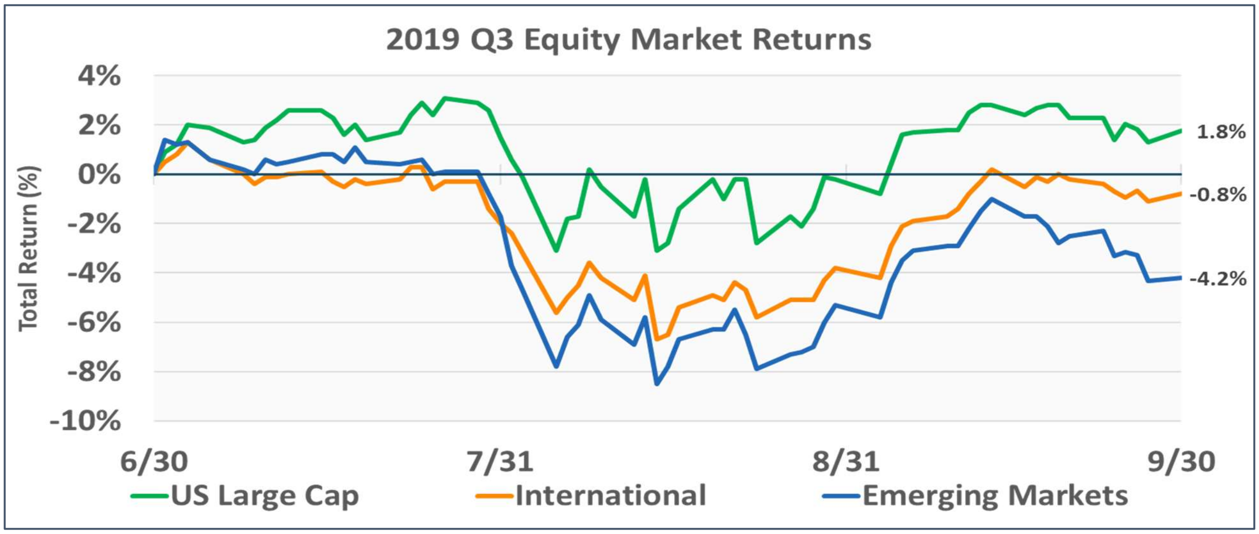
Third Quarter 2019 - Uncertainty and Complacency Coexist Redux



Uncertainty and Complacency was the title of our Third Quarter 2018 Commentary.

Today feels eerily similar, even though the fundamentals have changed a bit. US equities (S&P 500 index) are at about the same level as a year ago but earnings are up a bit, so valuations are a touch better. A year ago, the Fed was raising rates and now they have lowered them. The 10-year treasury at the end of the 3Q18 was at 3.06% and is now at 1.76%. Global growth seems to be slowing down a bit, but the US is proving to be quite resilient. Despite these differences, in both periods of time equities and bond markets were calm overall but both were experiencing bouts of brief volatility spikes.

The big news of the third quarter included Central Banks around the world easing, Brexit worries, Hong Kong unrest, trade/tariff uncertainty, Iran, and a pending impeachment inquiry. In terms of equity market valuation in the US, Howard Silverblatt of S&P Corporation is forecasting earnings of $161 per share for the S&P 500 index for the full year 2019, which puts the P/E multiple at 18.5x. Fourth quarter earnings are expecting to produce a very strong comparison to last year, so the forecast at $161 is heavily dependent on this coming through and it seems like there are plenty of things that can go wrong in the 4Q.

Bond markets appear very calm, with credit spreads (what you pay for lower rated credits) at or near all-time lows. This complacency seems illogical, but markets can turn on a dime and cause a lot of pain. The liquidity of the bond market is extremely low because dealers have been forced out of trading and holding inventory by the regulators. Thus, when bonds need a buyer it can be expensive and cause quick and large price swings, especially on the downside. Lower credits are set up for big downside surprises if bond buyers begin to trade up in quality. We have discussed this before and feel that the traditional bond indices have much lower credit quality components than at any time in history, so we are not using traditional bond indices to execute our fixed income strategies.

One anomaly in credit markets recently is the sudden seizing up of Repurchase agreement (REPO) trading. REPO is used by financial institutions to finance short-term cash needs and in the last few weeks has not been functioning well. Lenders drew back for no apparent reason and the Federal Reserve Bank had to step in to provide liquidity to that market. This feels eerily similar to the commercial paper problems that occurred in 2008. The Fed has stop gapped this issue effectively, but we see this as a symptom of financial markets' nervousness. Again, regulatory changes to force the banks to build their balance sheets (a good thing) has led to unforeseen consequences and the regulators and the Fed are in uncharted territory. *Matt Underwood, CFA, our Director of Research and Portfolio Management, has written a brief paper on the REPO issues and it is attached to this Commentary.*

We do not believe in forecasting because the evidence of it being accurate or helpful is lacking but it is worth thinking about economic conditions both in the US and around the world. US economic fundamentals seem pretty solid - the consumer is in good shape and not losing confidence, corporate balance sheets are healthy, etc. Meanwhile, the Federal Reserve has lowered short-term rates to try to backstop any softness. The media is trying to talk us into thinking that a recession is right around the corner, but the hard facts do not support this view. One observation - the US economic recovery has now set a record in terms of its longevity, but its expansion has been very mild in its pace. As a result, there are few excesses in the US economy relative to past pre-recession events. Logic would say that any US economic pull back may look and feel more like a sluggish period versus a more "normal" big bust event.

Major economies outside of the US seem much more sluggish. Brexit is a big swing factor for Europe and is worth watching. Asia seems to be in good shape but is experiencing some slowdowns (especially in China) and US/China trade relations seem to be the culprit. Non-US equity valuations reflect these fundamentals with emerging economies especially attractively priced.

Our equity portfolio positioning continues to be tilted toward defensiveness with US overweights in the value sectors and underweights in smaller companies. Small capitalization companies in the US have dramatically underperformed, especially in the last year, and we are examining this sector to consider bringing its weight up to normal. We will keep you posted. We have tilts toward non-US developed and emerging markets for valuation reasons. In your fixed income sectors, we are also defensive. We are strongly tilted away from lower quality credits and have shorter maturities than normal.

Thank you for your confidence in us.

Sincerely,

Donald E. Callaghan
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