Clear Point
ADVISORS INC

Quarterly Commentary

Third Quarter 2019

Investment Commentary

Despite ongoing trade tensions, concerns about a slowing economy and fears of recession and presidential impeachment threats, many U.S. equity classes gained modestly, as the S&P 500 Index gained 1.7% in the quarter.

Through September, the S&P 500 Index gained 17.2%. Large-Cap Growth and Value performed roughly in line with each other for the quarter, but the same was not true for smaller companies. Within Small- and Mid-Cap sized companies, Value outperformed Growth by 3.6% and 1.9% respectively. On the year, Mid-Cap Growth was the best performing market segment with a 22.3% return.

Once again, the US outperformed international equities, as the US Dollar strengthened. International equities struggled in Q3--developed markets fell 1% and emerging markets slumped 4.3%. Though not keeping pace for the year, international stocks, as measured by the EAFE index, have gained 13.6% year-to-date.

Investors also sought the safety of long-term bonds. The Bloomberg Barclays US Aggregate 10+ Year bond index rallied 6.6% for the quarter. Why? Bonds gained as a result of interest rates falling.

Economic Backdrop

The US economy as measured by Gross Domestic Product (GDP) grew at a modest annualized rate of 2% in Q2. Q3 GDP is scheduled to be released at the end of October. Weak exports and business investment weighed on growth even as consumer spending had its strongest quarter in nearly five years. With unemployment near historic lows at 3.5%, the US consumer has been resilient this year, though consumer confidence has dropped recently. Concerns remain about the strength of the economy, as the ISM US Manufacturing PMI Index slipped to its lowest level since 2009.

As market participants expected, the US Federal Reserve again cut interest rates in Q3. After two quarter-point rate cuts last quarter, the FOMC's target federal funds range is currently between 1.75% and 2.00%.

The rate reductions were driven by the global slowdown and trade. Chair Powell indicated these cuts were a "mid-cycle adjustment" rather than a trend for the future. FOMC members are divided on whether further cuts are warranted even though the market is indicating a greater than 75% chance of another rate cut in October.

Fixed Income Overview

The broad US bond market, as measured by the Bloomberg Barclays US Aggregate Index, returned 2.3% for the quarter to investors as risk sentiment continued on its roller coaster. Following the Fed's "recalibration" cut in late July, US interest rates turned sharply lower as trade tensions heightened and global growth forecasts fell. These concerns led to significant demand for high quality fixed income assets. Demand for US Treasuries pushed rates to levels not seen since 2016. The 10-Year Treasury Yield ended the quarter at a paltry 1.66% rate.

The reduction in yields affected loan rates, as low mortgage rates continue to fuel home sales nationally. The rate on a conventional 30-year fixed mortgage dropped to 3.64% at the end of September, down from 4.51% at the beginning of the year.

Additional rate cuts in Europe by the European Central Bank (ECB) pressured bond yields lower in Europe and Asia. Despite negative interest rates in many overseas markets, our foreign bond funds generally posted attractive total returns. This was due, in part, to a strong US Dollar and currency hedges that most of our selected funds employ. Bond markets are eagerly awaiting indications of any further rate reduction in the U.S. by the Fed, perhaps prompted by economic data.

Over the past many years, inflation has remained stubbornly low. More recently, a key inflation indicator, the Consumer Price Index (CPI), moved higher, posting its fastest annualized growth since 2008. The CPI index, which measures the price of various goods and services such as food, housing, and medical expenses, rose 2.4% over the past year. Medical insurance and healthcare-related expenses saw some of the largest increases.

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Recession Fears-What's up with that?

Concerns about the prospect of an upcoming recession have been a focal point, due to low rates and weakening economic indicators.

Recession concerns were further fueled by an inversion of the yield curve during the quarter, where the 10-year Treasury rate briefly fell below the 2-year rate. According to Credit Suisse, stocks typically see 18 months of gains following inversion of the 2-10 spread. The market rallies more than 15% on average in the 18 months following the inversion. (Of course, as usual, past results do not guarantee a future outcome.)

Economists view recessions as a normal part of the economic cycle that moves from expansion to contraction. Historians indicate that there have been 47 recessions in the United States dating back to the Articles of Confederation, from 1781. The duration and intensity of each recession has been unique, with various factors affecting economic conditions. A recession occurs about every 4.5 years on average and lasts about 11 months; the current economic expansion has now extended more than 10 years.

Modern recessions occurring in the 20th and 21st century have resulted from financial crises and market-driven events such as the subprime crisis of 2008 -2009, while recessions that occurred in the 1800's were primarily driven by war and the weather, due to the dependence on agriculture. The recession during 1980 through 1982 was driven by inflation and rising interest rates that created an expensive and restrictive environment for consumers and businesses. Ironically, economists believe that any near-term recession would be driven by our ultra-low rate environment with minimal inflation; a downturn perhaps precipitated by excessive Fed stimulus along with dismal economic growth projections. It's not possible to gauge the health of an economy through a single economic indicator. One of the more heavily considered, though, is the Conference Board's Leading Economic Index (LEI). The index reflects ten factors that include wages, unemployment claims, manufacturing orders, stock prices, housing permits, and consumer expectations. The recent trends in the LEI are consistent with a slow but still expanding economy that has been primarily driven by strong consumer spending and robust job growth. In general, a recession is defined as two quarters of negative growth (GDP) so it's worth noting that we have not yet had one quarter of declining GDP.

While it has been a great year for global stock markets, economic growth is a different story. Although we still haven't had any recent quarters of negative GDP, the U.S. seems to be in a mild downward trend since 2018. The broader issue is that the Eurozone and Japan are experiencing an even more pronounced slowdown. This could mean that economic weakness has become more interconnected, allowing countries to drive each other downward and trigger a global slowdown.

Outlook and Discipline

This theme essentially has two parts. First, the bull market in stocks and the economic expansion are mature. While this doesn't necessarily mean that the demise of either is imminent, we believe that we may be in a late-cycle market environment. This means that while continuing with our strategy of broad diversification, it is appropriate to include some defensive positions in our portfolios at this time. Second, despite the prospect of near-term slower growth, we believe the future remains bright for the global economy and markets. Due to innovative technologies, the economy is being reshaped, and new opportunities are being presented in a variety of industries, including cybersecurity, clean energy, healthcare, fintech, artificial intelligence, robotics, and biotech, among others.

Best Regards,

Clear Point Advisors Inc.