October 2019 Commentary

It was only one year ago that the stock market began tumbling nearly 20%. Investors and economists were worried about the Fed over-tightening interest rates, trade wars dooming the global economy, and the business cycle swiftly ending in a recession.

While economic growth has slowed and trade disputes between the U.S. and China have been a source of uncertainty, the economy and stock market have continued to chug along. As we kick off the fourth quarter, the S&P 500 is up 20.6% including dividends. Investors who abandoned ship when markets were rocky last year would have missed out on the spectacular rebound.

This is the nature of the "wall of worry" that all investors must climb. Constant economic data and news headlines may be troubling but attempting to time the market rarely works. Instead, history shows that while there may be short-term fluctuations in the market, those who stay invested are often rewarded. Understanding longer-term trends is the better way to construct portfolios that stand the test of time.

Perhaps the most dramatic market development over the past quarter has been the rollercoaster move in interest rates. The 10-year Treasury yield, which had been falling all year, plummeted to around 1.45% - the lowest in three years. As a result, the yield curve officially inverted, meaning that the yields on the 2-year Treasury were higher than those on the 10-year. Interest rates are higher since then and the yield curve is steeper, but not by much.

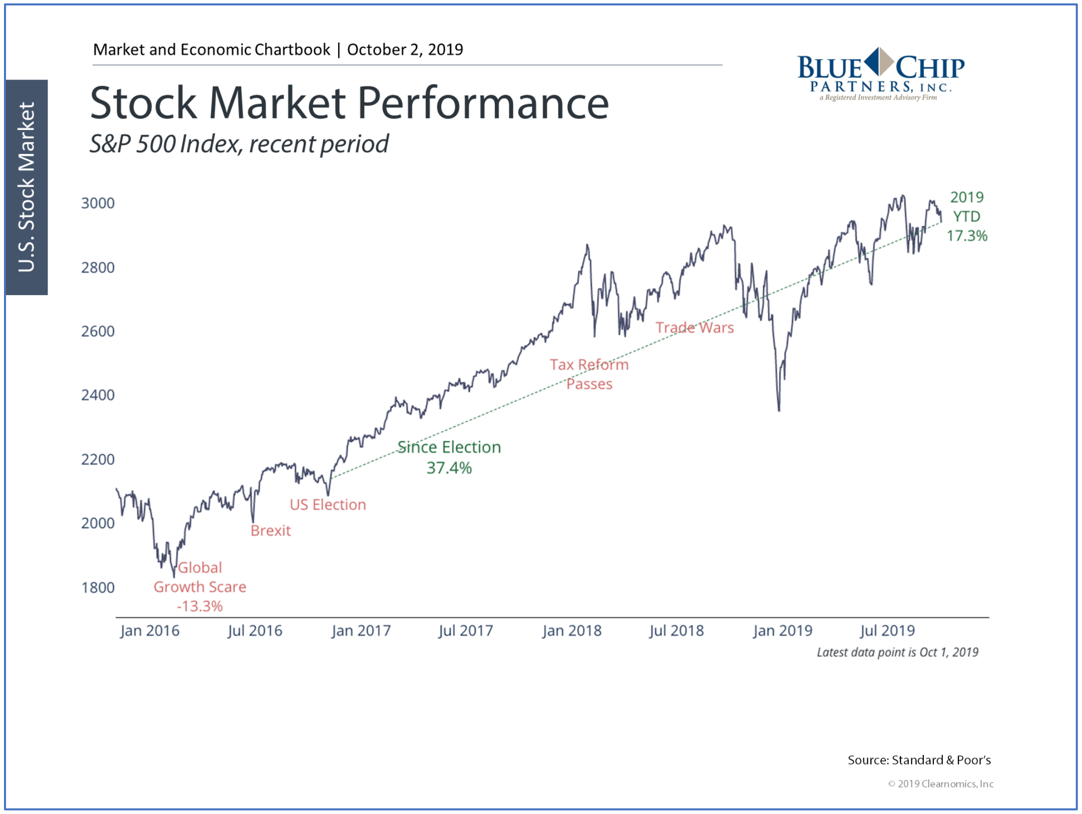
The yield curve is important as a standard measure of the business cycle. Specifically, a yield curve inversion has historically acted as a canary in a coal mine for upcoming recessions. There have, however, been false positives in the past - most prominently in the late 1990's. More importantly, the end of a cycle is a process that takes time. Historically, it's taken up to 2 years between a yield curve inversion and a recession. This could be the case this time given the low nature of interest rates and previous Fed tightenings.

Still, it's undeniable that the economy has slowed. This is partly due to where we are in the business cycle, with a very low unemployment rate and a historic level of job openings, and partly due to uncertainties around issues like U.S.-China trade. The Leading Economic Index confirms that the economy has been slowing for a year, and other measures such as the ISM manufacturing index suggest that industrial activity has slowed too.

Just like the yield curve, these measures imply that we may eventually have a recession. But for long-term investors, this is nothing new. Preparing for a variety of economic outcomes by staying invested and maintaining a diversified portfolio, rather than trying to get the exact timing right, is always the main playbook. Thus, the key to achieving one's financial goals in this market environment is no different than in other circumstances.

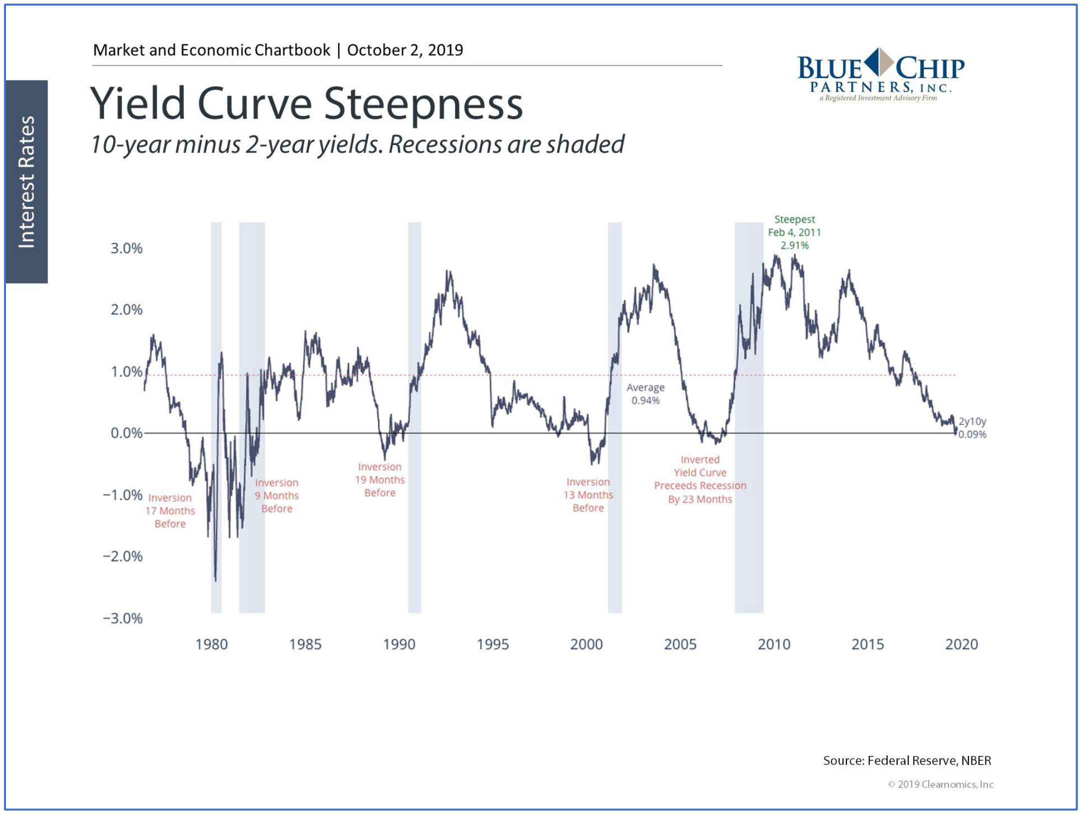
Here are charts on topics that will continue to move markets during the final quarter of the year:

1. The Stock Market has had a strong year



The S&P 500 has gained 19.1% with dividends, and the Dow Jones Industrial Average 16.0%. Much of this was a rebound from the market lows that resulted from market volatility one year ago. Those investors who stayed focused and disciplined were able to enjoy the recovery.

2. Interest rates have fallen sharply and the yield curve inverted for the first time this cycle



Interest rates have fallen further over the past few months. Not only is the Fed now *lowering* interest rates, but low rates globally continue to drag U.S. rates down. The most important result of low interest rates, economically speaking, is that the yield curve officially inverted. This is a classic signal of a recession, usually within two years. Still, this is no reason for investors to panic.

First, the chart above shows that this has been a steady process. Based on what we know about historical market cycles, it was very likely that the yield curve would eventually invert. Second, yield curve inversions and recessions are a process, not an overnight event. And finally, this time is slightly different due to the low nature of interest rates over the past ten years.

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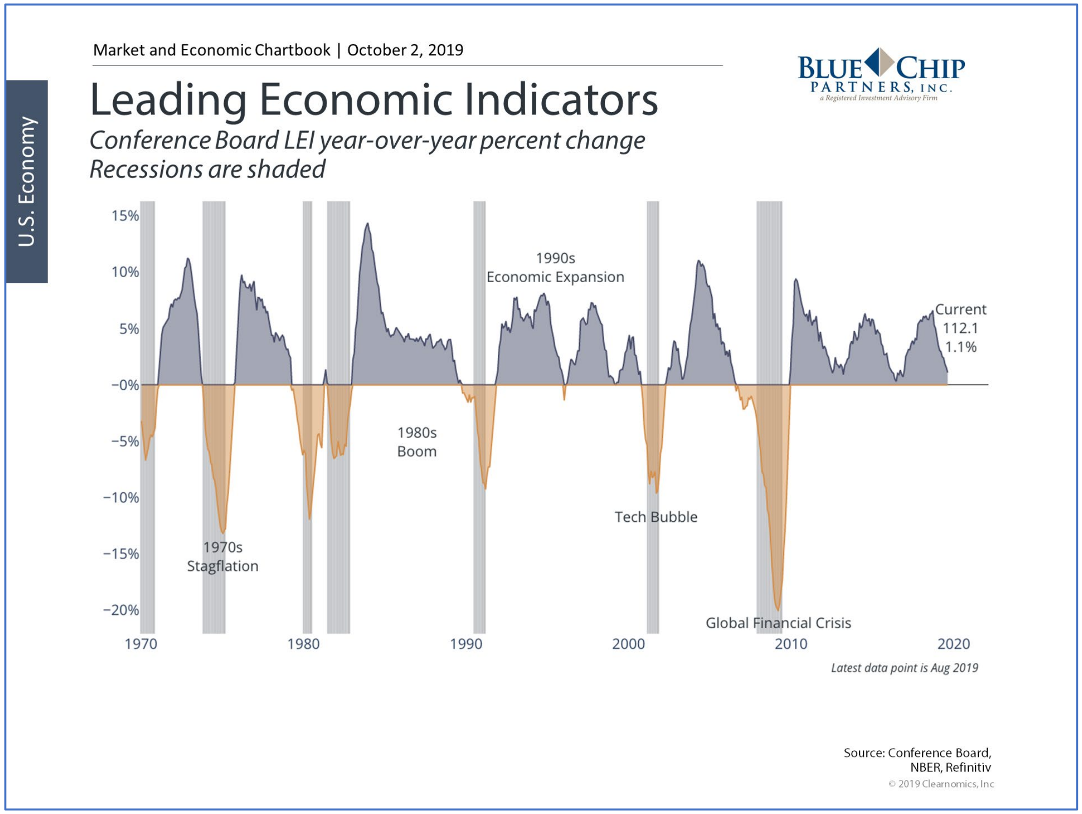
3. Economic growth is slowing



Consistent with the shape of the yield curve, economic indicators suggest that the economy has been slowing over the past year. This is partly due to how far along we are in the business cycle, which is now the longest in U.S. history, and partly due to uncertainties around trade agreements and other macro-economic events.

What matters for long-term investors is that, even if the economy is slowing, it is still fundamentally healthy. The economy has created an average of 158,000 new jobs per month this year. Consumer spending is still positive with household net worth at historic levels. GDP growth may be slowing to 2%, but that is still a healthy pace.

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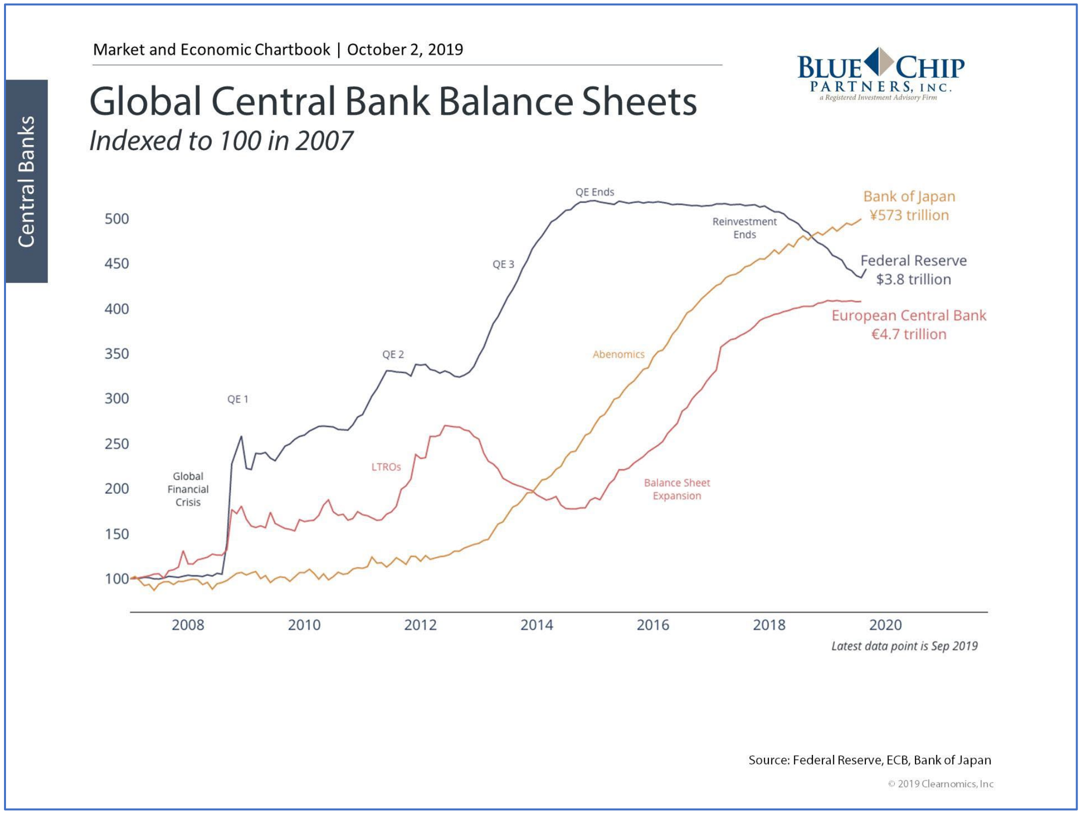
4. Central banks are increasing economic stimulus



As a result of global concerns and an inverted yield curve, the Fed began cutting interest rates during the middle of the year. They've now cut twice by 25 basis points (one-quarter of one percent), after nine rate hikes earlier in the cycle.

The good news is that this may support the economy during a period when there is greater uncertainty. The bad news is that many investors may come to expect the Fed to "bail out" the markets. This is often referred to as the "Fed put" - i.e. it's akin to a put option that protects investors from losses.

The Fed isn't alone. The European Central Bank recently lowered interest rates further into *negative* territory and increased its asset purchase program. It's clear that central banks have come full circle and are working to support their economies once again.

What's the bottom line? There will continue to be economic and market uncertainty during the latter months of 2019. Long-term investors should stay patient and maintain diversified portfolios to achieve their financial goals.