MARKETS IN FOCUS

THIRD QUARTER 2019 OCTOBER 16, 2019

Quarter-in-review – Looking back on the third quarter what really stands out are the number of cross-currents buffeting both the global economy and the financial markets. Everything from trade concerns and political uncertainty to interest rate cuts and renewed Middle-East tensions made the headlines. The markets bounced around on the news flow and returns for the quarter were a mixed bag, at least as far as the equity markets go. The U.S. market performed reasonably well with the S&P 500 gaining +1.7%. However, this masked some divergent moves. Large-cap value added +2.8% for the quarter but the NASDAQ picked up just +0.2%. Small-cap stocks lost -2.3% but REITs gained +7.4%. But in general U.S. equities benefited from being the 'cleanest dirty shirt' in the global equity universe. Most other markets overseas lost money during the quarter. The developed EAFE index fell -0.8% while emerging equities dipped -3.6%. Hong Kong stocks swooned -12.3% as political demonstrations simmered during the quarter. Also weighing on emerging market equities were renewed financial troubles in Argentina.

Bond markets in the developed world were more consistently positive. In the U.S., 10-year bond yields declined 32bps while in Germany 10-year yields fell from -0.33% to -0.57%. Consequently, intermediate-term Treasury bonds gained +2.8% for the quarter, bringing the YTD return to +9.6%. High quality corporate bonds performed even better, picking up +3.4% for the quarter (+15.7% YTD).

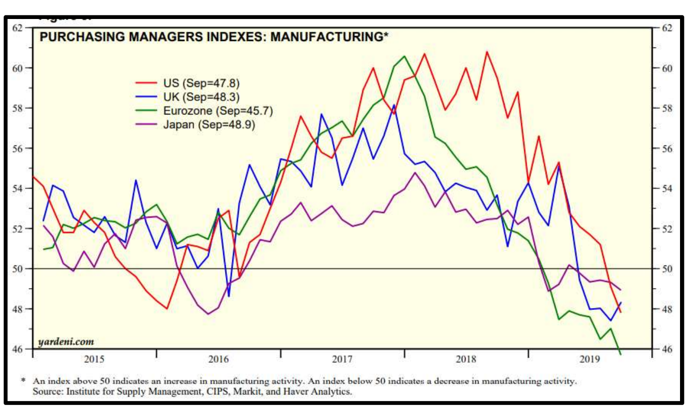
Portfolio Update – It was something of a mixed quarter for the portfolios. On the positive side our DFA and Social portfolios generally matched or outperformed their benchmarks. The resurgence in value stocks boosted the DFA portfolio returns and the majority of the DFA funds beat their individual benchmark during the quarter. The performance of our Social allocations is also related to individual fund performance. For example, both Calvert Capital Appreciation and Parnassus Mid-Cap beat the mid-cap benchmark by +2% or more. Similarly, the DFA sustainable fixed income fund added +2.7%, fully capturing the rally in bonds. Our ETF allocations fractionally lagged the benchmarks and our active allocations also lagged due to three specific funds. Harbor Capital Appreciation and Goldman Sachs Small/Mid Growth fell short of the benchmark by -2% or more. These growth funds suffered during the quarter as the market rotated strongly away from aggressive growth names towards more value-oriented companies. Both funds are performing well for the year, though, and we are not unduly concerned. Oakmark Select, on the other hand, lagged its benchmark by more than -6%, adding to a relatively long period of underperformance. In what should have been a decent period for the fund's value strategy, certain large holdings struggled for various reasons. We are looking closely at trimming or eliminating this position in the fourth quarter

Market Benchmarks

Market Indices	3rd Qtr	YTD	3-Yr An
S&P 500 Index	+1.7%	+20.4%	+13.2%
Russell 2000	-2.3%	+14.1%	+8.2%
Global Equities	+0.1%	+16.3%	+9.7%
Int'l Index (EAFE)	-0.8%	+13.3%	+6.4%
Emerging Mkts	-3.6%	+8.0%	+5.0%
Other Indicators	**9/30/19**	**6/30/19**	**12/31/18**
Fed Funds Rate	1.75%-2%	2.25%-2.5%	2.25%-2.5%
2-Year Treasury	1.62%	1.75%	2.49%
10-Year Treasury	1.68%	2.00%	2.69%
S&P 500 P/E Ratio*	16.8	16.7	14.4
Crude Oil	$54.07	$58.01	$45.84
Core Inflation	1.8%	1.6%	1.9%

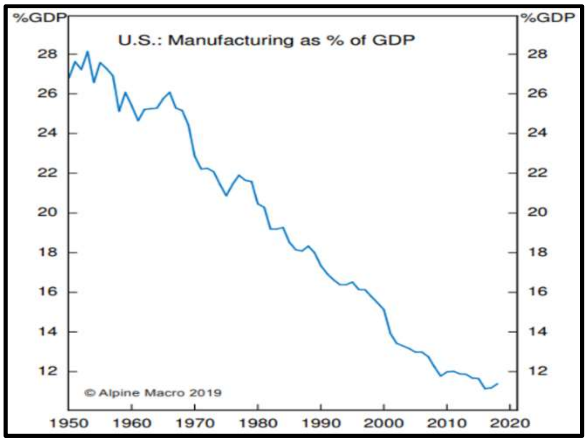
**Forward 12-month operating earnings per S&P*

Manufacturing Takes it on the Chin – Between our quarterly letters and our weekly market updates we have covered the various stages of the trade dispute. We won't delve into all the details again, but needless to say, the initial small and targeted tariffs levied against solar panels and washing machines is morphing into a tax on all of China's exports to the U.S. as well as a possible limit on U.S. portfolio investment in China. In retaliation China is naturally taxing some of our exports to them. Chinese and U.S. negotiators are meeting as we write this, but few expect a major breakthrough.



* An index above 50 indicates an increase in manufacturing activity. An index below 50 indicates a decrease in manufacturing activity.
Source: Institute for Supply Management, CIPS, Markit, and Haver Analytics.

The immediate consequence of the trade dispute is that global trade is slumping and manufacturing around the world has fallen into recession. The chart on the previous page shows the latest manufacturing indexes for the U.S., U.K., Eurozone, and Japan. Any number below 50 means manufacturing is contracting.



However, we should not jump to the conclusion that the global economy is falling into a recession because of this. There are three reasons. First, manufacturing is more important to some countries than others, as you can see in the middle column below.

	Manufacturing (% of GDP)	Exports (% of GDP)
China	29%	20%
Germany	21%	47%
Japan	21%	16%
United States	***11%***	***12%***
United Kingdom	9%	31%
Australia	6%	21%
Source: The World Bank		

Secondly, some countries are much more reliant on exports to drive growth (right column of the table above). On both scores Germany ranks poorly. Manufacturing makes up over a fifth of their economy and exports clock in at close to 50% of GDP. They are closely tied to the health of the global trading regime. Conversely, the U.S. is relatively insulated. As you can see from the chart at the top of the page, manufacturing has fallen from roughly 20% of GDP back in 1980 to just 11% today. Based on this China, Germany, Japan, and the U.K. (due in part to Brexit) are all in a weak spot. The U.S. on the other hand is far less exposed to a slowdown in trade.

The Consumer Reigns Supreme – The last point is that the consumer remains in decent shape, and this plays a much larger role in many economies. Take a look at the chart below. You can clearly see that GDP growth (black line) is much more closely correlated with the consumer driven service sector (red line) in the U.S. than the manufacturing sector (blue line). Seeing as the consumer comprises close to 70% of GDP this makes total sense. We doubt the consumer buckles this year for the following reasons:

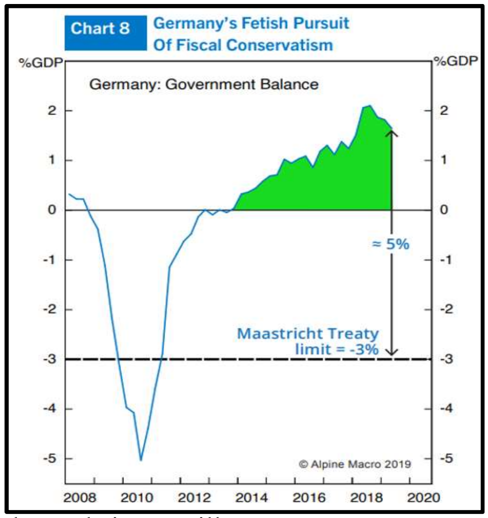
1) The unemployment rate fell to 3.5% in September, the lowest rate since May 1969.
2) This is spurring retail sales which are growing at a +4% year-over-year pace.
3) Housing activity is picking up due in part to lower mortgage rates.
4) Lower rates is also feeding through into an acceleration in refinancing activity. This puts more money in consumer's pockets.

What this all means is that GDP growth in the U.S. is on track to grow at between +1.5% and +2.0% in the third quarter depending on whose model you look at. The estimates for the fourth quarter average +1.6%. While not robust, this is a long way from recession territory.

The situation is less constructive overseas. There is a good chance the German economy shrinks in the third quarter, but even here, the consumer and services sectors are still growing. The U.K. is in a similar boat as Brexit uncertainty weighs on confidence there. Finally, Japan will be dealing with the consequences of a higher VAT rate through at least year-end. This is why we have generally underweighted these markets in 2019.

The above analysis argues against a broad-based global recession, but there are clearly pockets of vulnerability. But none of this is a surprise, though, and is largely priced into markets today. After all, European and emerging market stocks have materially lagged U.S. equities this year because of the divergent growth backdrop. The key question for investors going forward is whether the situation will continue to deteriorate or if countervailing forces lead to either stabilization or possibly a rebound in global growth in early 2020.

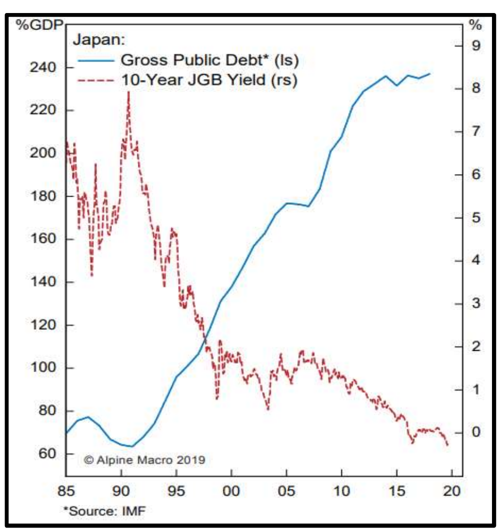
Some Questions are Too Hard – If the trade war is triggering a manufacturing recession, then a truce would obviously lead to a turnaround. What are the odds of this? If only we knew!! Trying to handicap the current trade situation is folly in our mind. You can make a convincing case either way. Let's take the role of the two-handed economist for a moment. On the one hand, President Trump clearly wants to be reelected. To do this he probably needs to avoid a recession next year. The more he pushes on trade the higher the recession risks. Therefore, the thinking goes, he will relent on the trade pressures at some point in the next few months to bolster his reelection prospects. Same thing for China. They don't want a weak domestic economy to cause other problems. After all, the demonstrations in Hong Kong are probably going to end that city's role as a financial hub for the foreseeable future. The last thing they need is for the political protests to spread to the mainland because of economic anxiety.



All very logical. But you can equally argue the other side. Why should China strike a deal when they can wait and see how the 2020 elections turns out? And for President Trump, he's consistently taken a tough line on trade. Why strike a deal over something that probably still wins votes in many areas, and any deal could be viewed as weakness? A deal also looks less likely after the U.S. placed tariffs on European planes, wines, cheese and Scotch. At minimum we have to assume the trade issue will be with us for months to come.

__Could We See More Fiscal Stimulus?__ – This is an interesting topic that is being contemplated around the world. Up until recently the debate about more fiscal spending was centered in Europe. As you can see from the chart above, Germany is currently running its largest budget surplus since before the financial crisis. More and more analysts, including outgoing European Central Bank (ECB) head Mario Draghi, are arguing that this should be reduced to spur growth. This view was bolstered after Germany agreed to a 50bn euro package of measures designed to help the country meet its 2030 emissions reduction goal. More recently, India embraced fiscal expansion. In September they rolled out a $20bn plan that entails cutting the tax on businesses to one of the lowest in Asia.

We doubt we see much more on the fiscal front, at least over the short-term. Large fractions of Germany's governing members, for example, are reluctant to increase spending whatsoever. Even the latest plan was bitterly contested. We think you will need to see a much more severe economic downturn to trigger more fiscal spending in Europe. It is the same situation in the U.S. Congress and the Administration are going to be consumed with the impeachment debate and the 2020 elections until this time next year. As we mentioned earlier, Japan actually raised taxes in October.



However, over the next few years the calls for more proactive fiscal policy are only going to grow louder. After all, if Germany can borrow money for ten years at -0.57%, almost any investment they make in the domestic economy will have a positive expected return. And if this is accepted, it is only a short ideological hop to the hot new economic theory of the day – Modern Monetary Theory. There are various versions of this, but essentially it entails the government creating money through the central bank to pursue expansionist policies. The only limit on debt issuance, per MMT, is inflation. Japan has been testing this theory over the last thirty years and so far they have not run into a limit on their capacity to issue debt, even with debt levels approaching three times that of the U.S.'s (see chart at the bottom of the page). MMT is unlikely to be tested in the U.S. immediately, but we should expect to read more and more about it as we close in on election season next year or if a recession rears its ugly head in the near future.

__Still the Only Game In Town__ – This brings us back to monetary policy. If the trade and fiscal levers are not going to be pulled, it is painfully clear that policy makers will be forced to adjust monetary policy going forward. Of course, this has already started to some extent. Central bankers around the world have been cutting rates over the last few months as growth slows and inflation continues to underwhelm. It is almost certain we are going to see more of this. The ECB will restart their Quantitative Easing (QE) program in the fourth quarter, and there is a decent chance they start buying a broader swath of bonds in the months to come.

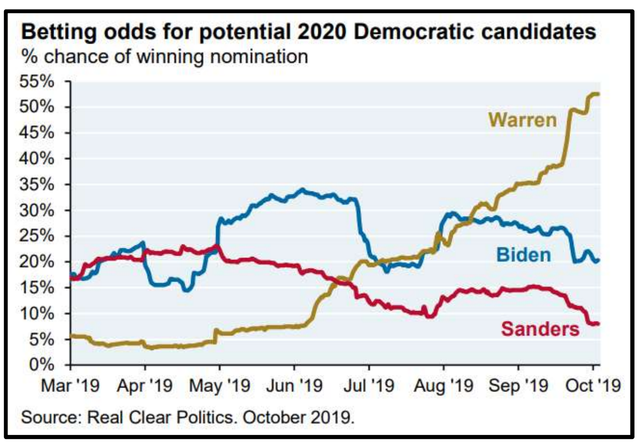
In the U.S. the Federal Reserve has cut rates twice so far this year. They meet two more times before the end of 2019 and it is reasonable to expect at least one, and possibly two more quarter point cuts. Furthermore, the Fed is restarting their bond buying program so as to supply more reserves to the banking system. Since the end of 2017 the Fed has been shrinking the size of their balance sheet, but they now plan to grow it by roughly $500bn through next June. This is a big reversal and probably means the balance sheet is going to be used more proactively to insure against financial shocks and recessions.

So herein lies the one area where we could see meaningful changes in the coming months to avert a growth slowdown. It is now clear in retrospect that the Fed raised rates too much in 2018. They are in the process of reversing this. If they move aggressively they will bring rates low enough to stabilize or even spur growth. More consumers will be able to refinance their mortgages. Borrowing rates will be low enough to incent spending. Corporations can rollover debt into cheaper loans, bolstering their profit margins. Finally, the housing market could continue to trend higher.

However, the risk of the Fed not moving is real enough. There is a serious debate within the Fed about whether rates should be cut at all given low unemployment and the perceived inflation risks. This battle between the hawks and the doves has yet to be decided. If the Fed leans towards restraint the U.S. and global economy will struggle. We doubt they take this path, but we are watching closely.

Looking ahead to November 3rd, 2020 – As much as we might like to, we can't ignore the fact that the election in 2020 is getting closer by the day. Early voting begins in California February 3rd and the Iowa caucus is the same day. There are 15 primaries on March 3rd. And as this story plays out the impeachment debate simmers. How any of this will impact the economy and the markets is the most asked question of the last few weeks. On the issue of impeachment, the historical data tells a mixed story. Nixon's impeachment took place against the backdrop of other major issues that weighed on the markets. Conversely, Clinton's took place during a tech boom. It is tough to draw any conclusions from these two examples other than to suggest the markets will probably follow what happens to the underlying economy, not what happens in the halls of Congress.

As for the election itself, there is a long way to go before election day. As you can see from the chart below, Warren is currently the leading Democratic candidate in the betting markets. But this can, and probably will, change dramatically going into the Democratic convention in July. If history is any guide, primary candidates stake out a position that appeals to the party faithful before tacking towards a more centrist position once they garner the nomination. It will be interesting if that plays out again this cycle. And whoever wins will have to contend with passing new legislation in today's divided Washington. Again, we think the markets will follow the underlying economic fundamentals until we get to the point that new legislation can actually be passed. We are many months away from that point, if it ever comes.



Looking Ahead – There is no doubt we live in interesting times. Whether this is a blessing or a curse is up for debate! But the number of cross currents today are as numerous as we have seen in a long time. Our view is similar to the one we shared last quarter. The global economic slowdown is real, and to the extent the trade battles continue the global economy will suffer. However, coordinated rate cuts from global central banks should ultimately gain traction and lead to stabilization. The markets will sniff this out ahead of time as usual. Of course, there are risks to this scenario. Rate cuts may not come soon enough or the trade war could spiral out of control. This isn't our base case expectation, but we will adjust as necessary.

We would be the first to admit that our crystal ball is as cloudy as anyone's when it comes to predicting which way the political winds will blow. But this raises a fundamental question – should you even factor in politics when it comes to your investment portfolio? We would caution against it for three reasons. First, as the saying goes, it's difficult to make predictions, especially about the future. This goes doubly for predicting political outcomes (Brexit and Trump's election are the most recent examples). Secondly, even if you know the future, it is awfully hard to guess how the markets will react. Think back to when the U.S. debt was downgraded in April 2011. Many analysts wrongly thought this would be a trigger for a recession and bear market. And third, the time horizon for your investment portfolio shouldn't be next week or next month, but many years from now. A longer-term time horizon is the individual investor's 'secret weapon' that allows them to avoid the siren's song of gloom that pervades the financial media today.

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