A View from the Tower

Third Quarter Summary 2019

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After rising in the first two quarters of 2019, post the December 2018 sell off, equity markets were a little more volatile in the third quarter. Domestic large-cap stocks was the only major segment to see an increase in the quarter (approximately 1.7% based on the S&P 500) with domestic small and mid-caps showing slight declines. In general, international markets (developed and emerging) were down in the quarter as the strengthening U.S. dollar represented a fairly significant headwind. Additionally, the Federal Reserve enacted two rate cuts at 0.25% each (0.50% in total); one on July 31 with the other coming on September 18. In the next few months, possibly quarters, we should likely start to see the benefits from this stimulus as rate cuts normally start to have a positive impact on the economy within three to eight months. In the short run however, it appears that the positive news of rate cuts was materially offset by continued discussions of higher tariffs and trade war with China. The market continues to look for a resolution to this situation as it potentially negatively impacts the industrial production component of the economy. However, so far we believe these dynamics have been more than offset by a resilient and strong U.S. consumer, which in the current era dominates the landscape, as we will see below.

A Tale of Two Parts of the Economy:

The Industrial Economy (15% of U.S. GDP): As alluded to above, the industrial portion of the U.S. economy has continued to weaken as the year has progressed. One of the better indicators to look at for a view of the industrial economy is the ISM (Institute for Supply Management) Manufacturing PMI (Purchasing Managers Index) as depicted below:

Source: Bloomberg

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The PMI is based on a monthly survey of supply chain managers across nineteen industries. As one can see, it peaked at 61.3 in August 2018 and has since plummeted to 47.8 in September 2019. What do these numbers mean? A 61.3 in the survey over time has represented a GDP growth trend of 5.6% while a 47.8 as seen in the most recent version has correlated with 1.5% GDP growth rate. So, while the industrial economy is clearly slowing, one could argue it was possibly near overheating in 2018, driven primarily by tax cuts. Now in 2019, we are moving back to a little below trend line (at 1.5% vs. expected GDP growth of around +2.0% for 2019) as we lap the tax cuts and experience tariff headwinds. Quotes from the August 2019 survey included the following:

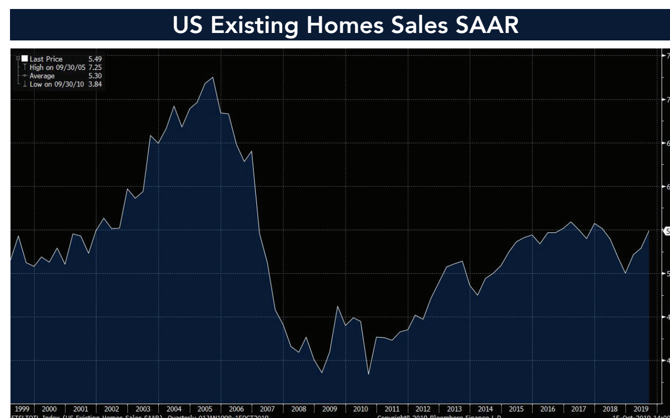
> *"Continued softening in the global automotive market. Trade-war impacts also have localized effects, particularly in select export markets. Seeing warehouses filling again after what appeared to be a short reduction of demand."* (Chemical Products Sector)

> *"Chinese tariffs going up are hurting our business. Most of the materials are not made in the U.S. and made only in China."* (Food, Beverage & Tobacco Products Sector)

> *"Economy seems to be softening. The tariffs have caused much confusion in the industry."* (Electrical Equipment, Appliances & Components Sector)

The commentary above is evidence of why we think a resolution on the trade front is particularly important, despite the potential positives coming from the aforementioned rate cuts by the Federal Reserve, with the possibility of a third cut before year-end.

The Consumer Economy (70% of U.S. GDP): The consumer economy remains resilient. Unemployment is currently at 50 year lows, wage growth has been picking up and the interest rate cuts have acted as igniter fluid for what had been a slowing housing market. Below please find a chart of the SAAR (seasonally adjusted annual rate) of existing home sales that helps to depict the health of the housing economy:



Source: Bloomberg

One can see that the housing market slowed in 2018, but with the recent fall in mortgage rates (the 30 year has moved from 4.75% within the last year to the 3.75% neighborhood recently) momentum in this area has picked up again in 2019. As long as the U.S. consumer remains healthy, GDP should continue to grow. However, an eye still should be kept on the industrial economy, as the recent stimulus moves will likely help that portion of the economy to find a bottom.

Finally, the market historically tends to remain relatively strong heading into an election year. As always, there are things to be worried about, but at this point, we do not see any specific reason to expect a recession in the near term. We are assuming the U.S. consumer remains strong and the slowing industrial economy hopefully stabilizes in the first half of 2020, barring any unforeseen further, tariff related events.

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