Market Commentary

Investing is an activity of forecasting the yield over the life of the asset; speculation is the activity of forecasting the psychology of the market. - John Maynard Keynes

The third quarter ended with a 20.6% return from the S&P 500, the strongest performance for the first three quarters of a calendar year since 1997. Large cap growth stocks continued to dominate, but by a smaller margin than last year. The 5.5 percentage point year-to-date spread between the 23.3% return of the Russell 1000 Growth Index and 17.8% return of the Russell 1000 Value Index fell well below the 13.2 percentage point outperformance of growth during the first three quarters of 2018. Similarly, while US stocks continued to outperform the rest of the world, it was by a smaller margin.

This performance came in the face of increasing risks. The drone attack on the Saudi Abqaiq oil processing facility signified a major escalation in that country's conflict with Iran. The facility processes approximately half of Saudi oil production. The Kingdom quickly announced faster than expected repairs, but production remains about 1.8 million barrels below pre-attack levels. Oil prices gave up their gains after just a couple of days, implying the market sees no further risks of disruption. The Saudi-Iranian conflict and its potential to disrupt oil and LNG supply remains a risk to the global economy.

US consumer and employment data remained strong through the end of the third quarter, despite the recessionary warning of an inverted yield curve. However, manufacturing data continues to weaken, with the ISM Factory Index reporting a contraction in manufacturing, similar to late 2015 / early 2016. The manufacturing slowdown in 2016 lasted only five months and the strength of consumption and the service economy kept the economy from recession. The current reading may signify a similar situation or the beginning of a larger slowdown that extends to consumers and services.

Despite the recent impeachment move added to the turmoil of the upcoming election, US politics does not appear to be currently a cause of volatility in the financial markets. Similarly, markets appear to be shrugging off the looming October 31 Brexit deadline. While domestic politics generally impacts financial markets far less than one might suppose, the current divisiveness may create problems should major economies slip into recession.

Looking out to the next decade, demographics will continue to transform the global economy. Aging baby boomers will continue to increase their impact on Social Security and Medicare. The Congressional Budget Office projects deficits over the next decade to average 4.3% of GDP, well above the 2.9% average over the 1969-2018 period. The debt issuance to finance these deficits will put increased stress on bond markets and lead to higher interest rates. Other developed countries face more severe demographic issues with outright population declines.

China's economy remains weak, and trade disputes threaten to erode its manufacturing base as companies look to diversify their supply chains. The US's symbiotic relationship with China served as the primary engine of the global economy for the past twenty years. While other developing economies – notably post-war Germany, Japan and South Korea – previously created a path to prosperity through export-driven manufacturing, their impact was dwarfed by the scale of the Chinese economy. With the world's largest population and the government's ability to suppress domestic consumption in favor of investment, the Chinese manufacturing sector was able to capture approximately 20% of global manufacturing and surpass the US in 2010.

During the period leading up to the 2008 Global Financial Crisis, the US ran record trade deficits, with imports of Chinese manufactured goods effectively financed by China's corresponding purchases of US Treasury bonds and other dollar-denominated assets. China's repatriation of trade dollars into the securities markets allowed it to maintain its US dollar currency peg and prevent the appreciation of the renminbi that otherwise would have eroded its trade advantage. Pundits during the mid-2000s wrote often about the unsustainability of this relationship and speculated on its potential negative impact. Few at the time saw that this influx of dollars turned out to be a primary driver of the bubble in residential mortgages that created the 2008 Global Financial crisis. American and European banks, responding to a seemingly insatiable demand for 'safe' dollar-denominated securities, facilitated a massive expansion of mortgage borrowing that ended with the now familiar story of the collapse of the financial sector in 2008.

After 2008, many thought this relationship would end. Economic historian Niall Ferguson and co-author Moritz Schularick wrote a piece entitled *The End of Chimerica* in 2009 predicting the imminent end of this relationship. Contrary to their thesis, the US and China remained economically bound as China's massive post-crisis infrastructure and real estate investment program provided a much needed economic stimulus for the rest of the world. A resumption of growth in China's trade surplus and foreign currency reserves followed. In 2014, China began allowing their currency to depreciate against the dollar, exacerbating the trade imbalance.

The US manufacturing job losses over the past 20 years fell predominantly on its Midwestern industrial heartland while the 'blue' coastal states benefited either through the repatriation of Chinese dollars into financial and real estate investments or through the globally distributed supply chains that supported the margins of the technology industry. This helped create the political divisions that enabled the election of President Trump and the current trade dispute. However, even without Trump's 2016 election, conflict would still exist with China in some form. Tellingly, at a recent debate none of the current Democratic presidential candidates said they would roll back the new tariffs on China.

Manufacturing is leaving China in reaction to the conflict, but very little is returning to the US. Rather, global manufacturers are diversifying to countries such as Vietnam, Bangladesh, Mexico or The Philippines. Despite a volatile near-term outlook, this spread of manufacturing should drive growth in these markets over the next decade.

The current slowdown in China threatens to unravel the distortions caused by decades of party-guided capital allocation. To date, China's high growth rate and near total government control of the financial sector prevented these imbalances from threatening the country's economic (and political) stability. Should economic growth continue to slow along with an exodus of manufacturing, China may face a difficult adjustment. This coincides with an aging population that, due to the one-child policy, will increasingly look like Western Europe over the course of the next decade.

Despite the challenging outlook, market timing remains a risky strategy. Using our Monte Carlo tool, we estimate that market timing on a year by year basis would require at least a 75% accuracy rate to add value over a buy-and-hold strategy. This accuracy rate in picking stocks would allow one to easily outperform the S&P 500 every year. While an investor could make dozens or even hundreds of stock picks per year, market timing decisions are made infrequently. A small edge in stock-picking can translate to outperformance due to its application across a large number of positions. Market timing involves a few large and infrequent bets and therefore requires an impossible level of accuracy for success. One bad market timing decision can negatively impact performance for decades.

Maintaining a disciplined asset allocation remains the best form of risk control for investors. Our process focuses on investing in strong businesses with manageable financial leverage alongside preserving multiple years of required cash flow in high quality bonds and cash. While the business cycle will lead to volatility in the prices of stocks and other risky assets, a reserve of safe liquidity provides a cushion to support distributions through a potential downturn.

- Stephen C. Browne, CFA
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