



## In a Twitter

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### in a twitter idiom

**Definition: in an agitated state.**

**Source: Oxford English Dictionary**

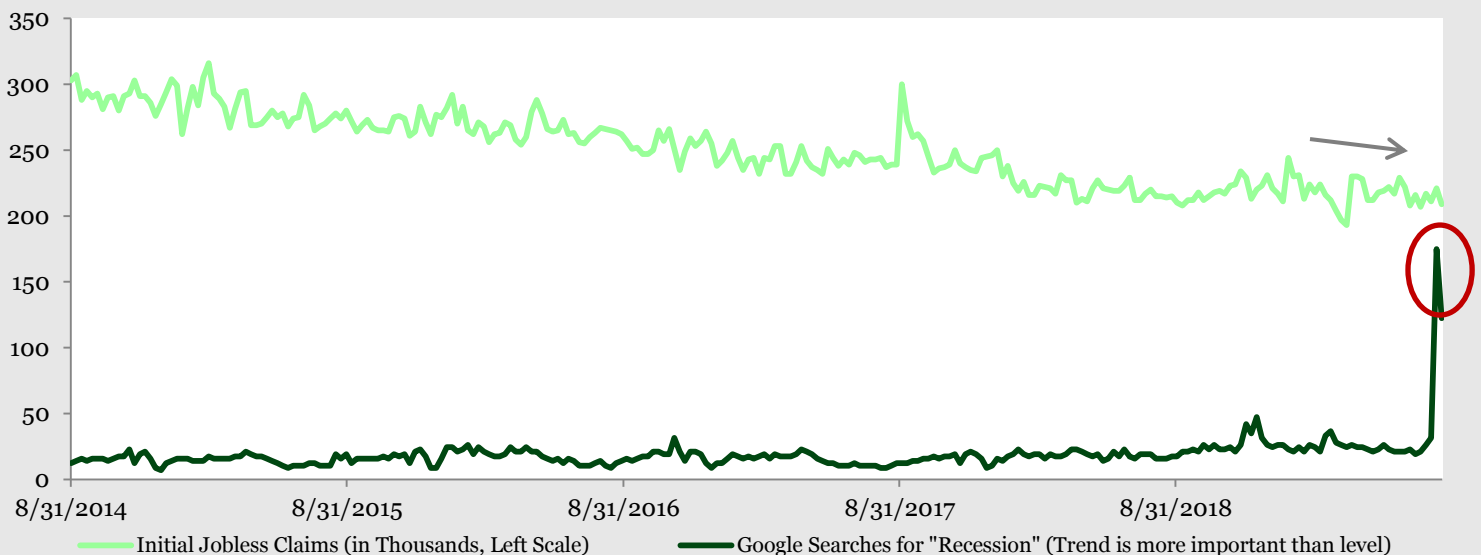
It has been a strong year for financial markets, but you'd hardly know it based on the attitude of investors. Nearly every type of investment has risen this year -- many handsomely -- and economic fundamentals remain solid. Yet investor angst about the economy is the highest in years (see the chart at bottom).

What accounts for this disconnect? We see two reasons. The first is that due to the trade war with China, Wall Street and Washington now share the same news cycle. America's raucous politics are part of the storyline for the stock market. In the past, it was easier for investors to separate the two.

The second reason is the proliferation of social media. Mark Twain wrote, "A lie can travel around the world while the truth is still putting on its shoes." In a similar way, misleading or alarmist market headlines can now be shared instantly around the globe through outlets like Twitter and Facebook. By the time careful and reasoned analysis arrives, investor attention has moved elsewhere. On top of this, smartphones allow investors to receive updates on their money any time, any place.

So, what should investors do? Unplugging from the news isn't the answer. Instead, remember that your long-term financial plan -- not daily market headlines and volatility -- should drive your investment strategy. Likewise, when consuming financial news, distinguish between what writer Nate Silver called "the signal" -- news intended to inform the reader -- and "the noise" -- news intended to entertain or provoke. Indeed, that is the aim of this quarter's report: to focus on what matters most for your money.

**Recession Fears Have Gotten Ahead of the Facts on the Ground**



## Asset Class Returns as of 9/30/2019

	Latest Quarter	Year-to-Date	1 Year	Annualized Return			Current Yield	P/E Ratio	
				3 Year	5 Year	10 Year			
Fixed Income	<b>Domestic Taxable</b>								
	Barclays Capital US Treasury Index	7.9	19.8	24.8	4.1	6.8	6.9	2.1	
	Barclays Capital US Aggregate	2.3	8.5	10.3	2.9	3.4	3.7	2.3	
	Barclays Capital Corporate	3.0	13.2	13.0	4.5	4.7	5.6	2.9	
	Barclays Capital High Yield	1.3	11.4	6.4	6.1	5.4	7.9	5.7	
	<b>Domestic Tax Exempt</b>								
	Barclays Municipal Bond Index	1.6	6.7	8.6	3.2	3.7	4.2	1.9	
	BarCap Muni High Yield	2.8	9.7	10.0	5.9	6.0	7.1	4.1	
	<b>International/Global</b>								
	Barclays Capital Global Aggregate	0.7	6.3	7.6	1.6	2.0	2.3	1.3	
Barclays Capital Emerging Market Bond	0.7	9.6	9.1	4.1	4.4	6.1	4.6		
Equity	<b>Domestic Equities</b>								
	S&P 500 Index	1.7	20.6	4.2	13.4	10.8	13.2	1.9	18.1
	Dow Jones Industrial Average	1.8	17.5	4.2	16.4	12.3	13.5	2.3	17.8
	S&P Mid Cap Index	(0.1)	17.9	(2.5)	9.4	8.9	12.5	1.8	18.3
	Russell 2000	(2.4)	14.2	(8.9)	8.2	8.2	11.2	1.6	28.0
	<b>Investment Styles</b>								
	S&P 500 Value	2.8	20.0	5.5	10.6	8.5	11.5	2.4	15.0
	S&P 500 Growth	0.7	21.1	3.2	15.7	12.8	14.7	1.5	22.3
	<b>Foreign Equities</b>								
	MSCI World	0.7	18.2	2.4	10.9	7.8	9.7	2.5	16.7
MSCI EAFE	(1.0)	13.4	(0.8)	7.1	3.9	5.5	3.5	14.4	
MSCI Emerging Markets	(4.2)	6.1	(1.7)	6.3	2.7	3.7	3.0	13.0	
Other	<b>Other Assets</b>								
	Bloomberg Commodity Index	(2.4)	1.4	(8.7)	(3.0)	(8.1)	(6.6)	0.0	
	Dow Jones Global Real Estate Index	5.1	20.5	13.4	5.8	7.5	6.4	3.1	21.0
	Gold	4.3	14.5	23.2	3.4	3.6	3.5	0.0	

Source: Hefren-Tillotson, Bloomberg

## Economic Trends & Expectations

Data as of 9/30/19

	Current	1 Year Ago	Change	Expectations
Fed Funds Rate	2.00%	2.3%	↓	The Federal Reserve cut interest rates twice over the summer.
Prime Rate	5.00%	5.25%	↓	
10 Year US Treasury	1.69%	3.05%	↓	Mortgage rates have fallen in the U.S. as interest rates have declined across the globe.
30yr PA Mortgage	3.8%	4.6%	↓	
GDP Growth %	2.3%	3.2%	↑	The economy continues to expand, but at a slower pace.
Industrial Production	0.4%	5.3%	↑	
Retail Sales	4.1%	6.1%	↑	Consumer spending continues to be strong, but recent concerns about a potential recession have likely weighed on sentiment.
Consumer Sentiment	93.2	100.1	↓	
Consumer Price Index	1.7%	2.7%	↓	Inflation remains low and the jobs market remains strong.
Unemployment Rate	3.7%	3.8%	↓	
U.S. Govt Surplus/Deficit	-4.4%	-4.3%	↑	The U.S. budget deficit has increased, but remains fairly steady as a percentage of GDP.
Corporate Default Rate	3.1%	1.7%	↑	
U.S. Dollar Index	99.4	95.1	↑	The dollar has risen as economic performance has been stronger in the U.S. than overseas.
Gold	\$1,470	\$1,193	↑	
Oil Prices	\$55	\$73	↓	Oil prices have plummeted over the past year, despite the recent spike following the attacks in Saudi Arabia
Home Prices Index	2.0%	5.9%	↑	

Directional arrows for economic data refer to change in level, not rate of change

## Market Review

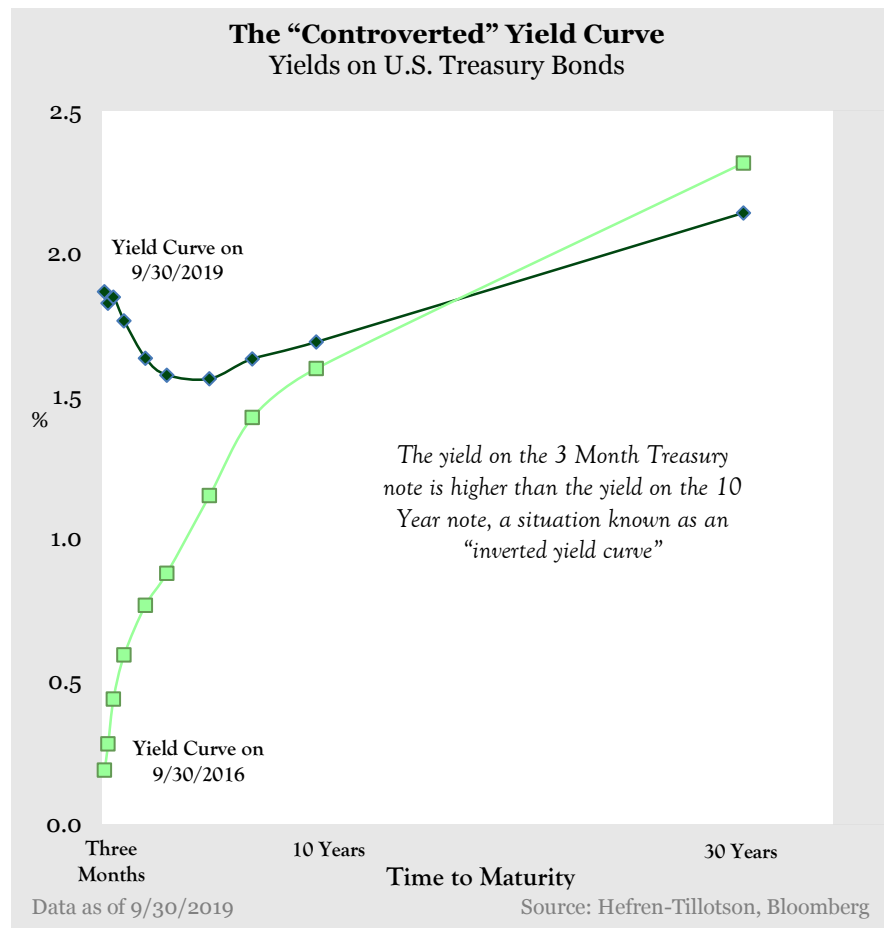
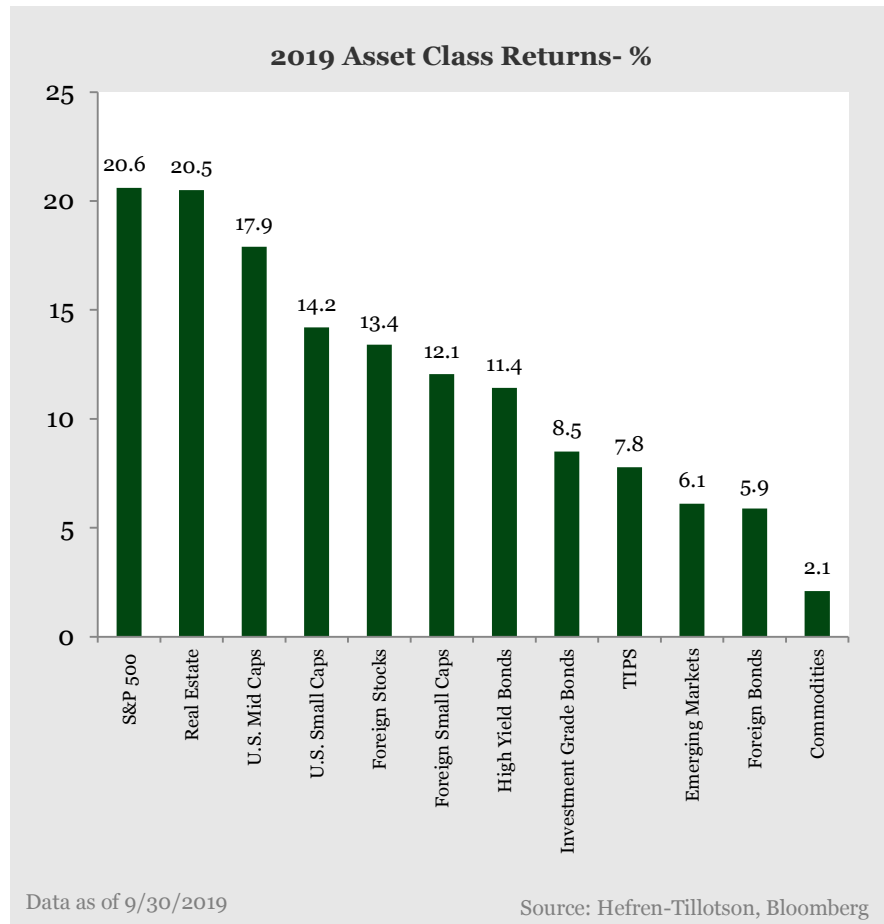
Financial markets have enjoyed strong gains in 2019, following a challenging year in 2018. Nearly every major type of investment has posted attractive returns (top chart). U.S. stocks have again led the way, with the S&P 500 index gaining 20% through September. Even the bond market has generated strong returns, despite interest rates being low.

How can markets perform so well when recession fears are rampant? Simply put, speculation about a recession has gotten ahead of the facts on the ground. This is perhaps best captured by the weekly unemployment claims numbers presented on page 1. Job numbers are one of the best real-time indicators of the economy's health, and continue to look solid. Indeed, the American economy remains in good shape.

So why all the talk about recession? One reason is the uncertainty around the trade war, which has indeed caused the global economy to slow, especially outside the U.S. But the main factor is the so-called "inverted yield curve." This is an unusual phenomenon where short-term interest rates are higher than long-term rates. Over the years, it has been one of the most reliable early indicators of a recession. It is also widely reported on by the media (both *The New York Times* and *The Wall Street Journal* have written more than forty articles on the subject just this year).

Not every inverted yield curve is equal, however. Typically, the curve inverts when inflation rises and the Fed responds by raising interest rates. This increases the cost of borrowing for businesses and consumers and eventually hurts the economy. The situation today is different. Inflation is low and the Fed has lowered short-term rates twice in 2019, making it easy to borrow. Instead, the curve has inverted due to something that is unprecedented: interest rates are now *below zero* in many parts of the world. This has caused long-term interest rates in the U.S. to fall to record low levels. As a result, the inverted yield curve looks less like a sign of impending recession and more like a false alarm caused by events outside the U.S.

Mark Twain had another famous quote, this one in response to a false newspaper report that he had died. He wrote, "The rumors of my death are greatly exaggerated." Likewise, speculation about a recession is overdone. The economy has indeed slowed down, but a full blown recession is unlikely in the near-term.



## Market Outlook

There are two critical factors to the outlook: the trade war with China and the Federal Reserve's policy on interest rates. While there is uncertainty about both, we expect that progress on trade and a market-friendly Federal Reserve will allow the economic expansion to continue and for stocks to perform well.

The trade war has been, to put it mildly, an unpredictable situation. Nevertheless, the economic incentives for China and the U.S. seem clear, and point to a likely thawing of tensions over the coming months.

For the White House, the incentive is to have the economy firing on all cylinders ahead of next year's election. A strong economy was an essential part of President Trump's pitch to voters in 2016, and presidents are rarely re-elected when the economy is weak (Calvin Coolidge is the only president in the past 100 years to win a second term after presiding over a recession within two years of the election).

Furthermore, the \$20 trillion U.S. economy does not turn on a dime, so the White House must act soon if it wishes for the economy to accelerate before Election Day next November.

China likewise has incentives to reach a trade accord. The Chinese economy grew at the slowest pace in nearly thirty years during the second quarter as the trade war took its toll. Exports to the U.S. fell 16% in August from the prior year, one of the steepest drops on record. Chinese leaders are also mindful of recent political unrest in Hong Kong, and want to avoid protests on the mainland if the domestic economy weakens further.

For these reasons, we expect a de-escalation of trade tensions in the coming months. While we don't expect a "grand bargain" between the two countries, something closer to a temporary "truce" is likely. This could involve a reduction in U.S. tariffs levied against China in exchange for large-scale purchases of U.S. goods, especially agricultural products.

Such an outcome would not be the final chapter in the U.S.-China trade saga. Even so, thawing tensions could help to boost economic growth over the short-run and lead to further gains for stocks.

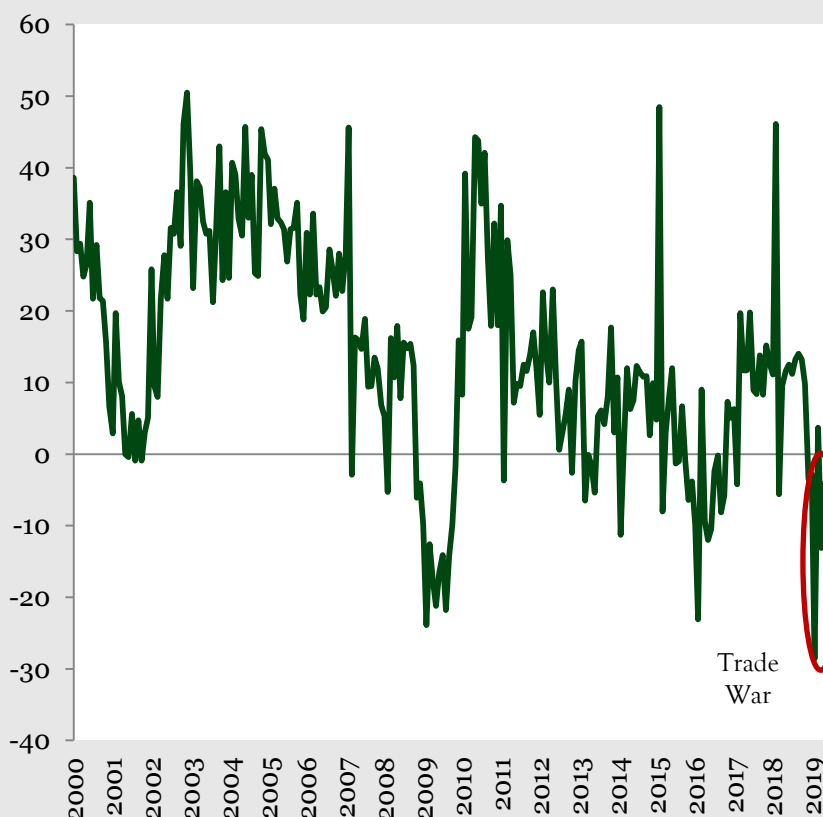
### Economic Performance and Election Outcomes

No Recession Two Years Before Re-Election		
President	Recession?	Re-Elected?
Obama	No	Yes
Bush II	No	Yes
Clinton	No	Yes
Reagan	No	Yes
Nixon	No	Yes
LBJ	No	Yes
Eisenhower	No	Yes
Truman	No	Yes
FDR	No	Yes
FDR	No	Yes
FDR	No	Yes
Wilson	No	Yes
Recession Two Years Before Re-Election		
President	Recession?	Re-Elected?
Bush I	Yes	No
Carter	Yes	No
Ford	Yes	No
Hoover	Yes	No
Coolidge	Yes	Yes
Taft	Yes	No

Data as of 9/30/2019

Source: Hefren-Tillotson, Strategas Research

### Chinese Exports to the U.S., 12 Month Rate of Change (%)



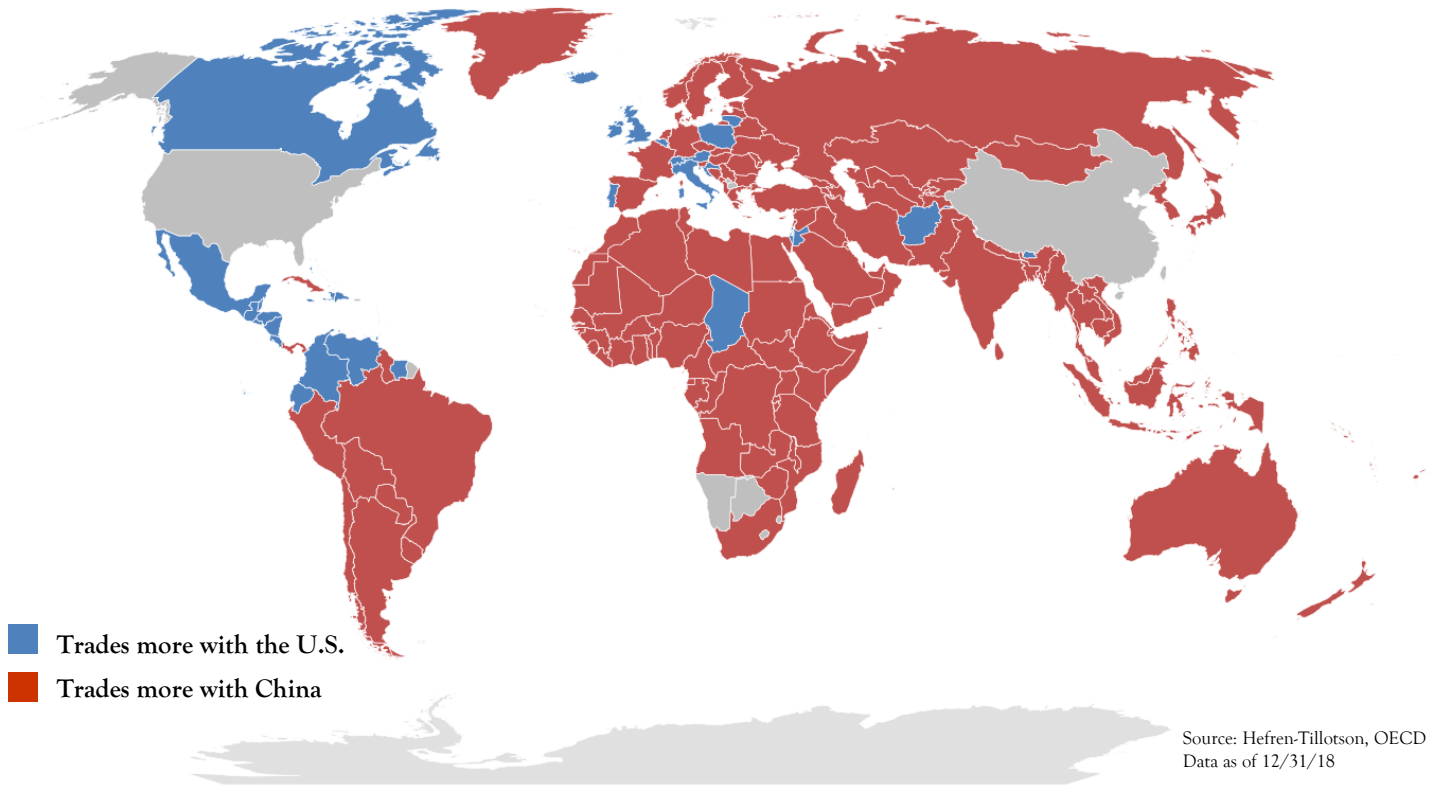
Data as of 9/30/2019

Source: Hefren-Tillotson, Bloomberg

## Outlook, Cont'd

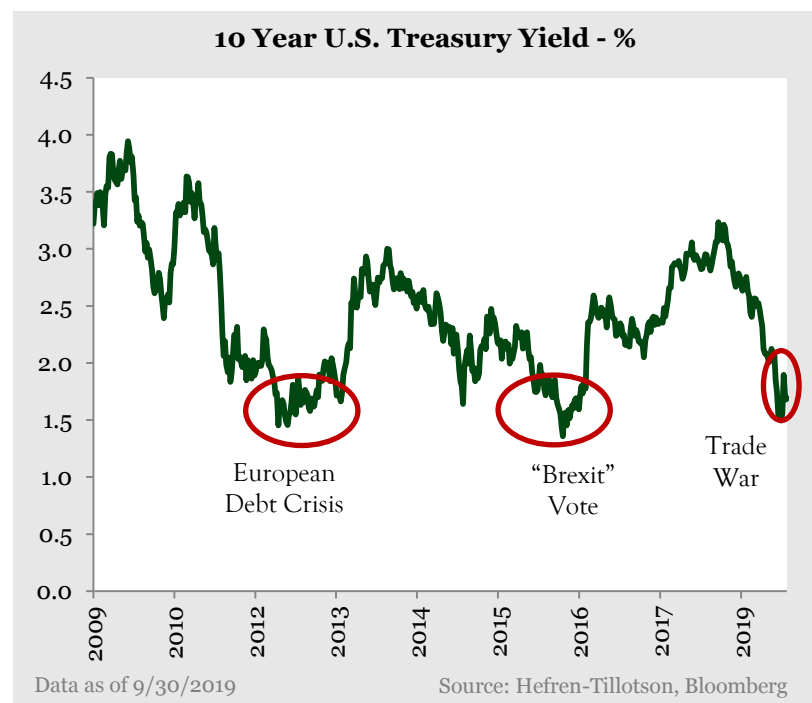
The outcome of the trade war is also important for stock markets outside the U.S. For most countries, trade makes up a higher percentage of their economies than it does in the U.S. This makes foreign markets especially sensitive to global trade. In addition, most countries have a larger trading relationship with China than they do with the U.S. This includes nations like France and Germany that are traditionally counted as part of “the West”. Many of these economies struggle to grow on their own and rely heavily on exports for growth (in fact, exports make up 47% of German economy compared to 12% for the U.S.). Over the short-term, this means overseas stock market performance may hinge on the trade war and its effect on the Chinese economy. Longer-term, this reordering of global economic ties has vast geopolitical implications that are barely being discussed today.

### Most Countries Have a Larger Trading Relationship with China Than They Do With the U.S.



The second critical factor to the market outlook is the Federal Reserve. The Fed lowered interest rates twice during the summer months, from 2.50% to 2.00%. Other countries have been even more aggressive in lowering rates in response to the slowdown in global growth. As a result, long-term interest rates have plummeted across the globe, even falling below zero in places like Europe and Japan. Rates are still positive in the U.S., but are near generational lows, with the 10-year Treasury ending the quarter at just 1.7%.

This is the third time this decade that U.S. interest rates have fallen to today's level in response to worries about the global economy. The first time was in 2012 during the European debt crisis. The second was in 2016 following the U.K.'s decision to leave the European Union. In both cases, not only was a global recession avoided, but the opposite occurred: low rates laid the foundation for a rebound in global economic growth.



## Outlook, Cont'd

We think a repeat of this scenario is likely. As long as the trade war does not get out of hand, low rates should stimulate the economy and extend the bull market. If that occurs, we expect parts of the stock market that are sensitive to economic growth to benefit, including financials, industrials, and parts of the technology sector. These sectors have been passed over by investors due to fears of a recession, and as a result appear to be attractively valued. Accordingly, we recommend that investors tilt equity portfolios toward these sectors.

Although we don't believe a recession is imminent, investors should nevertheless remember that periodic economic downturns are ultimately inevitable. It is also (despite our efforts here) difficult to predict when they will occur, which means investors should have a plan in place to ride out a recession...just in case. This includes having the right mix of stocks and bonds in your portfolio, and setting aside cash for upcoming spending needs.

## Impeachment Proceedings

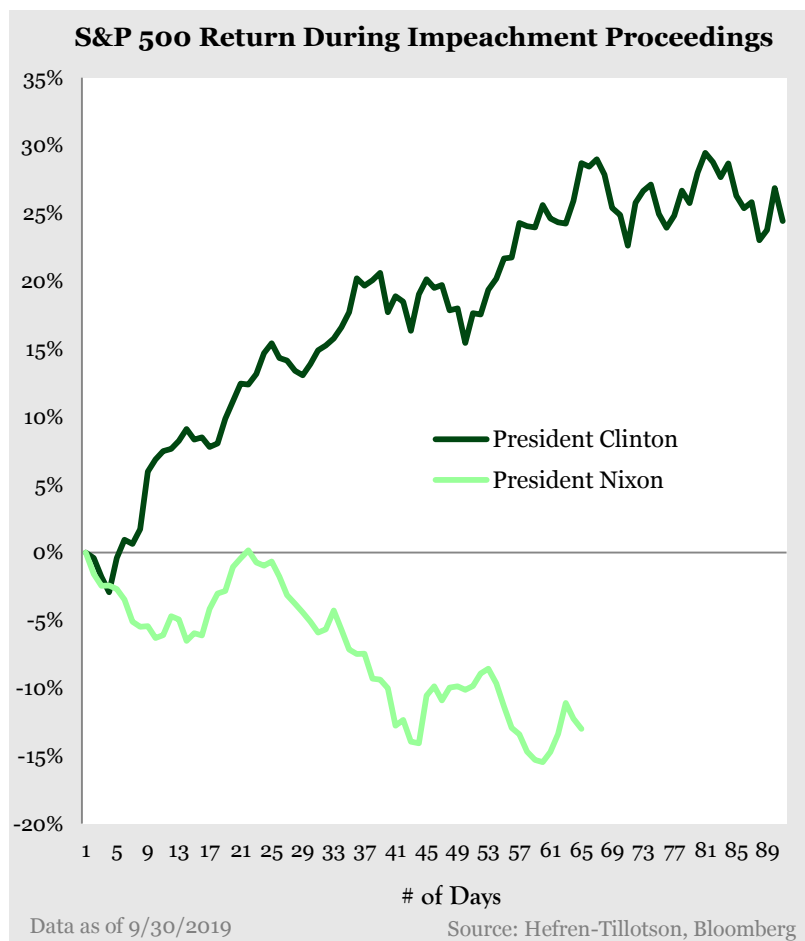
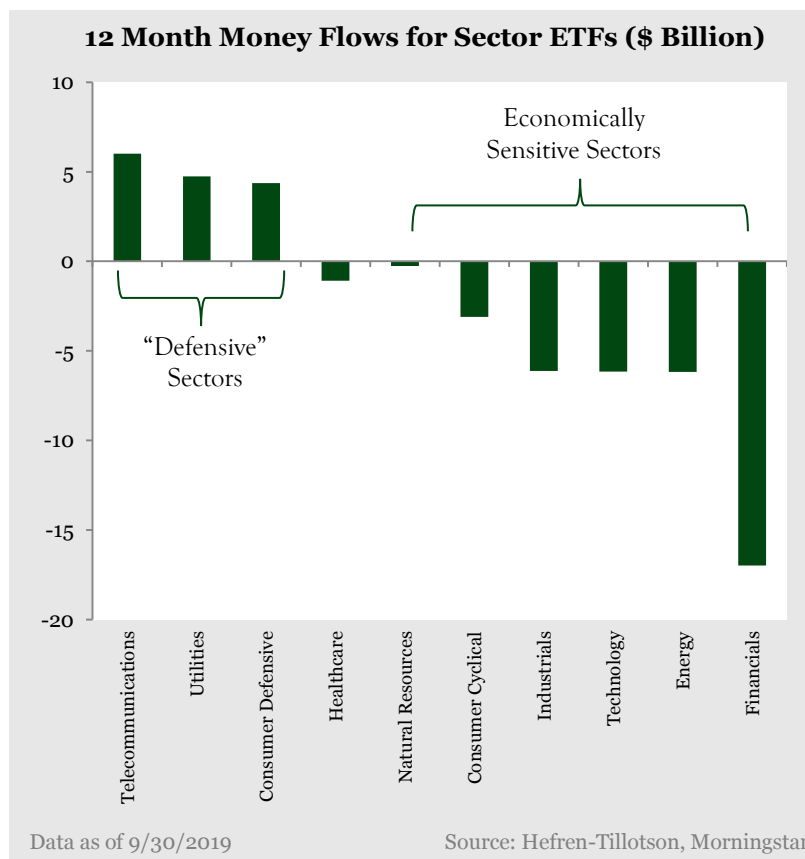
The outlook for the trade war and the Fed may seem beside the point given the political situation in the U.S., where Congress has announced its intention to open an impeachment inquiry against President Trump.

However, the two modern-day precedents we can point to suggest that impeachment proceedings are not the most important consideration for investors right now.

President Nixon was subject to impeachment proceedings in 1974, but resigned from office before he could be impeached. President Clinton was impeached in 1998 and acquitted of the charges. In both cases, it was the performance of the economy, not political developments, which drove market performance.

Stocks performed poorly during the Nixon scandal due to recession, an energy crisis, and runaway inflation. On the other hand, the Clinton impeachment unfolded during the late 1990's technology boom and stock performance was strong (chart).

We cannot predict how the politics will unfold this time around, but we do expect that Washington will take a backseat to the economy in terms of driving stock market performance.



## Signal or Noise?

The proliferation of social media means investors face an onslaught of market information – some of it relevant, but much of it a distraction from what matters most for your money. Here is our take on the hot topics of the day and how investors should respond.

**Trillion Dollar Deficits** - In September, the Congressional Budget Office reported that the nation's annual fiscal deficit now exceeds \$1 trillion. The news caused some investors to ask whether the nation's ballooning deficits might lead to a crisis in financial markets.

While a thirteen-digit deficit is certainly eye-popping, it is not terribly out of line with history when viewed as a percentage of GDP – 4.4% today vs. a forty-year average of 3.3%. Furthermore, cumulative government debt as percentage of GDP has risen only a small amount in recent years as the economy has grown at a solid pace. Thus, while the government's finances are on a worrisome long-term path, there is virtually no sign of an impending fiscal crisis. Indeed, the extraordinarily low level of interest rates on Treasury bonds suggests the U.S. government presently has no problem financing its deficits.

*Bottom line: The nation's fiscal challenges could eventually present a challenge for the economy, but it is far too early for investors to position for this outcome.*

**Brexit: Deal or No Deal?** – If you think Washington is in chaos, then look across the Atlantic where the U.K. has yet to exit from the European Union after more than three years of trying. Now, after several delays, “Brexit” is scheduled for October 31<sup>st</sup>. Newly elected Prime Minister Boris Johnson states he'd “rather be dead in a ditch” than delay Brexit again, even if that means forgoing a deal with the E.U. to smooth the exit process. Investors fear that this potential outcome, also known as a “Hard Brexit”, could disrupt the entire world economy.

However, given that investors and U.K. government leaders have had three-plus years to grapple with the possibility of a Hard Brexit, we expect the worldwide fallout to be limited. On the other hand, a surprise deal with the E.U. to procure a smooth exit for the U.K. could lead to a rebound in this important corner of the global markets.

*Bottom line: The U.K. is the world's fifth-largest economy and too big for investors to ignore. Expect more global market volatility as we approach the Brexit deadline this month.*

**Negative Interest Rates** – There exists more than \$14 trillion in government debt around the world that yields less than zero percent. Yes, you read that right. Investors are lending to governments, knowing they will receive less money back than they lent in the first place.

How can this be? The main reason is that some institutional investors like banks and pension funds have rules that require them to own a portion of their portfolio in government bonds...no matter what. When the demand for bonds from these investors outstrips the supply of bonds available for purchase, bond prices can keep rising and cause interest rates to fall to absurd levels.

*Bottom line: Sometimes policies can get in the way of common sense. Don't buy negative-yielding debt.*

**Federal Reserve Liquidity Injections** – Investors were confronted in September with news about the Fed “rushing to rescue the economy” in response to “cracks in the financial system.” While the headlines were scary, the reality is more benign.

The Fed lends money to banks to purchase newly issued U.S. Treasury securities. With Treasury issuance up and banks having little cash set aside to purchase bonds due to regulatory changes, the Fed has stepped in to make it easier for banks to borrow. Some news stories drew parallels to 2008 when the Fed intervened to rescue failing banks. But the situation today is completely different.

*Bottom line: Banks are in strong financial shape today and comparisons to 2008 are misleading.*

**“Volfefe Index”** – In September, Analysts at J.P. Morgan Chase unveiled an index aimed at measuring the impact of President Trump's tweets on the financial markets. It turns out that his tweets - numbering more than 10,000 since inauguration day - have had a measurable impact on the markets (although the effect is statistically short-lived).

This is not meant as a criticism of President Trump, as almost all politicians have embraced social media. The point for investors is that the Wall Street and Washington news cycles have merged, creating even more noise for investors, and with it, the potential for market volatility.

*Bottom line: Let your long-term financial plan, rather than the latest political developments, guide your investment strategy.*

# Investment Strategy Summary

## Outlook and Strategy Overview

- Speculation about a recession has gotten ahead of the facts on the ground. Although economic growth slowed during the summer months, the economy remains in good shape. A recession should be avoided over the near-term and the bull market in stocks should continue.

- Federal Reserve interest rate policy and the trade war are the two factors most critical to the market outlook. Lower Fed interest rates or easing trade tensions could boost stocks. On the other hand, an escalating trade war is the biggest threat facing the markets and economy.

- Investors should be mindful of the associated risks, but focus more on the opportunities. The White House likely desires a trade deal to boost the economy ahead of next year's election, and could accept a temporary truce with China.

- Economically-sensitive parts of the global equity markets have underperformed since the trade war began, resulting in attractive valuations in many cases. Thus, investors in these areas could be well-rewarded if trade tensions thaw. Areas of interest include industrials, financials and parts of the technology sector in the U.S., as well as overseas and emerging market equities.

- Continue to de-emphasize speculative and expensive parts of the U.S. equity market, some of which are found among recent initial public offerings. High valuations may increase downside risk and limit long term return potential for these areas.

- The economic expansion could eventually end in typical fashion, with the economy overheating, inflation rising, and the Federal Reserve raising interest rates aggressively. However, those conditions are not present today.

- While we do not forecast a recession, given the extended duration of the economic expansion, investors should have a plan for one, just in case. This includes remaining diversified between stocks and bonds and having cash on hand to meet short-term spending needs.

## Fixed Dollar Assets

- Short-term interest rates are high today compared to long-term rates, making short-term fixed-income vehicles an attractive option.

## Fixed Income Strategy

- Emphasize short-term bond funds, which are a good source of income today relative to the amount of risk entailed.
- Some foreign bond markets offer attractive valuations and solid return potential, in our opinion.
- Municipal bonds continue to enjoy solid fundamentals, including strong demand from investors and limited new supply. High yield muni bond funds should benefit if rates stay low.

## Equity Strategy

- We believe economically-sensitive parts of the global equity markets are generally inexpensive and poised to perform well if recession fears fade.
- Overweight emerging markets given the potential for higher long-term returns. More broadly, international markets appear to be inexpensive, but may require stronger Chinese economic growth to perform better.
- Emphasize large caps over small caps.
- Avoid speculative parts of the U.S. market.

## Other Assets

- Some corners of the real estate market exhibit positive fundamentals and a solid level of income.

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