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2019 Third Quarter Review
"Trade Wars and Recession Watch"

Stocks ended the third quarter on an upswing but have rapidly hit turbulence in the traditionally scary month of October. At the end of September the Dow Jones Industrials had advanced 15.39% for the year while the Russell 2000 Index representing smaller companies' stocks rose 12.96%. Interest rates have been sinking ever since the Federal Reserve curtailed their rate increases early this year, then began cutting rates in July. Currently the 2 year U.S. Treasury note yields about 1.5% while the 30 year U.S. Treasury bond yields just over 2%.

News relating to trade wars and manufacturing weakness has dominated the economic headlines. (The political headlines are a whole different story!) We are currently in a trade war with China and the President is threatening to ramp one up against Europe as well. This creates difficulties for many businesses as their costs of goods gyrate and they search for alternative sources. This "supply chain disruption" prompts many corporations to cut back on purchasing and investing plans, which in turn contributes to slower economic activity. Over the past few quarters, the U.S. has been a beacon of growth in a world of slowing economic activity. Our employment levels are the highest in decades and our financial markets continue to clip along. Recent economic data, however, suggest that the picture may be changing.

It seems as though every year since the Great Recession of 2008-09 we have heard warnings of the next recession being just a few months or quarters away. None of those predictions have been accurate so far. However, those warning calls grew much louder recently after a few weak economic statistics were released. The Institute for Supply Management produces a widely-watched indicator of U.S. economic activity called the ISM Manufacturing Index. (It is also known as the PMI for Purchasing Manager's Index.) This index showed a slight contraction in manufacturing activity in August and a greater one in September. This would be consistent with the beginnings of a general economic contraction, aka a recession. Some economists believe we are already in a "manufacturing recession" and this contraction could spread to the service sector as well. Stocks don't tend to do well in recessions and expensive "growth" stocks tend to fall the most since they are priced to include rapid growth rates which often slow dramatically.

For the last several years, however, value stocks (those that are "cheaper on the current numbers") have lagged those of the faster-growing but more expensive variety. Goldman Sachs just named its list of favorite recession stocks which include cheaper and steadier stocks like many of those that we own. Although the temptation is always there to buy into the most recent winners, with prospects for recession appearing to be on the rise, perhaps now is not a good time to switch horses in this particular economic stream. "Cheaper and steady" may turn out to be the best horse to ride if things get uglier.

Why is the Federal Reserve Board lowering interest rates from already low levels?

The Federal Reserve Board has a goal of supporting economic growth, partially by increasing inflation when it falls below their target level of 2%. The wisdom and accuracy of that particular 2% inflation target are highly debatable, but that is the world we find ourselves investing in. However, recent measures of “core CPI” show inflation holding at 2.4% annual rate which is an 11 year high. While prices for inflation for core goods actually declined slightly, inflation for services (including medical care, insurance, housing, and education) increased by 3%. One economist quips that inflation is rising on things we *need* and is only slightly offset by declines in some of the things we *want*.

The Fed recently lowered interest rates twice in three months after raising them 4 times in 2018. Clearly, the trade wars are taking their toll, economic statistics are showing signs of slowing and the Federal Reserve is concerned enough about faltering growth (at least partially caused by the trade wars) to start a new series of rate cuts. That should give is pause about the strength of the economy, even while stocks are buoyed by lower rates.

The stock market is particularly “newsy” right now as rumors and reports related to trade negotiations and political developments dominate the headlines and produce wide swings in prices. Just today, the S&P 500 futures contract has fluctuated by over 2% in value since early this morning on rumors of trade war problems or improvements. We should not be surprised by a cheerful announcement of a minor agreement with the Chinese soon, for which the markets may rally sharply but which may leave long-term problems in place.

Risks to the stock market include the possibilities of deepening trade wars, record-high debt loads both in the private and the public sectors, valuations at statistically high levels, the slow-down in manufacturing spreading to services sector, and the possibility that this decade-old recovery may not be revived by lower rates. Some liken this last problem to the Fed “pushing on a string” in an attempt to spur growth. There remains the possibility of a decline in corporate profits (“an earnings recession”) being reported this quarter. Political developments may become destabilizing as constitutional conflicts escalate while perhaps giving a boost to some Democratic Party candidates who may be viewed as unfriendly to the equity markets. Counterbalancing these factors are lower interest rates boosting stocks, the possibility of meaningful trade conflict resolution and a possible resumption of healthier growth. In any case, it is a bumpy sea that we are sailing and it may get bumpier yet.

Enclosed are you quarterly reports and statements to review at your convenience. I encourage you to call me if you would like to change the mix of assets in your portfolio in response to your personal financial situation or comfort level. Here’s hoping that the rest of October isn’t too scary!

Sincerely,

Claude R. Carmichael CFA