# AMB Newsletter 4th Quarter 2019

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**Third Quarter 2019 Review**

Volatility in the markets continues to be a theme and there was no exception in the third quarter. After a decent start to the quarter, risk assets sold off sharply in August. This was seemingly driven by Jerome Powell's, the Federal Reserve Chairman, hawkish cut the last week of July. Instead of the start of an easing cycle, the FOMC made a point to say this was a "mid-cycle adjustment". This is not what markets wanted to hear henceforth selling off by 6.5% in August. However, like we have seen many times recently, this corrective activity was quickly reversed in the month of September after yet another rate cut and the reopening of negotiations with China.

US equity markets, measured by the S&P 500, finished the quarter up 1.70%. Year to date returns for the S&P 500 now stand at 20.56%. Defensive sectors led the market higher for the quarter. Health Care and Energy were the largest detractors for the quarter. Health Care continues to face drug pricing scrutiny while worries of a global slowdown and oversupply of oil continue to weigh on the Energy sector. Information Technology was the top contributor and was responsible for 105 bps of the upside return. The overall return from the market has been broad based with all eleven sectors trading higher on the year. Information Technology continues to lead the way for the market now up 31.37% for the year and contributing over 30% to the S&P 500's total return for the year.

International developed equities trailed the US market for the quarter. Our international counterparts posted a combined return measured by the MSCI EAFE of -1.00% which puts them approximately 700 bps behind the US for the year. For the past year, we have written that international markets may not be as cheap as they appear based on their recent economic slowdown. However, the ECB has now stepped in once again to try and combat this slowdown in the Eurozone. During the quarter, they cut interest rates even further into negative territory and once again initiated their bond buying program. The Bank of England and Bank of Japan both stayed put during the quarter.

Emerging market equities once again trailed their developed counterparts. Emerging Markets, measured by the MSCI Emerging Markets Index, was down 4.11% for the quarter bringing its total to 6.23% for the year. This is 1400 bps behind the US market. The same factors that plagued Emerging Markets at the end of the year are still in play. As we said last quarter, "We do not expect emerging market strength to occur until we begin to see a real weakness in the US Dollar or growth around the globe starts to show signs of life. For now, we would rather be invested in the US equity markets." Dollar strength has continued in the face of an easier Fed and slowing global growth, as it seems the US economy is the only one buffing the trend of a slowdown. China's economic data continues to deteriorate, and global growth has continued to stall. We believe emerging markets have the best risk/return profile over the longer term; but as of now, we recommend staying invested domestically.

**Third Quarter 2019 Review (continued)**

Interest rates around the globe continued their downward move during the third quarter as macro data continues to disappoint and Central Bank policies continue to become more dovish. We are far from last year's autopilot comments at this point. The US FOMC has now cut rates twice this year, and there is the possibility of two more cuts this year. The ECB has cut rates further negative and reinstated their bond buying program. The economies in Japan, Europe, UK and China continue to look soft and it does not seem that a trade deal is close between the US and China. With all these factors weighing on rates, we have seen a dramatic move across the curve in the US with the 30-year breaking 2% for the first time in history. Over the past twelve-months, fixed income returns have outpaced their equity counterparts.

## 4th Quarter Outlook

### Economy (Global)

We stated at the end of last year that we felt imminent recession fears for the US economy were overblown. This was the correct call as the US economy has remained relatively strong. First quarter GDP came in well above expectation printing above 3%. In the second quarter, we began to see some signs of slowing growth, but GDP growth still surprised to the upside posting above 2%. AMB expects US economic growth to continue albeit at a slower rate as we are now entering our tenth year of this expansion. With the most recent data surprising to the downside, we have seen our belief realized that we are in the late stages of the current cycle. Even though we are beginning to see warning signs, our key indicators remain stable. Financial conditions remain stable and inflation has remained subdued as confirmed in the recent PMI releases. We still believe the earliest we will see a US recession is the summer of 2020.

Inflationary pressures will remain our focal point with our main indicator from those releases being wage growth. With 70% of the US economy comprised of consumer spending, this metric is our favorite for obvious reasons. Recent releases show that wage growth has yet to accelerate posting year over year growth of just 3.5% for supervisory workers. This continues to point to weakness in the labor market even with the unemployment levels being at historic lows. If we begin to see upward pressure from wages, our outlook will change. As it currently stands, the majority of World Central banks are easing as inflation has waned once again which gives them the leeway to loosen financial conditions further.

Our views on China and its overall impact on the global economy has not changed since our last letter. As we stated, "The main focus for the Global Economy should remain on China as it has contributed approximately one-third to global growth over the past eight years. Starting in 2018, China's slowing growth has been a drag on the global growth story which was brought on by increased trade conflicts with the US and tighter domestic policy. Both of these issues appear to be improving. Trade negotiations seem to be progressing between the two global economic powers after talks seemed to fall through in the second quarter, and financial conditions are easing as the PBOC injects liquidity into their financial institutions. We believe trade talks will progress as we get closer to 2020 due to the US's impending 2020 presidential election as trade spats hindering growth will not look flattering." One positive catalyst that has taken place that will ease pressure on China and the rest of the emerging economies is the pivot from the US Federal Reserve. Moving from a rate hiking cycle to a rate cutting cycle should help with capital flow issues and dollar strength which have both hindered the growth of emerging markets.

## Economy Global (continued)

As always, Central Bank monetary policy will continue to play a role in our economic projections as their role in the global economies continues to expand. Their actions have a direct impact on the money supply which can either promote or hamper growth. The US Federal Reserve has moved to full on easing and is expected to cut rates at least one more time this year. The ECB has taken their benchmark rate further into negative territory and restarted their bond buying program. The BOJ never stopped easing and will up the ante if they feel it is needed. All of that to say, world central banks are all in on delaying or averting the next global economic downturn. Our models and projections on future expectations will hinge on the moves these Central Banks make in the future.

As we move forward, our thoughts have not wavered, global economic growth will continue albeit at a slow pace. We feel fears of a global recession in 2020 are overblown and markets have overreacted to the downside, especially in regards to rates. Uncertainty will continue to be a headwind as the global trade disputes drag on. We do not expect growth to ramp up around the globe unless we get some kind of resolution. Without a trade deal, we expect the global economy to limp along throughout the rest of the year and on into 2020.

## US Equity Market

US Equity markets, measured by the S&P 500, turned in another positive quarter, posting a return of 1.70%. This takes the total return for the year to 20.56%. After the struggles of last year, 2019 has been a welcomed sight for equity investors. In our view, the move this year has been driven, by the overreaction in the fourth quarter of last year. The market seemed to be pricing in an imminent recession; and as we predicted many times, this did not take place. Because economic conditions are better than expected, markets had to be repriced once again and this has been to the upside for equity investors.

Our positive themes from the first half of the year remain intact. We believe the global expansion will continue throughout 2019; but as we said, we expect this growth to slow. Monetary policy has moved from a headwind to a tailwind in the last six months. We believe the easier financial conditions will put a floor under equity valuations. Resolving trade negotiations could be the largest tailwind for equities going forward.

Looking ahead, the short term still holds plenty of uncertainty. We expect the market to be volatile and headline driven from now through the election. On the bright side, profit growth has remained strong, and we expect strong single digit growth though the first quarter of 2020. With equity market multiplies currently trading in line with their historical averages, we believe there is still plenty of room for US markets to move higher.

Here at AMB, we believe in investing for the long term to reach your long-term financial goals. It is impossible to judge quarter to quarter market fluctuations but our “longer term” fundamental view of the equity markets remains intact, for now. We continue to believe we are in a secular bull market. Trade spats and other crosscurrents will put earnings expectation and global growth in flux. Because of these ongoing issues, we believe quality companies with strong balance sheets and free cash flow are where we need to be positioned.

Our equity summary from last quarter still fits our narrative precisely. We stated, “The US equity market continues to be more attractive than the rest of the world. It is true that Europe trades at a cheaper valuation. The reasons for this are plentiful, and we believe those suppressed valuations will continue as the Eurozone continues to slog along. We remain negative on emerging markets as well. Until the trade is resolved, EM countries are going to struggle. The UK looks attractive; but with the current overhang of BREXIT, we don’t recommend putting money there. When looking around the globe, US large cap equities remain our top pick.”

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## US Fixed Income

After three years of a tightening cycle, the US Federal Reserve has changed course and once again entered an easing cycle even if they do not want to call it that. As a panic hit the markets at the end of 2018, Fed Chairman Powell calmed markets with a dovish pivot. Since that time, the FOMC has cut interest rates twice, stopped the balance sheet runoff of assets, and created a standing repo facility (QE light). With the US economy still growing at a respectable rate and unemployment at historic lows, the Fed had to change from its data dependent mantra and take a more global outlook.

Due to the mid-cycle adjustment by the Fed, fixed income markets have seen further declines in interest rates. During the quarter, we witnessed the 30-year Treasury break at 2% for the first time and also saw a 2/10 inversion. This move has led to very strong returns for bond investors. Fixed income returns have outpaced their equity counterparts over the latest twelvemonth period. We continue to keep our eyes on the credit markets for any signs of cracks. The 2/10 inversion earlier in the year has been a good indicator of an upcoming recession if viewed from the lenses of the past. However, with the unprecedented bond buying of the Federal Reserve that has artificially lowered longer term rates, we are not sure if it still carries the same weight.

Our views have not changed since December. We still believe it is a good time to move out of lower credit and into higher quality credits. As we have seen, credit markets flashed warning signs at the end of the fourth quarter and now the yield curve and economic data are flashing yellow. With the massive amount of corporate debt on the books, a major economic downturn could turn ugly quickly. With this in mind, being in higher quality names is prudent. Another major factor is liquidity. If we get into a credit crunch, high yield markets could seize up. We still like the belly of the curve, but we are moving our duration target from overweight to neutral. The long end remains unattractive as one is not being rewarded for the increased interest rate risk that would be taken.

As always, investors should remember why we invest in fixed income. It is not the growth engine of portfolios, yet it brings stability and predictability. When using a buy and hold strategy, interest rate movements are irrelevant as we are investing for a stream of cash flows and the safety of principal (which will be repaid upon maturity as long as the bond is credit worthy). Fixed income provides diversification and stability to an inherently more volatile equity portfolio, and we feel it should play a part in every portfolio in some facet.

## Conclusion

Volatility has continued throughout the third quarter and we do not expect that to change heading into the end of the year. We are still forecasting positive growth for the US economy although we do expect it to moderate closer to the 2% range. Barring a major shock to the global economy and trade tensions not worsening, we believe the US will avoid recession in 2020. Our view on the equity markets remains intact, as it has all year. We continue to believe we are in a bull market, but we believe leadership within the market will change in the coming quarters. Value has long underperformed growth and that disparity is now the same as it was in 1998. We expect value to outperform its growth counterparts in the near future. Fixed income investing remains tough with real rates hugging the zero line. Until we get some movement in the curve, we believe the belly is the best place to be invested along with investing in higher credit quality names. As always, we will be keeping a close eye on economic, geopolitical and fundamental data; and if perceived risk begins to rise, we will take action to position accordingly.

Thank you for the opportunity to help you achieve your financial goals.

**Matthew J. Roach, CFA ®**

**Director of Portfolio Management**