Monthly Market Review

September 2019

What happened in September?

The MSCI All Country World Index gained **+2.1%** in August while the Barclays US Aggregate Bond Index fell **-0.5%**. Gold was down **-3.8%** and underperformed broad commodities, which were up **+1.8%**. This month's market action reflected a partial retracement from the trends that persisted in August, when equities were down while bonds and gold were up.

The global manufacturing recession continues.

Manufacturing continued to contract across major global economies in September, and it was especially noticeable in the world's largest economies. China's industrial production decelerated to a seventeen-year low, while Germany's manufacturing PMIs continued to plummet to levels not seen since 2009. The US manufacturing sector, which had been semi-resilient to the global manufacturing recession, has now contracted for the second consecutive month and is at a ten-year low.

We are monitoring the consumer and service economies closely despite their strength.

Throughout history, there have been several instances where the US manufacturing sector has contracted without leading into a full-blown economic recession. The services sector accounts for a large portion of economic growth in developed economies, and it is still expanding in the US and globally. The US consumer sector is not stressed yet, but we're keeping a close eye on it because if these data start to deteriorate it may signal that we are likely to enter a recession sooner rather than later.

Central banks are easing, but do they have the ammunition to engineer a soft landing?

Central banks are proactively cutting interest rates in an effort to extend the economic cycle. The Federal Reserve cut its policy rate by another -0.25%, and it is likely to begin expanding its balance sheet again in response to the recent turbulence in overnight repo markets. The European Central Bank cut its policy rate from -0.4% to -0.5%, going further into negative territory, and introduced a bond-buying program that was larger than anticipated. China is expected to further support its markets as its growth continues to decelerate and trade war uncertainty mounts; however, there are serious concerns as to whether China will be able to implement the stimulus necessary to stop its economy from slowing.

How will the market react to the first negative earnings season in three years?

Three weeks from now, most S&P 500 constituents will have reported 3Q earnings. Consensus

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is expecting earnings growth to be negative, and if they're right that would be the first time the S&P 500 has registered negative earnings growth since 2Q16. It will be interesting to see how the market responds to that because negative earnings growth in conjunction with deteriorating economic data could facilitate higher market volatility in the coming weeks.

We expect inflation to accelerate over the next two quarters, which could provide a backdrop for higher commodity prices and lower bond prices in the near term.

After a year in which investors were rewarded for taking duration risk in every asset class, it is possible that the consensus is under-positioned for a transition in inflation expectations. If the US economy stops slowing over the next one or two quarters while inflation is accelerating—which is currently our base case forecast—that could provide a tailwind to commodity prices and a headwind for bond prices. As a result, it may be prudent to reduce duration and increase exposure to commodities/equities in the very near term. However, we are keen to exercise patience here by waiting for the market to signal that this phase transition is underway prior to acting, especially given the increased likelihood of a tough Q3 earnings season.

We continue to favor defensive assets.

Although we manage each portfolio individually, we have generally positioned them conservatively to help protect against the effects of rising recession risks and a slowing-to-flat growth trajectory in the coming quarters.

- **Reduce equities; increase bonds**: We have reduced equity exposure and shifted to more defensive assets such as bonds and other yield-oriented investments.
- **Reduce growth stocks; increase value stocks**: We have shifted exposure from growth equities to defensive equities, replacing technology stocks with utilities, consumer staples, and REITs.
- **Reduce European equities**: We have decreased exposure to European equities because the growth outlook for the region has diminished and the European Central Bank has limited tools at its disposal to combat the next economic contraction.
- **Increase credit quality within fixed income**: We have increased credit quality by reducing corporate bonds and increasing exposure to US Treasuries.
- **Increase duration within fixed income**: We have increased exposure to intermediate and long-term US Treasuries. Longer-duration treasuries have historically performed well when economic growth is slowing and inflation is under control.
- **Increase exposure to gold**: Gold can provide a hedge against 1) lower real interest rates, 2) increased market volatility, and 3) an erosion of purchasing power. We believe that preserving purchasing power will be important in the coming years given the unprecedented levels of monetary and fiscal stimulus (i.e., money printing) that will likely be required to stem the next economic downturn.

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