Market Review and Outlook—October 11, 2019

A bumpy Carnival Ride—Much like the rusty, and terrifyingly collapsible, carnival rides that I loved to ride as a child, the recent stock and bond market ride has brought unexpected bumps, fits, and spins. July was smoothly ascending until the last few days of the month when US and foreign stock markets tumbled into a jumpy and negative August. As stocks fell, bonds moved up to positive territory, gaining more than 2% in many cases in August. The first few days of September brought sharp increases in global stock markets as news broke that the US and China agreed to meet in Washington in October. This short-lived spike made up for the August decline, before settling flat for the remainder of September. The quarter finished mixed. Thus we got on the ride at the beginning of July at about the same place that we finished the ride in September, in spite of a bumpy ride.

Hard Year on Stocks—Seeing all the red in the center of the **12 Months** column might be surprising, when some stock indices have recently reached all time highs, however indices track selective stocks and aren't representative of the entire market. The last quarter of 2018 was awful, worse for US stocks than foreign stocks, driven by the start of severe trade war escalation. The first and second quarter of 2019 brought a strong rebound, allowing US stocks to outpace foreign stocks in the same timeframe. Even though the third quarter of 2019 looks unexciting and the one-year stock numbers are varied, the year-to-date figures are **very** strong.

Federal Reserve—The Fed lowered interest rates twice in the last quarter, noting that there are risks to the positive strength and outlook in the economy right now. More than in the past, there is division among the Fed's policy-setting committee, making it difficult to measure the impact on the Fed's voting members of trade war concerns and worries over the US manufacturing slowdown. Therefore there is little consensus about what the Fed will do next, but what we know for now is rates have been kept low compared to longer-term historical trends. While bonds should provide protection from sharp stock declines during an economic downturn, it is likely that annual rates of return for bonds will remain subdued for several years (illustrating the price of safety).

An Economic Shift?—Economic expectations have shifted during the past quarter. The Fed has changed the direction they are moving rates, manufacturing survey results are negative for the first time in years, and stock returns have bounced around on good and bad global trade news. We still do not know when the next recession will begin, but investors over the last year have become much more concerned with this risk. When facing uncertainty, we favor sticking to basics, or a "home base." Consider ensuring that your portfolio is at, but not above, your long-term allocation to stocks, while avoiding any extra exposure to risky investment areas. Steady as she goes.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.47%	+2.01%	+1.22%	+0.74%	+0.38%
Intermediate Term Bond	+1.99%	+9.35%	+2.58%	+2.95%	+3.59%
Intermediate Muni Bond	+1.41%	+7.60%	+2.59%	+3.01%	+3.54%
Large-Cap Stock	+1.45%	+3.00%	+11.70%	+8.98%	+11.76%
Mid-Cap Stock	+0.10%	-1.36%	+8.47%	+6.61%	+10.94%
Small-Cap Stock	-1.27%	-7.72%	+7.21%	+6.89%	+10.68%
Foreign Large-Cap Stock	-1.28%	-2.04%	+5.55%	+2.92%	+4.51%
Health	-6.34%	-10.83%	+7.15%	+7.05%	+13.72%
Finance	+0.76%	+0.87%	+11.58%	+8.48%	+9.59%
Technology	-1.37%	+0.90%	+17.01%	+14.90%	+14.72%
Moderate Allocation (60% stocks)	+0.92%	+3.53%	+7.13%	+5.60%	+7.80%

The data in this table comes from Morningstar and is as of September 30, 2019

Uncertainty is a Certainty—It is hard to remember a time when there was not a lot of economic uncertainty. However, other than following the 9/11 attacks, and during the 2008/2009 financial meltdown, it is hard to remember a time when uncertainty was higher than it is now. The President of the United States has regularly criticized the President of the Federal Reserve Bank, whom he appointed. It has been twenty years since we last withstood impeachment deliberations, and relations between the two leading political parties in DC are incredibly contentious. We have regular trade war/tariff threats in our headlines, causing global trade to decline. Constitutional crises have been claimed in both the US and Great Britain. Oil facilities in the Middle East have been attacked, and North Korea continues to launch rockets. How can investors sleep at night?

It's Fundamental to Focus on Fundamentals—In light of uncertainty, it is critical to have a plan and stick to it. We look at the US and global economy and its direction, inflation and interest rates and their direction, and then consider cash, bonds, and stocks to see the best mix to handle the (currently high) range of possible paths ahead of us. We focus on fundamentals, informed but not paralyzed by uncertainty.

Is There Growth? This is a critical question, for the definition of a recession is the absence of growth. Fortunately, the US economy has enjoyed positive real (after adjusting for inflation) economic growth for over a decade. During this expansion growth has averaged a fairly low 2.3% rate, below the 50-year 2.7% average. While the late 2017 tax-cut boosted growth in 2018, this year the growth rate has fallen back to the low-2% level, and some expect the rate to fall below 2% by year-end. So there is growth in the US economy, but it is low. With this lower-than-normal rate of growth, this recovery has been able to not only last longer-than-normal, it has lasted the longest in over 70 years. While it may surprise most investors, global growth has also remained positive for a decade, and is currently running at 2.6%. So there is growth, just not hot growth.

Inflation, What Inflation? Core inflation over the past 50 years has been close to 4%. It has been closer to 2% for the past decade. While it appears to be rising recently, it seems to be keeping under 2½%. Global headline inflation has not strayed far from US headline inflation.

Interest Rates—Down Again? After nine quarter-point increases from 2015 through 2018, the Federal Reserve Bank (the Fed) cut rates twice this year, in August and September. Cuts are typically made when there is weakness in the economy. These cuts are partially tied to the uncertainty that surrounds the stock and bond markets, tied to the trade wars. This uncertainty leads to lower corporate activity, especially in manufacturing. While the Fed sets ultra-short term interest rates, longer term interest rates have also been very low, leading to a 'negative yield curve' in which some longer-term Treasury bond yields are lower than shorter-term rates. While this sometimes indicates that a recession is imminent, there are several other factors which indicate that recession risks are not as pressing.

Where Do We See Value? Interest rates for cash (money markets, very short term CDs and bonds) are very low. Thus investors are not being paid much for these zero and near-zero risk investments.

Bonds have done very well in the past year, as the slowdown in growth has led to rising recession fears and a bond-buying spree that raises prices but drives yields down. Bond yields are quite low. 10-year Treasury bond yields are about one-tenth of their levels from 38 years ago (1.7% versus 15.8%). This means that, like yields for cash, yields for bonds are unattractive. The two positive factors are 1) while low, bond yields are greater than for cash vehicles, and 2) there appear to be few risks that rates will rise meaningfully anytime soon (and rising rates result in falling bond prices and low future returns). Thus we find bonds to be unexciting, with both low risk and returns expected in the future.

This leaves stocks, which, unfortunately, we also find uninspiring. US stocks are neither underpriced nor very overpriced. **US stocks appear a little overpriced, but not enough to really worry us.** The challenge is that we don't see reasons for strong positive returns from US stocks over the next year or two, while we do see a small risk of losses should the economy surprise us and enter a recession. **We find foreign stocks to offer a similar bland outlook.** While foreign stock prices seem cheaper than US stocks, and we like cheap, we can't see reasons for positive breakout economic moves overseas. All global markets are currently haunted by this trade war gloom.

In this 'nothing great' environment, we are keeping portfolios pretty boring, driving down the middle of the investing highway, not leaning far in any direction. In this manner, our focus is to keep making progress, while avoiding any big costly mistakes. We don't see obvious minefields ahead, nor do we see great opportunities. When uncertainty is higher than normal, moderation is warranted. **While there is drama in the headlines, strive to avoid drama in your portfolio.**