Review & Outlook

THIRD QUARTER 2019

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Review and Outlook

Except for the recent addition of potential impeachment, the list of uncertainties remained largely unchanged in the third quarter, with the China-U.S. trade war and Brexit remaining at the top of the list. An increasing number of people are arguing that a recession will hit within the next twelve months, and while we think the underlying economic data is trending negative, we don't think it is likely that we will experience a recession right away. The economy continues to show steady growth, and consumption in particular remains strong, but there is also growing weakness in manufacturing caused in large part by the protracted trade war and slowing business investment. While cautious, we can also see a scenario where markets could push significantly higher. A successful trade deal could reinvigorate the economy through increased capital expenditures, maintaining the expansion.

Index Performance Data
Total Return as of 9/30/2019

Indices[1]	Q3 2019	Trailing 12 Months
CRSP U.S. Total Stock Market Index	1.11%	2.92%
MSCI Global ex-U.S. Total Stock Market Index	-2.50%	-4.01%
Bloomberg Barclays U.S. Aggregate Bond Index	2.27%	10.30%

This quarter, investors continued to look past many issues that would have negatively impacted markets in the past. For example, despite Iran launching a very large and precise attack on Saudi oil infrastructure, the markets mostly yawned. We think that lack of response is due to slowing global growth, which negatively impacts the demand for oil, and historically low interest rates, which continue to keep oil prices low and make US stocks a reasonable investment alternative.

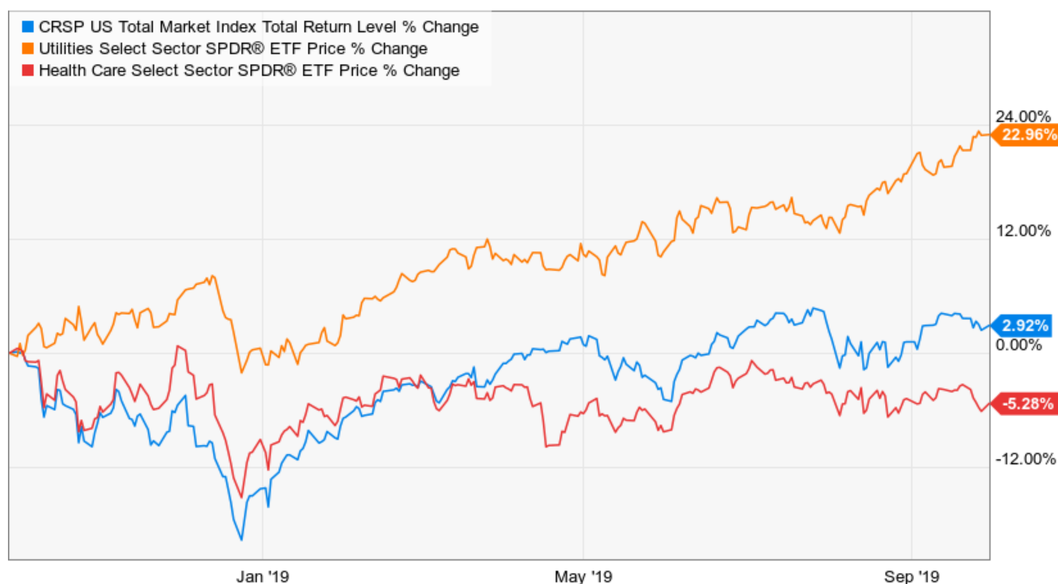
We continue to favor U.S. markets over global markets for now, since many of the strongest global growing companies are in the U.S., and our global positions have been more heavily weighted towards foreign developed markets than emerging markets this past quarter. Our main concerns for emerging markets are the trade war and a high US dollar relative to other currencies. There is a high level of dollar-denominated debt in emerging markets, and a strong U.S. dollar could make those loans difficult to service. Our REIT position has continued to perform well, and is up 6.7% for the quarter, but our master limited partnership position performed poorly in the first part of the quarter, so we sold it. Our long-term outlook for MLPs is now poor, as recent changes to their regulations have caused us to lose confidence in their underlying business model, so we will avoid that space for the foreseeable future. As we approach the last quarter of the year, we think it best to maintain a slightly defensive posture for our clients' portfolios.

In Focus

Over the past year, we have written about taking a more defensive position in our client portfolios, so we want to take some time to examine what that means. Traditionally, when an active asset manager is concerned about a potential market downturn, they consider shifting their clients' portfolio allocations to fixed income investments and to stocks that are considered "defensive" in nature, meaning stocks with earnings that are expected to be stable, even through a market contraction. Usually, these stocks come from the the utility, consumer staple, and health care industry sectors.

Given recent concerns about a recession and an associated market downturn, we have shifted our client portfolios to a slightly conservative position by holding more fixed income and cash than we would otherwise. But because we still want our clients to have exposure to the stock market, we've also shifted our clients' stock holdings towards what we consider

to be defensive industry sectors, particularly utilities, while avoiding the traditionally defensive sectors of health care and consumer staples. With respect to the health care sector specifically, we feel that there are good reasons to think its defensive nature no longer holds as well as it has historically. The table below shows total return prices for the health care sector, the utilities sector, and the broad sector CRSP index over the past 12 months.[2] As you can see, the utilities sector has outperformed the health care sector, and we think this trend will continue.



The health care sector is largely insurance, hospitals, and drugs. While it seems reasonable that, recession or not, people will continue to generate health care bills and company earnings will keep rolling in, we are not so sure. A closer look at the nature of the industry's sub-groups, how they get paid, and how some of this payment may ultimately be political in nature (medicaid for all, single payer, etc.), leaves us feeling there is historically high levels of risk in this sector. In particular, we think the upcoming 2020 Federal election will be a challenge as health care will be a major policy battleground. And any policy that becomes popular because it could cut costs or increase choices will likely be at the expense of health care company profits. Further, the fact the health care sector in the US is currently over 18% of GDP, a level over 5% higher than almost every other developed nation in the world (without better outcomes to show for it), suggests that there is room to cut the volume or price of health care services, or both. One area that seems particularly exposed to potential price-cuts this election cycle is pharmaceuticals, where Medicare Part D drug plans are still prohibited by law from negotiating bulk-rate pricing. There seems to be growing bi-partisan agreement this arrangement is absurd. And cutting pharmaceutical prices, while good for consumers, will be bad for those companies' earnings, which should have a corresponding negative affect on their stock prices.

In addition to avoiding the health care sector, we are also avoiding consumer staples. The price of consumer staples stocks relative to earnings is at historic highs, as investors have been bidding up the price of these stocks in response to concerns about an economic downturn. We have also observed tremendous market disruption in this sector as companies continue to see their earnings challenged by companies like Amazon, and generic labels from all the major retailers like Costco and Kroger (Fred Meyer). The combination of high valuations and historic levels of disruptive competition seems like a cocktail to simply avoid.

Going forward, we will continue to remain cautious. There are a few policy driven events that could create swift upward momentum in the markets, namely a trade agreement with China and a successful resolution to the Brexit. Because the outcomes are impossible to know, and downside risks remain, we will continue to hold larger positions of securities that we believe to be defensive in nature.

1. Index price data is downloaded from ICE Data Services. Index performance data is calculated by Axys portfolio accounting software, a product of SS&C Advent.
2. This chart was created using the YCharts platform on October 3, 2019 at 2:28 PM EDT for the period 9/30/2018 – 9/30/2019.

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