Market Update & Outlook

Stock returns were mixed in the third quarter as U.S. markets rose slightly while foreign shares slipped. Signs of a slowing world economy reduced investor enthusiasm. Bonds continued to perform well in an uncertain investment environment, driving returns to above-average levels.

MARKET SCOREBOARD	3Q 2019	2019 YTD
S&P 500 (Large U.S. stocks)	1.70%	20.55%
MSCI EAFE (Developed international stocks)	(1.07%)	12.80%
Barclays Aggregate Bond (U.S. taxable bonds)	2.27%	8.52%
Barclays Municipal Bond (U.S. tax-free bonds)	1.58%	6.75%
Wilshire Liquid Alternative (Alternative investments)	0.42%	5.06%

1. VOLATILITY SEEMS TO BE INCREASING. HOW DID THE MARKETS HOLD UP IN THE THIRD QUARTER?

Stock market volatility reached the highest levels of the year in August but were only modestly elevated by historical standards. Lingering trade and tariff concerns, weakening economic data and potential impeachment proceedings all contributed to the instability. U.S. stocks managed a small advance in the quarter, while international stocks fell slightly. Bonds fulfilled their role as a buffer to risk, posting the best returns of any major asset class in the third quarter. Overall, diversified portfolios delivered modest gains during the period.

2. WHY DID THE FEDERAL RESERVE CUT INTEREST RATES TWICE?

Chair of the Federal Reserve Jerome Powell characterized recent rate cuts as a “midcycle adjustment” rather than the start of a long-term easing cycle. With unemployment dropping to a new 50-year low of 3.5 percent in September and the U.S. economy growing, this is an unusual environment for the Fed to lower rates. But global trade friction is starting to show negatively in manufacturing activity and business sentiment, causing the Fed to opt for “insurance” cuts to offset further deterioration in the economy. With inflation hovering at a low 2 percent, the Fed has more room to maneuver than usual.

The futures market currently forecasts two more rate cuts over the next year. But Chairman Powell did not commit to additional easing at the September meeting, stating only that the Fed would take action “as appropriate” to sustain the economy. If employment conditions continue to tighten, inflation could rise and cause an abrupt end to this round of easing.

3. HOW WILL IMPEACHMENT PROCEEDINGS AFFECT THE MARKETS?

U.S. politics became more complicated as the House started an impeachment process against President Trump. With the 2020 election season kicking into high gear, how will this affect the economy and markets? In general, the impeachment levy is not good for either, as it adds more uncertainty into an already tenuous environment. Impeachment may be unlikely, given that it requires a two-thirds vote in the Senate. But if it does occur, it will create ambiguity around next year’s election and would be received negatively by financial markets here and abroad.

An additional effect is that the circumstances surrounding impeachment have caused Democrats to reduce support for Joe Biden, their most moderate candidate. Currently, the Democratic front-runner is Elizabeth Warren, who is considered more likely to depart from two current key policies: modest taxation and lower regulation. In summary, additional political turmoil is unwelcome for a market already searching for direction in a muddled economic world.

4. HAS THE LIKELIHOOD OF RECESSION INCREASED?

While the economy is still growing at a modest pace, the probability of recession has increased. There have been several midcycle slowdowns during this 10-year expansion, the last occurring in late 2015. Although soft patches are quite normal, they tend to create angst for investors. This time around, the ongoing trade conflict is sapping confidence and causing a decline in global manufacturing. Countries dependent on trade are stuck in neutral. European economies, also battered by Brexit concerns, are flirting with recession.

The U.S. economy has been relatively resilient to these issues but lately has shown signs of slowing. While U.S. manufacturing has been weak for a while, overall economic growth has not been affected much, as this segment represents just above one-tenth of U.S. output. The larger services sector also is slowing but remains in expansion mode. This leads most economists to expect continued growth in the range of 1.5 percent to 2 percent. It is likely that our economy is experiencing another soft patch rather than the onset of recession. Given the dynamics of the current environment, we are monitoring the data closely.

5. WHAT SHOULD INVESTORS EXPECT FOR THE REMAINDER OF 2019?

As we head down the year's homestretch, investors might be haunted by memories of last year's fourth quarter. From late September through Christmas Eve 2018, stocks dropped nearly 20 percent. Previous major market declines also have occurred in October, including the "Black Monday" single-day drop of more than 20 percent on October 19, 1987. But over the past 50 years, October has actually been a pretty good month for investors, producing positive returns on average.[1] We also are entering what has historically been the strongest segment of the year for stocks: November through April. So October fears may prove to be unfounded!

From the December 2018 lows, stocks rallied to post their best start in years, delivering well-above-average returns in the first half of 2019. The pace of increase slowed in the third quarter, along with the global economy. Balanced portfolios managed to tack on small gains to the strong first-half results. All things considered, the environment through year-end is likely to look a lot like the third quarter—lower returns across asset classes and elevated volatility. Here are our thoughts regarding the major asset classes:

- U.S. Stocks – Already up 20 percent for the year; additional gains may be limited. Earnings growth slowed in 2019 but is expected to pick up in 2020. This could reinvigorate stocks in the new year.
- International Stocks – Foreign shares are more attractively valued than U.S. stocks. But geopolitical risks are abundant, including trade wars and Brexit. This could cap near term gains.
- Bonds – Interest rates have declined significantly (and unexpectedly) in 2019. Since prices rise when rates fall, bond indexes have produced above-average returns this year. The decline in rates is likely over, so expect more modest returns going forward.
- Alternative Investments – This category comprises a wide array of strategies. The diversity of return drivers in this asset class should afford additional opportunity.

"Don't fight the Fed" is an age-old investment mantra. Markets tend to do reasonably well when the Fed is lowering rates, as is the case currently. Election years also tend to be positive for stocks, which may improve prospects for 2020. But with many important and unresolved issues in the economic backdrop, the potential for further gains will likely come with additional market turbulence. Maintaining portfolio discipline and diversification can help investors get through the difficult times to benefit from long-run asset class returns.

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[1] *Source: Standard and Poor's.*

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