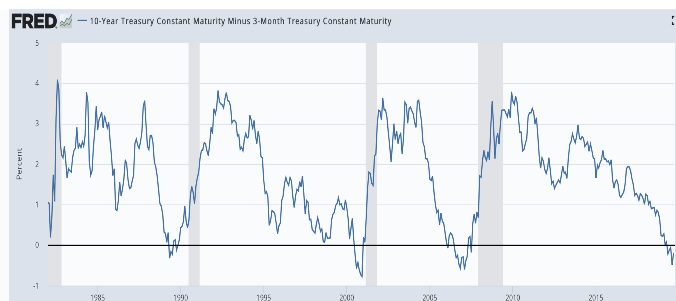
equity buybacks by corporations. Along the way, equities, and in particular the S&P 500 have garnered safe-haven status, which they really don't deserve to have.

In the meantime, US equities over the last 2 years have really not done much from a price appreciation standpoint and on a risk adjusted basis have underperformed bonds and to an extent short term, risk free, fixed income investments.

Where We Stand

From last quarter's report, our stance has remained: "for the past 18 months our strategy has been one of capital preservation and opportunistic market timing. That is, to keep volatility in our portfolios low, by having an underweight equity holding and by enjoying the higher return offered in relatively risk-free bonds. We have increased our equity allocation on market corrections and reduced it in over exuberant rallies. This is a strategy tailored to the belief that we are late in the economic, and hence investment cycle, and forward equity returns are limited in the medium term. This is different to how we conducted our strategy earlier in this cycle (with aggressive equity allocations) and how we will do so at the beginning of the next cycle. "

We don't see any reason to change our strategy at this point. What has changed since last quarter is the decline in global bond yields, which in and of itself has reintroduced the 'TINA' strategy by various portfolio managers. There Is No Alternative. In other words, "because bond yields are inordinately low, lets buy equities". We understand this strategy, to an extent, but feel like it was one that worked in the earlier part of the cycle and will fail to work if the fall in yields is signaling a nearing recession. Different this time is that this fall in



long term yields have created an inversion of the yield curve, a phenomenon that almost always presages a recession. The 3-month to 10 year yield curve has been inverted for 6 months now, and as shown in the previous chart, when this happens, recession follows at some point thereafter.

Risk assets globally are in no way shape or form pricing in the possibility of recession, although bond yields are - another unusual and concerning disconnect. This is something we are acutely aware of and keep in mind when managing your assets.