<u>FROM THE DESK OF BOB CENTRELLA, CFA</u> **October 9, 2019**

Q3-19 SUMMARY & OUTLOOK

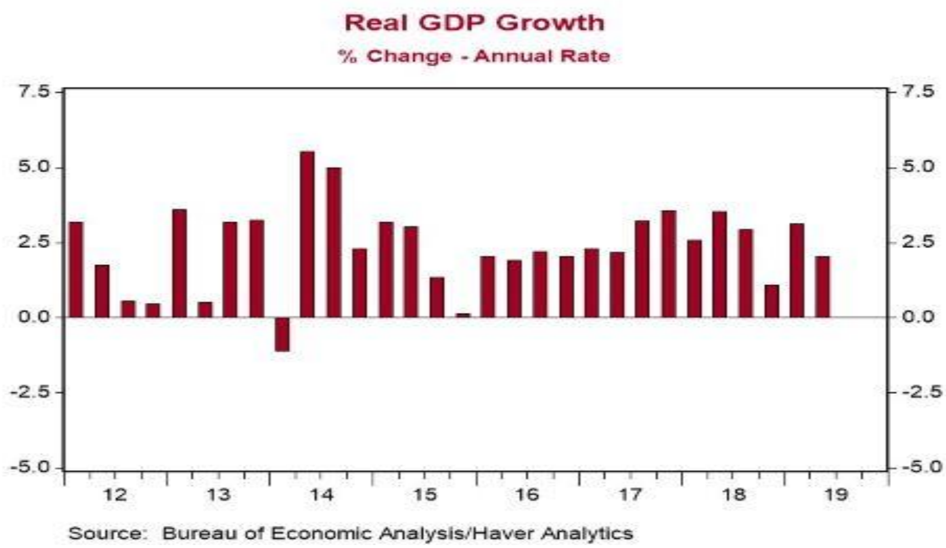
The Q3 letter is one of my least favorite to write because it's after summer has officially ended and back to work for those of us that enjoyed some beach, travel or other trappings of summer. You can't help but feel a little down until you get re-engaged with more work and less play. We were able to do a little travel this summer both to the West coast and then back across the other side to Europe as we wanted to see upclose whether or not there was a world economic slowdown. So, yes we were doing research!

But meanwhile, the financial markets never vacation or sleep for that matter. And Q3 was not a yawner. The growing Wall of Worry made for an interesting 3 months. First and foremost, the ongoing China Trade War continued to dominate the headlines and was a root cause of volatility depending on positive or negative news. As I write this we are 2 days away from the next round of talks and again the market is selling off a bit ahead of it. I wouldn't expect any major breakthrough and there is much pessimism among investors but negative news could still lead to a downdraft. Next we had a flurry of other issues including a global economic slowdown and Central Bank rate decreases, the Democrats ongoing effort to find a way to impeach Trump since day 1 which has moved onto a new phase, and a hard Brexit being among the biggest topics. Finally, the surge in the polls by Elizabeth Warren and the market selling off is not just a coincidence – a Warren candidacy and possible presidency would very likely be "not good" for stocks and has investors worried. I don't say this in a political way but as an investor – Warren is no friend of financial markets. If she were to be the Democrat nominee, we will be looking to make some changes to portfolio allocations.

Weak economic numbers and a global slowdown are causing central banks to again look for ways to loosen monetary policy. In the US, we saw the Fed lower rates for the first time since 2008 followed by stock volatility in August and a surprising bit of a rebound in a normally weak September. Yields on Treasuries tumbled and there was even talk of negative yields as the yield curve inverted again and recession fears climbed back into the marketplace. The 20-yr UST (+8.3%) was one of the better investments in the quarter as a result. Stocks rose slightly in the quarter with the S&P 500 returning 1.76% while the dollar rallied and Gold climbed 4.26% as a safe haven.

ECONOMY

First, I will start by saying I do not believe we are headed to a recession. There is enough underlying strength in the economy IMHO. While recent weak economic numbers are giving investors pause, they are also stoking hopes of more Fed rate decreases. And as I said last quarter – ***Don't Fight the Fed***. Second quarter Real GDP growth was finalized at 2.0% growth. A slowdown from 3.1% last quarter but about where it's been the last 10 years after solid growth in Trump's first 2 years. As the chart following shows, GDP growth has been consistent since 2016 but with the downtick to 2.0%, we await Q3 numbers which are likely to show a further decline below 2.0% to around 1.80%.



The FED did lower rates for a 2nd time in September and other signs of a decline in manufacturing and services are making it likely of a 3rd decrease coming this year. The China trade dispute is becoming a fiscal drag and now is taking its toll on Manufacturing. The ISM manufacturing index data for the past 2 months has been below 50.0 which indicates declining manufacturing.

Regarding China and the overall trade deficit which persists at $55 Billion, China imports were down 13% in August from a year ago while up 31.5% from Vietnam, 14.0% from Taiwan, 7.6% from India, 6.8% from South Korea, and 2.2% from Mexico. Companies are shifting production out of China. And the longer this drags on, the worse the outcome will be for China.

Meanwhile the US jobless rate hit a 30-year low at 3.5% and inflation remains below 2% showing signs the economy is still holding up despite the global slowdown. What it really comes down to is will the rest of the world stabilize and show some growth or will the US succumb to forces around it? The US has remained the best house on the world block for some time now, but a serious global slowdown would be difficult to overcome. What we need is some fiscal stimulus such as an infrastructure bill but with an election looming, Democrats in the House will not give Trump anything to help the economy – which is a cold hard shameful fact about politics on both sides. Both sides too often put re-election ahead of the country.

STOCKS & FINANCIAL ASSETS

Below is a list of various asset returns for the month, quarter and YTD. Among stocks, Large caps outperformed Mid and Small caps and Value stocks finally beat Growth as economically sensitive cyclical industries got a bid after being beaten down in the past. Around the rest of the world European stocks declined in the quarter (Germany -4%, Spain -3.7%, UK -2.8% and France -1.7%) as did most Asian markets including China (-3.8%) and India (-4.2%) except Japan which rose almost 4%. Hong Kong was slammed -12.3% as protests and unrest continued.

Asset Class Performance YTD, Q3, and Sept - Total Return (%)

US Related

ETF	Description	Sept	Q3	YTD
SPY	S&P 500	1.95	1.76	20.40
DIA	Dow 30	2.16	1.84	17.38
QQQ	Nasdaq 100	0.92	1.31	23.14
IJH	S&P Midcap 400	3.15	-0.09	17.86
IJR	S&P Smallcap 600	3.37	-0.20	13.46
IWB	Russell 1000	1.79	1.52	20.29
IWM	Russell 2000	2.04	-2.33	14.13
IWV	Russell 3000	1.83	1.26	19.89
IVW	S&P 500 Growth	0.37	0.79	20.82
IJK	Midcap 400 Growth	1.27	-0.78	18.04
IJT	Smallcap 600 Growth	0.98	-1.99	11.33
IVE	S&P 500 Value	3.82	2.82	19.86
IJJ	Midcap 400 Value	4.99	0.74	17.11
IJS	Smallcap 600 Value	5.57	1.45	15.21
DVY	DJ Dividend	5.07	3.37	17.32
RSP	S&P 500 Equalweight	3.27	0.74	19.91
FXB	British Pound	1.09	-3.16	-3.56
FXE	Euro	-0.90	-4.35	-5.41
FXY	Yen	-1.79	-0.44	0.96
XLY	Cons Disc	1.28	1.60	23.16
XLP	Cons Stap	1.75	6.40	23.27
XLE	Energy	3.93	-6.23	5.94
XLF	Financials	4.55	1.97	19.36
XLV	Health Care	-0.11	-2.31	5.45
XLI	Industrials	3.01	0.81	22.40
XLB	Materials	3.18	-0.01	16.98
XLK	Technology	1.58	3.52	31.22
XLC	Comm Services	0.22	0.85	20.74
XLU	Utilities	4.25	9.41	25.18

Global

ETF	Description	Sept	Q3	YTD
EWA	Australia	2.63	-1.29	17.95
EWZ	Brazil	2.78	-3.64	11.69
EWC	Canada	2.52	0.98	21.71
ASHR	China	0.04	-3.80	23.53
EWQ	France	2.20	-1.66	16.47
EWG	Germany	2.51	-4.06	9.06
EWH	Hong Kong	-0.61	-12.29	2.41
PIN	India	3.46	-4.19	0.38
EWI	Italy	2.45	0.07	17.84
EWJ	Japan	5.23	3.96	12.95
EWW	Mexico	2.91	-1.52	5.85
EWP	Spain	4.19	-3.70	5.25
RSX	Russia	2.47	-3.47	21.65
EWU	UK	3.59	-2.75	9.84
EFA	EAFE	3.16	-0.79	13.33
EEM	Emerging Mkts	1.69	-4.75	5.43
IOO	Global 100	3.09	1.25	18.21
EEB	BRIC	0.43	-5.66	9.19
DBC	Commodities	1.42	-4.39	3.80
USO	Oil	-1.05	-5.81	17.39
UNG	Nat. Gas	0.81	0.20	-19.34
GLD	Gold	-3.39	4.26	14.53
SLV	Silver	-7.17	11.10	9.64
SHY	1-3 Yr Treasuries	-0.13	0.58	2.95
IEF	7-10 Yr Treasuries	-1.19	2.76	9.59
TLT	20+ Yr Treasuries	-2.68	8.35	19.70
AGG	Aggregate Bond	-0.61	2.34	8.32
BND	Total Bond Market	-0.57	2.34	8.62
TIP	T.I.P.S.	-1.11	1.52	7.69

In the US, there has been a definite shift to cyclical value stocks in the past several months but I'm not sure that this isn't a bit too soon. Investors are buying Value stocks and looking AHEAD to cyclicals rebounding in sales and earnings AFTER/IF the economy turns around. Third quarter earnings will be coming in the weeks ahead and excluding the geopolitical news, that will likely drive the market. We will see what companies say about the 4th quarter and 2020. It is more likely that cyclical companies such as Industrials will miss numbers and talk about negative effects of the trade dispute and tariffs. How investors react to this will be interesting. Do they shrug it off and look ahead, or do they stay in the moment and penalize?

By sector, so far this year stocks have been led by Technology (+31% YTD) , Utilities (+25%) and Consumer (+23%) companies. Kind of a flight to safety in Consumer and Utilities along with growth and innovation in Technology. Lagging sectors are Healthcare (+5.5%) and Energy (+5.9%). Healthcare is being dragged down by concerns over Medicare for all and talk of government interventions in drug price increases. Energy stocks continue to struggle with the price of oil below $60 due to slowing demand and ample supply.

From here (S&P currently at 2910) I still see stocks moving higher by year-end. I gave you the Wall of Worry issues and I think most are baked into the market here except China will continue to cause volatility. After we get through Q3 earnings, we enter the seasonally strong period for stocks. It's going to be bumpy with all the issues confronting the market but overall, I still see room for stocks to move higher especially if the Fed lowers rates again. I recommend a diverse portfolio but stay underweight Energy stocks for demand reasons and Healthcare due to political pressures. I also would be prudent with financials if the Yield Curve remains inverted. Technology and Consumer stocks are a crowded trade but if the companies produce good earnings, I still see more gains ahead. So, staying diverse but owning stocks in most sectors will help balance things out. In the end, I always look for strong fundamentals which investors will reward regardless of the sector in which it operates.

BONDS

The yield on the 10-Year UST dropped in Q3 to 1.58% from 2.06% at the end of Q2 and from 2.71% at the end of 2018. Bond prices are rising and as a result the Barclays Bond Aggregate has returned 8.6% this year which is about the long-term annual return on stocks. I will be the first to admit that I did not see this coming and as a result missed much of that return. I (and many others) had recommended investing in short-term bonds to collect a yield of 2.5 to 3% annualized. The Yield curve remains inverted with short term rates above the 10-year rate. For the inversion to correct itself we need short term rates to decline or long-term rates to move higher. More likely, the Fed will lower rates another 25 bps and the Yield Curve will flatten or move to normalcy. The last 2 quarters I softened my stance on bonds and recommended a combination of individual short-term bonds and intermediate term ETFs. I still recommend this approach in a diverse manner with government, corporate, preferred and convertibles. I would also include a small allocation to higher-rated high yield bonds as well.

CONCLUSION

Not too much changes from our ongoing recommendation – we prefer stocks to bonds but with rates still likely to be cut by the Fed, bonds offer stability and a hedge against stock volatility. We would maintain both in the overall allocation of balanced portfolios. Look for stocks to show some volatility through the next few weeks as the China trade dispute headlines dominate and Q3 earnings results are announced. But we think stocks rally from here by year-end. We continue to prefer US stocks to international as we have for the last few years. With a weak global economy, we stay mostly in our own backyard but still recommend an allocation to international stocks through diverse ETFs. There will be plenty of noise out there with the Wall of Worry issues. In general, use weakness as a buying opportunity.

Enjoy the Fall and coming Winter and talk to you soon! -Bob