Quarterly Investment Perspective

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Key Points:

- *After a down year in 2018, stock markets around the world soared through the first three quarters of 2019 despite no resolution on a U.S.-China trade deal and a myriad of global geopolitical risks. Similarly, global bond returns have been strong due to investor demand amid declining interest rates. The outlook for both stocks and bonds includes more volatility and lower but still positive returns.*
- *Amid fears of an imminent recession in the U.S., many of the economic indicators that we track suggest that this is premature.Trade disputes have rippled through the global economy causing a significant slowdown in global manufacturing activity across Asia and Europe. Overall global economic growth is expected to slow to 2.9% this year and remain low in 2020.*
- *With the recent start of a formal impeachment inquiry against President Donald Trump, many investors are asking how it might affect the markets. There are certain market and economic conclusions that can and can't be made by looking at past impeachment proceedings. We highlight reasons why investors should not consider the current impeachment inquiry in their investment decisions.*

Market Review & Outlook

Stocks rose on rate cuts and hopes of a trade truce

Despite market volatility rising in August, stocks around the world finished the third quarter with modest gains.[1] While there was still no resolution on a U.S.-China trade deal, the decision by President Trump to delay tariffs on nearly $160 billion in Chinese imports until December 15th temporarily eased investor concerns with hope that there would be a finalized deal by then. Meanwhile, stock markets moved higher as 16 major central banks around the world continued lowering interest rates to combat weakening economic growth.[2] Stocks in aggregate have recovered their losses from 2018.[3] (See **Figure 1**.)

Bonds extended gains amid worries about a slowdown

Despite declining in September, bonds around the world gained significantly in the third quarter due to a combination of strong investor demand for safe assets and falling interest rates. Lower economic growth and inflation expectations continued contributing to significant declines in long-term interest rates. Meanwhile, the Federal Reserve (the Fed) cut short-term interest rates by 0.25% twice (in July and September) to help offset the effects that weak global growth and trade tensions have had on the U.S. economy. For the same reasons, the European Central Bank cut rates deeper into negative territory and committed to additional economic stimulus.

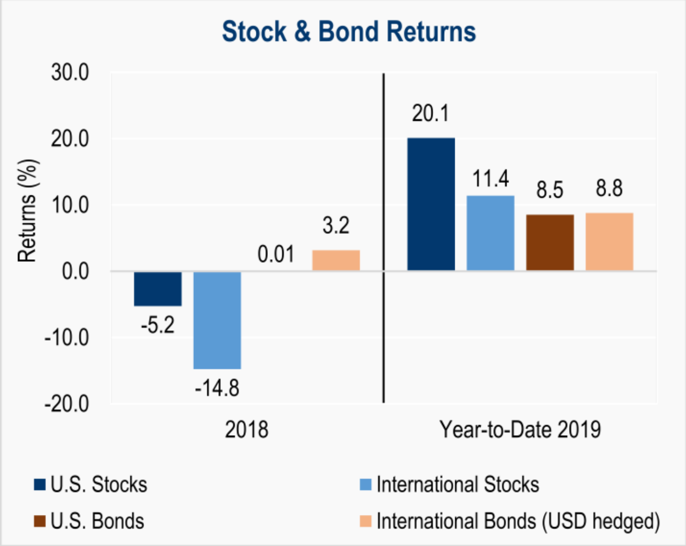


Figure 1. After a down year in 2018, stock markets around the world soared through the first three quarters of 2019. Concerns about global trade and slowing economic growth have been offset by a series of global government and central bank measures intended to boost economies and revive investor sentiment. Similarly, global bond returns have been strong due to investor demand amid declining interest rates.

U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Barclays Aggregate Bond Index. International bond returns are represented by the Barclays Global Aggregate Ex USA Hedged Index. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Source: Morningstar, Russell, MSCI, Barclays. Data as of 09/30/2019.

Outlook for markets remains positive yet volatile

Notwithstanding the risk of trade-war escalation, the current environment for stocks is generally favorable. The recovery in stocks this year is likely to continue given relatively easy financial conditions (i.e., low interest rates), as well as the eventual positive impact of global economic stimulus on business and consumer spending, which should help corporate earnings growth. However, stock market volatility will likely remain as geopolitical uncertainties continue to unnerve investors. The story with bonds is different, since one of the consequences of lower interest rates is that future bond returns are likely to be lower. However, high-quality bonds will likely continue to be positive and could extend their gains when market volatility picks up.

Economic Review & Outlook

The U.S. economy remains on strong footing

In recent months, markets have been volatile amid fears of an imminent recession in the U.S. However, many of the economic indicators that we track suggest that these fears are premature. While business investment and manufacturing have shown recent signs of weakness in the U.S., the overall economy is still very strong due to the resilience of consumers. Consumption in the U.S. continues to be a relative bright spot amid the backdrop of a healthy job market (see **Figure 2**), which has resulted in wage growth and high consumer confidence. In aggregate, the most recent consumer and labor market data imply that there is no looming recession.

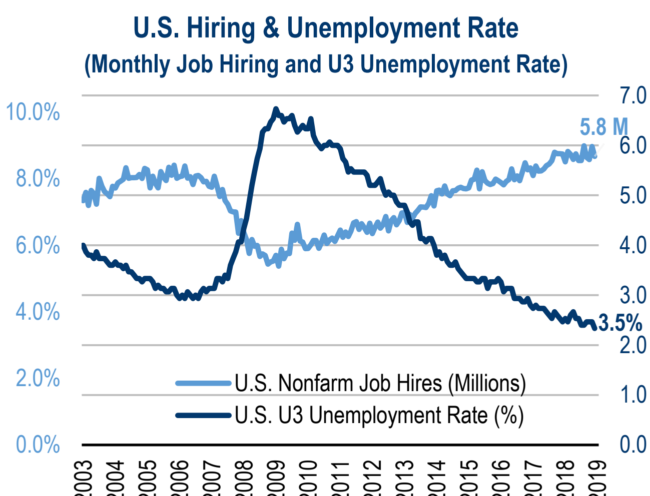


Figure 2. The U.S. unemployment rate has fallen to a new cycle low as the level of hiring has reached a cycle high.

Sources: Bureau of Labor Statistics, YCharts. Data as of 09/2019.

Trade disputes have weakened economies abroad

The fallout from the trade disputes between the U.S. and China have rippled through the global economy. A significant slowdown in global manufacturing activity across Asia and Europe (see **Figure 3**) has contributed to declining economic growth rates, particularly for trade-dependent countries. Adding to Europe's troubles are the lack of a finalized plan and deal for the U.K. to leave the European Union. However, lackluster factory activity around the world has yet to materially spill over to the consumer, as low unemployment rates in most major economies continue to support consumer confidence. Meanwhile, central banks around the world remain commited to responding with new stimulus measures that keep interest rates low to support their economies.

Global slowdown to continue until trade agreement

Overall global economic growth is expected to slow to 2.9% this year and remain low in 2020.[4] While this would be the smallest annual output rise since 2009, an all-out global recession is not expected to occur any time soon. The U.S.-China trade dispute will likely end with only marginal changes. Nevertheless, the big potential issue is that material negotiations could linger for the foreseeable future. This will continue to dampen business confidence and investment, as well as global economic growth altogether. Continued central bank employment of stimulus measures will likely help to stave off a global recession until a trade agreement, and eventually result in a pickup in global activity once again.

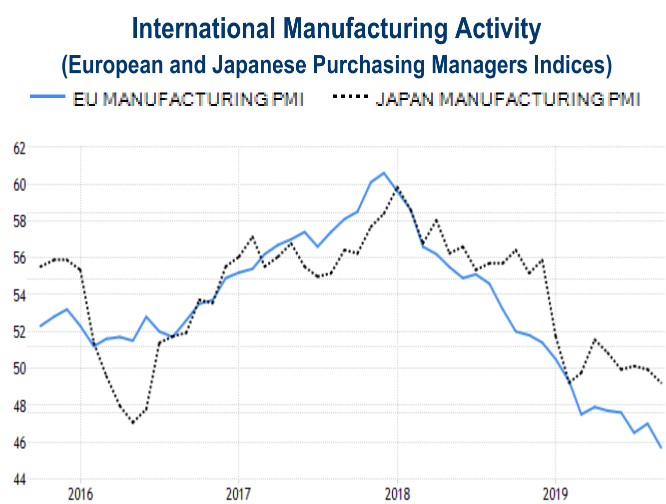
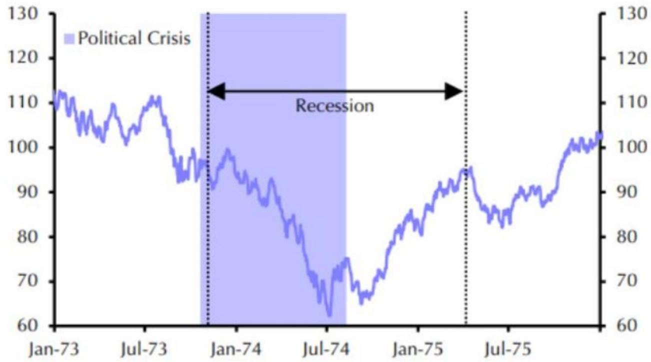


Figure 3. Manufacturing activity in many leading industrial and export economies has been slowing since early 2018.

Sources: TradingEconomics.com, Markit Economics. Data as of 09/2019.

S&P 500 & 1973-74 Political Crisis (Nixon)



S&P 500 & 1998-99 Political Crisis (Clinton)

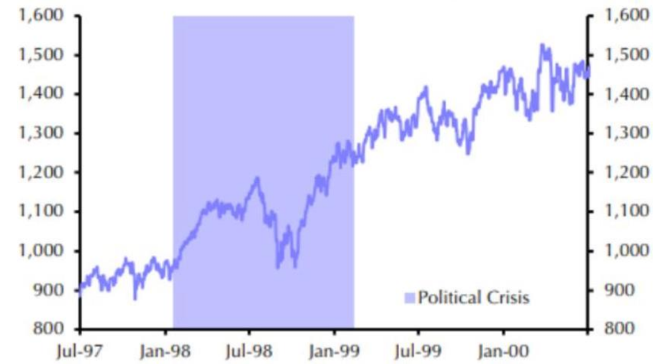


Figure 4. Stock market performance during the last two U.S. impeachment proceedings. Sources: Bloomberg, Capital Economics.

On the Minds of Investors

How might an impeachment affect the markets?

With the recent start of a formal impeachment inquiry against President Donald Trump, many investors are asking how an impeachment might affect the markets. One way to answer the question is to look back in history at previous impeachment proceedings, but the sample size is extremely small. When Andrew Johnson was impeached in 1868, the stock market didn't exist as it does today. This leaves us with only two other occurrences. (See **Figure 4.**) Stocks declined during the Watergate investigation leading up to President Richard Nixon resigning in August 1974. In contrast stocks continued to climb during President Bill Clinton's impeachment process. We can't draw any concrete conclusion from this data about the direction of stocks.

What we can conclude about the prior two impeachments proceedings is that economic and market forces played a much bigger role in driving stock prices. In the 1970s, inflation had a far larger and longer-lasting impact on investment performance than Nixon's resignation. In the late 1990s, the tech bubble fueled by easy Fed policy was of far greater importance. Today, the greatest risk for investors is trade conflict continuing to slow growth or an unanticipated surge in inflation resulting from persistently low rates.

One of the unfortunate effects of an impeachment inquiry is that it adds another layer of uncertainty to the financial markets which are already confronted with many geopolitical risks. In the short-term, market volatility will likely increase. However, aligned with our investment philosophy of focusing on things you can control and sticking to a disciplined investment plan, we strongly believe that investors should not consider the impeachment inquiry in their investment decisions.

Portfolio Management

Long-term bonds have benefited portfolios

Amid all the stock market volatility we've experienced over the last twelve months, one of the best performing asset classes has been high-quality long-term bonds. This asset class has performed well due to strong investor demand for safe-haven assets during a period of slowing global growth and increasing market uncertainty which altogether has resulted in significantly lower interest rates. High-quality long-term bonds have played a vital diversification role in portfolios containing stocks and have dispelled any doubts of their ability to provide portfolio ballast even at historically low or negative yields.

Why an allocation to long-term bonds still make sense

Over the last two years, portfolios have benefited from our strategy to move them toward high-quality long-term bonds to provide better diversification against elevated stock market risk. Admittedly, while long-duration bonds have led in performance over the last year, their yield per maturity-length profile has become less attractive. However, there is still some "term premium"—the extra return an investor earns from holding a longer-term bond—that will be realized over long periods of time. Additionally, these types of bonds should continue to provide a consistently effective hedge for stock market risk.

Of course, there is a risk to holding long-term bonds – that is, they can lose money when interest rates move up. To mitigate this risk, we strategically structure bond allocations to include a diversified mix of bonds across varying maturities and sectors. This structure is aligned with our philosophy that portfolio diversification should be considered both within and across asset classes.

Sources & Notes

[1] International stocks as measured by the MSCI ACWI ex US 100% Hedged NR USD, returned +1.10% in local currency terms from 7/1/19 to 9/30/19. Source: Morningstar Direct.

[2] JPMorgan Chase & Co.

[3] Stocks in aggregate as measured by 50% Russell 3000 Index and 50% MSCI ACWI Ex USA IMI index, have returned +15.75 in USD terms from 1/1/19 to 9/30/19. Source: Morningstar Direct.

[4] According to Organization for Economic Cooperation and Development (OECD) as of September.

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