Review & Outlook – 3Q 2019

Though full of sound and fury, the stock market signified very little in the third quarter. Despite an inverted yield curve, which is traditionally seen as a recession signal, escalating trade tensions with China and movement toward impeachment, stocks gained an unremarkable 1.7%. The S&P 500 increased 1.4% in July, dropped 1.6% in August, then finished strong with an almost 2% return in September, close to all-time highs. The Bloomberg Barclays U.S. Aggregate Bond Index returned 2.3% and a 60% S&P 500/40% total bond market portfolio gained 2.0%.

Although any given quarter's returns are mostly noise in the context of a five- or ten-year time horizon, they can often provide some interesting insights if you look a little further into the numbers.

First, the S&P 500's 1.7% return for the quarter doesn't seem like a lot but compounding this across an entire year gives the investor a 6.8% annualized return, close to most longer-term forecasts for this asset class. So, this quarter, despite the near-constant bombardment of headlines, was pretty darn average for stock investors.

Second, the benefits of diversification were apparent in the third quarter, as the 60/40 portfolio easily outpaced an all-equity portfolio, with lower volatility. Not only did bonds have strong returns, but this asset class also had a negative 1.0 correlation with the S&P 500 – which means, in very simple terms, when stocks "zigged," bonds "zagged" by the same amount, resulting in higher returns and a smoother ride than an all-stock portfolio this quarter. While smooth returns may not matter for a 25-year old with 40 years of work ahead of her, it definitely matters for a 70-year old retiree who is taking regular distributions from his portfolio.

But that was the past, and, as we always say "past returns are no guarantee of future results" – especially the small sample of one quarter's or even one year's worth of returns. This is why we always try to keep the big picture in mind and stick with first principles – diversify the portfolio both within and across asset classes, buy high-quality companies in the stock portfolio, and periodically rebalance to maintain a proper risk profile and also possibly (but not always – see disclaimer above) gain an extra bit of return by "buying low and selling high."

The key issues facing the economy and financial markets last quarter still loom large this quarter, although the politically-driven issues are pushing further to the front of the line as the presidential election cycle shifts into another gear. President Trump has taken former Clinton strategist James Carville's famous phrase "it's the economy, stupid" to heart, and has been browbeating the Federal Reserve for more and faster rate cuts – the latest 0.25% cut not enough in the eyes of Mr. Trump. At the same time, he is trying to walk a fine line on tariffs and Chinese relations in general while the effects of the tariffs have taken their first nibble out of the economy. As icing on the cake, Democrats are moving (slowly) on an impeachment process, which has added even more uncertainty to the mix.

With this running in the background, the economy is still trundling along. The unemployment rate hit the lowest point since 1969, but the latest Institute for Supply Management Purchasing Manager's Index (PMI) survey was a bit troubling with a below-50 rating (i.e. contraction) and the lowest rating since 2016 - although the correlation between below-50 readings and recessions is spotty. (Remember the "Great Recession of 2016?") So, while tariffs are having an effect and the economy is most likely slowing, the consumer is still healthy, and nothing is falling off a cliff like it was in late 2007.

The key issues on our radar include:

1. Earnings – Stocks generally follow the path of earnings, since that is what equity investors get when they buy a stock. The 3Q earnings reporting season begins the second week of October with the big banks, and comparisons with last year will be very tough, as 3Q18's profits for the S&P 500 increased **27.5%** compared with 3Q17. Almost all the excess growth was driven by the corporate tax cut, which will not repeat this year. Therefore, the consensus forecast for 3Q19 S&P 500 profits is a slight drop in earnings (-3.2%) compared with 3Q18. Since companies try to "under promise and over deliver," we expect the actual number to be closer to +/- 0% growth. Even using a -3.2% growth rate, the two-year annualized earnings growth rate is still over +11%, which is very healthy.

2. The Fed – The action - or inaction depending on who you ask - of the Federal Reserve will most likely remain a "key issue" for the foreseeable future, and they are on the move again with a 0.25% September rate cut. While there is no guarantee they will cut at the next meeting, the possibility of a cut provides a psychological backstop to investors in the case of bad economic news. This was evidenced on a very small scale when the poor ISM PMI report came out – stocks dropped like a rock within 5 minutes of the report's release, but are now almost back to the pre-report level, as the market's perverse reverse psychology took hold. ("Bad news is really good news…which is really bad news, but is actually good news," and so on…it's like the poisoned wine scene in the movie The Princess Bride).

3. The election cycle – The election cycle has previously centered on President Trump laying the economic groundwork for re-election (tariffs, yelling at the Fed, tax cuts, etc.) but has now added a second dimension with the Democratic race firming up. The general consensus is that "President Biden" would be much better for the stock market (and possibly the economy) than "President Warren," so the market is now starting to react to news on that side of the aisle. As to the possible impeachment proceedings – investors don't seem to be worried, and the lack of Democratic votes in the Senate would make an actual conviction a remote possibility.

As we have said before, most of these so-called "key issues" create a lot of noise and not much else in the grand scheme of things. While it's very important for us to understand, say, the long-term implications of trade policy with China, or the probability of President Warren passing "Medicare for All" in a divided Congress, the daily news really doesn't drive our daily decisions. The global economy is going to have good years **and** bad years, but it generally keeps growing over time, and your portfolio provides you your own little piece of that economic growth.