2019 FALL INVESTMENT OUTLOOK

The underlying economic picture in the United States remains satisfactory. The nation's economy grew at a 2.0% rate in the second quarter. While this represented a slowdown from the 3.1% recorded in the first three months of the year, it was sufficient to extend the current expansion to a record 123 months assuming growth continued through August. Ongoing economic progress allowed for continued gains in the labor market which has experienced a record 107 consecutive months of job growth. Meanwhile, the unemployment rate at a current 3.7% hovers near a fifty year low. Wages and household incomes are displaying similar positive trends and have been supportive of consumer confidence, an important factor in a nation where consumer spending accounts for over two-thirds of economic activity. Indeed, even in the advanced stages of this economic cycle, consumer spending remains robust and above the long term trend line.

Inflation has remained tame if one excludes the prices of homes and other financial assets. Modest growth and subdued inflation provided cover for the Federal Reserve to reverse its rate hiking campaign which saw the Fed raise its key lending rate nine times between December 2015 and December 2018. In July, the federal funds rate was cut by 0.25% as the Fed acted to reduce its benchmark yield for the first time since 2008. Another 25 basis point reduction was enacted this week which lowered the Fed's key lending rate to a range of 1.75-2.00%. On their own, domestic conditions may not have justified these Fed rate cuts as economic progress remains acceptable as noted above. Developments overseas, however, may have helped force the Fed's hand as weak international growth has caused numerous global central banks to ease policy this year. The Fed is mindful that if U.S. interest rates diverge too much from rates abroad this could impact capital flows, currency moves, exports, growth and inflation in negative ways that could create larger problems down the road.

While the Fed is taking a measured approach to adjusting the federal funds rate, the bond market's reaction to global developments has been less subtle. The recent sell-off in the bond market caused the U.S. ten year treasury rate to soar to 1.90%, up 44 basis points from a closing price of only 1.46% two weeks ago, though it has since fallen to a current 1.75%. Stocks, meanwhile, continue to be a favored asset class by global investors who remain bullish on prospects in the equity market despite the global slowdown noted above. Investors may be ignoring other concerns as well. Slower economic growth has dented world trade. Global commerce has also been negatively impacted by the ongoing trade and intellectual property dispute between the United States and China. The United Kingdom's pending exit from the European Union adds another layer of uncertainty to the business environment. Corporate executives report that escalating tariffs and the seemingly impulsive and unpredictable nature of the changing rules of trade are causing disruptions in their current and future business planning.

Geopolitical concerns remain an ongoing threat as evidenced by the recent attack on Saudi Arabia's oil infrastructure. Four months of protests in the streets of Hong Kong are another reminder of unsettled global conditions. The U.S. dollar has been strong which has hurt overseas profits of publicly traded U.S. multinational corporations. This has been one factor which has contributed to a potential retrenchment in S&P 500 earnings through the first three quarters of the year. Domestic private capital markets are also flashing warning signals to investors. The planned tech unicorn WeWork's initial public offering (IPO) had to be postponed indefinitely despite a proposed offering price less than half the level of its last private financing round. This points to clear excesses in the private equity arena that may have implications for the public markets at some point. Despite these and other concerns, investors have pushed the popular equity benchmarks higher since the summer, extending year-to-date gains as noted below. It is worth mentioning, however, that these figures have been artificially boosted by low starting valuations due to the severe downturn in the fourth quarter of 2018. Including that challenging period, the S&P 500's total return is less than 5.0% over the past twelve months.

Equity Markets – 9/18/19

	Index Price Level	2019 YTD Total Return
Dow 30 Industrials	27,147	+18.5%
S&P 500	3,007	+21.7%
NASDAQ Composite	8,177	+23.2%
MSCI All Country World Index ex-USA	281	+13.1%

Outlook

The interplay between the competing forces noted above will determine how investors will fare in the coming months. A favorable backdrop for capital markets is premised on the continuation of the longest economic expansion in our nation's history. On this front, there is reason for optimism at least in the near term. Reduced tax rates and regulatory reforms continue to provide a tailwind to growth even as the positive impacts have moderated. Companies continue to hire new workers, albeit at a slower pace than earlier in the cycle. So far in 2019, the U.S. has added jobs at a rate of just over 158K per month. While below the average figure of nearly 198K per month since the consecutive jobs gain streak began in October 2010 and well below 2018's 233K monthly average, the current pace is acceptable at this late stage in the cycle. Importantly, wages are finally responding to the tight labor market as average hourly earnings have increased at a rate exceeding 3.0% every month this year. This is the fastest pace in the past decade and nicely above the overall inflation rate which has averaged under 2.0% in 2019. Household income growth remains strong as more people are working and average hours worked remain relatively stable.

Government fiscal policy remains stimulative as tax cuts and spending increases benefit economic growth. A bipartisan deal made it through Congress in August which increased government spending by an additional $320 billion over the next two years while also suspending the debt ceiling through mid-2021. For now, investors remain unconcerned that this has contributed to a federal deficit that exceeded $1 trillion over the first eleven months of this fiscal year. The nonpartisan Congressional Budget Office (CBO) predicts that the government will run a surplus in September, so its full year budget deficit forecast is $960 billion, still a 23% increase over the fiscal 2018 figure. More worrisome, the CBO predicts that federal deficits will average $1.2 trillion per year over the coming decade. The federal government is acting to aid a recovery that remains the weakest in the post-WWII era. The economy has expanded at a compound annual rate of only 2.3% since the last recession ended. This is well below the 3.7% and 4.6% rates over the past five and ten economic expansion periods, respectively.

Many foreign governments are facing a similar quandary as persistently low inflation, low growth environments present challenges. Central banks have responded with unprecedented easing of financial conditions which has failed to restore economic progress to historical levels, perhaps in part due to the secular headwinds of weak productivity gains, slowing population growth and aging demographics. While these accommodative actions have forestalled the onset of the next recession, they have done little to sustainably rebalance supply and demand and likely have resulted in unintended consequences.

Monetary easing has contributed to flattish yield curves and a glut of negative yielding bonds which recently totaled over $17 trillion globally. This, in turn, has made the basic banking business a less profitable one and may discourage lending as banks struggle to earn acceptable spreads on loans. All else equal, less credit in the financial system will ultimately lead to slower economic growth and lower inflation, exacerbating current trends. Additionally, there seems to be evidence that low interest rates, rather than encouraging people to borrow and spend, are causing consumers to retrench. The theory is that as investors project that the low rate environment will persist for many years, they will require additional savings in order to generate a similar level of income. Also, if investors anticipate that rates may move even lower, they may hold back current consumption based on the expectation of less expensive borrowing costs in the future. Finally, there is a growing consensus that rock bottom interest rates may allow so called zombie companies to remain afloat. This term refers to firms that cannot cover their debt obligations after paying for basic operating costs. In other words, these are companies that rely on the never-ending willingness of lenders to extend credit in order to remain in business. One consequence of this is that these unprofitable firms can reduce competitors' pricing power which negatively impacts industry profit margins and puts downward pressure on inflation. Clearly, these numerous potential side effects of easy money policies run counter to what central bankers intended.

In any event, it is likely that fiscal policy will need to play a larger role in addressing global shortfalls. Japan's experience with easy money is a long term case study in the ineffectiveness of using monetary policy on its own to cure what ails the global economy. Despite experiencing decades of low rates, the Japanese economy still suffers from persistently low growth and inflation. More recently, it is becoming clear that the near zero interest rate policies in both Europe and even the U.S. are similarly falling short of policy goals. Both at the August Jackson Hole conference of global central bankers and again during the press conference after the September European Central Bank meeting, major central bank heads admitted that they have limited policy tools available to them. In a break from tradition, monetary authorities very publicly called for fiscal authorities to act more aggressively. It remains to be seen if political leaders heed this call to action and what the unintended consequences may be if they do. The obvious fiscal tools available include tax cuts and investment spending but, in a world with record levels of debt, these actions would not be without economic risks. Additionally, any such attempted policy fixes will create winners and losers so an escalation of the partisan politics that has gripped many nations around the world may result as there are simply no easy solutions.

Geopolitical events remain central to the outlook and there are several issues that demand investor's attention. While a short term truce seems to be in effect at the moment, relations between the U.S. and China have deteriorated on several fronts. Trade, intellectual property and even military disputes between the two nations continue with no obvious resolution in sight. Both countries' economies are suffering as a result which may be the reason for the temporary détente, but one should expect issues to resurface as deeper, more existential issues are at stake in this pivotal relationship. Fifteen consecutive weekends of protests in the streets of Hong Kong may also complicate relations between the world's two major powers. Particularly if the U.S. comes to believe that human rights violations are occurring, it is likely that an escalation of tensions with China may resume. What happens in Hong Kong is important as that city is the gateway for most of money that flows between mainland China and the outside world. Shifting to the Middle East, significant Saudi Arabia oil capacity will be taken offline for some time as critical infrastructure needs to be repaired. This has led to a spike in oil prices that will feed through to consumers in the coming months. The attack also complicates already difficult relations with Iran, as evidence would appear to support that nation's involvement in this incident.

Stock prices ultimately respond to underlying company fundamentals. This basic fact is worth noting because S&P 500 corporate profits may decline through the year's first three quarters with only very modest full year gains expected. Despite this, the index has posted a total year-to-date return of 21.7%. So nearly all the market's return this year has been due to rising investor expectations rather than improving cash flow and earnings. Forward price-earnings multiples have expanded from 14.6x at year end 2018 to a current 17.1x. Furthermore, the current multiple would appear to be overly optimistic as it is based on a double digit earnings gain that is unlikely to be achieved in the coming quarters.

Other warning signs exist for investors. Perhaps most notably, the last time the gap between S&P 500 operating profits and corporate profits measured on national income account basis was as large as it is now was during the 2000-2002 market downturn. This is important because operating profits are subject to managements' discretion whereas national income based profits are far less prone to manipulation. Discrepancies between these two metrics often peak late in the cycle and as Vanguard founder Jack Bogle once noted, "When there is a gap between perception and reality it is only a matter of time until it is reconciled…in favor of reality." Another late cycle phenomenon relates to signs of excess in the private capital markets and there is clearly evidence of this today. The case of WeWork was noted previously and it is not the only overpriced private equity investment. Both in the U.S. and abroad, private company valuations are near record levels. Skeptical investors cannot short the shares of a privately held company and insiders typically are barred from selling stock so there is essentially no true price discovery until the shares are sold publicly. In the case of Uber and Lyft, which are down 24% and 35% from their IPO prices, respectively, public investors would have been wise to avoid the shares. These are unlikely to be the last disappointing IPOs this cycle. A look at Softbank, a lead early investor in both WeWork and Uber, offers another reason for caution. The company has borrowed against its post-IPO, locked up shares of both Uber and Alibaba to get cash to pay back investors. It is also reportedly on the hook for over half of the new money invested in its latest $100 billion venture fund, including $20 billion loaned to its employees to purchase shares of the fund. Adding leverage to these already risky investments may prove disappointing and costly in due course.

Investment Conclusions

The capital market outlook remains as uncertain as it has been in many years. Global growth is slowing despite ongoing stimulus efforts that appear to be increasingly less effective at the margin. Unconventional fiscal and monetary policies are being employed to prolong the expansion with yet to be determined longer run consequences. Perhaps not surprisingly, in a world of ultra-low interest rates, investors have responded by bidding up the price on a wide array of risk assets including stocks, bonds, private placements, real estate and artwork to name a few.

We would caution those who seek undue excess returns this late in the economic cycle, particularly those who are crowding into the same overpriced publicly traded equities as well as investors in many private equity and hedge fund vehicles. These latter two asset classes are illiquid, have very high fees and have experienced broad based, risk adjusted returns that compare unfavorably to the publicly traded equity markets. To this last point, according to BarclayHedge, a leading provider of information on alternative assets, 2018 marked the tenth consecutive year that the hedge fund industry underperformed the S&P 500. Despite this fact investors continue to allocate money to these asset classes, a decision that ultimately is likely to be met with regret by many.

As we survey the broad investment landscape, we believe that today's elevated stating valuations imply more subdued returns over the short to intermediate term. As a result, now is an appropriate time to shift the focus toward managing risk rather than chasing returns. One of the ways we mitigate risk is by performing relentless due diligence on the companies owned in client portfolios. Our deep knowledge of company fundamentals combined with our strict price discipline has allowed our clients to enjoy favorable risk adjusted returns over the thirty year history of the firm. We believe this time tested strategy will continue to benefit investors in the coming years regardless of any near term challenges that may be on the horizon.

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