OCTOBER 18, 2019

The third quarter of 2019 was a slugfest in the equity markets. On three separate days in August, the S&P 500 declined more than 2.50%, any one of which would have been the worst single day in 32 of the last 70 years. Yet, over the entire period, stocks modestly advanced, with the index rising 1.75% between July 1 and September 30. In our view, this volatility was triggered primarily by growing fears of a slowing U.S. economy. However, equity investors were quickly mollified by an accommodative Federal Reserve Board and sharply lower interest rates. The U.S. central bank cut the Federal Funds rate twice (in July and September), and U.S. interest rates declined across the board.

| | 6/30/2019 | 9/30/2019 |
|---|---|---|
| U.S. 1Y T-Bill | 1.94% | 1.76% |
| U.S. 2Y T-Note | 1.73% | 1.62% |
| U.S. 5Y T-Note | 1.75% | 1.55% |
| U.S. 10Y T-Note | 2.00% | 1.68% |
| U.S. 30Y T-Bond | 2.52% | 2.12% |

Faced with historically low rates and aided by generous lenders, capital continues to flow into the stock market. Yet fears of a slowdown persist despite buoyant equity prices. The case for recession seems straightforward and convincing. Investors have a well-worn laundry list of worries: Brexit, Eurozone weakness, the negative effects of trade wars and escalating tariffs, and the unprecedented length of the recovery.

The last of these can be addressed head on. While we have benefitted from a decade of uninterrupted growth, the rate has been moderate and has not led to the excesses that typically signal an overheated economy. Unemployment is at historic lows, but there has been little or no upward pressure on wages. Inflation remains below 2%. Recoveries do not die of old age alone.

Brexit may command headlines, but we do not believe it will have a significant impact on the U.S. economy, no matter how sloppy the process. If impeachment proceedings are brought against President Trump, history will not provide much guidance about the potential market reaction. Stocks declined meaningfully during the Nixon trial, but that was a continuation of an already 18-month-old bear market. Likewise, stocks followed the already established trend during the Clinton proceedings by continuing to rally. If the hearings had any impact in either or both cases, it was undiscernible.

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We are more concerned about the possibility of policy errors here and abroad. Trade wars and escalating tariffs clearly have the potential to add unproductive costs, damage both business and consumer sentiment and derail well established markets and supply chains for goods and services. These risks now appear to impact the Eurozone as well as the U.S. and China.

Europe has an additional set of risks. The effectiveness of monetary stimulus alone seems to have run its course. Eurozone GDP was a paltry 0.2% in the second quarter, half of what it was in the first. Both Mario Draghi and Christine Lagarde (respectively the outgoing and incoming presidents of the European Central Bank) have called for member countries to employ meaningful fiscal stimulus to spend their way out of the slowdown. With more than $5 trillion of negative yielding debt, the European bond market seems to be suggesting that those pleas are falling on deaf ears.

We entered 2019 with the view that economic growth would at least slow in the U.S. and that a mild recession was a possibility. These views have not changed. Corporations and consumers are still well positioned to weather a retrenchment. Lenders have not overextended. Recessions are a certainty, no doubt. But if the next one arrives sooner rather than later, we continue to believe that it will be shallow and not approach crisis levels.

Treasury rates continue to be anchored by extremely low global rates and the fear of lower growth in Europe affecting the U.S. more than originally anticipated. As of the end of the third quarter, the U.S. boasted the third-highest 10-year Treasury rate among developed nations (1.68%), and those levels have attracted foreign buyers on both a currency hedged and, in some cases, an unhedged basis. The occasional increase in interest rates, typically on the news that the U.S. and China are headed for a trade agreement, is quickly retraced given investors' desire for fixed income. At almost every opportunity, the demand for yield has pushed yields back towards new lows.

It's difficult to believe we'll have any period of sustained higher rates in the near to medium term. Inflation remains contained, and monetary stimulus is losing its efficacy. Even if the Federal Reserve introduces additional tools beyond its expanding balance sheet and low lending rates, the emphasis seems to focus on avoiding a slowdown rather than fostering growth.

If 2019 has proven anything, it is that even in a low-rate environment, fixed income securities can have significant positive returns. Our portfolios that are actively managed were able to take advantage of the higher rates at the beginning of the year and we believe, within a client's financial plan, adjusting durations, rotating sectors, or avoiding individual credits will continue to be fruitful even while rates remain low.

**Looking Forward**

As we head into year-end, we will continue to be watchful for evidence that either confirms or contradicts our economic assumptions. This does not mean sitting transfixed by twitching monthly indicators like unemployment claims or various regional manufacturing surveys. We are more interested in the potential appearance of the formerly unpredicted.

The U.S., China and the European Union are the three main drivers of the global economy. The U.S. is in the best shape. Growth has slowed in China but is still solidly positive (according to admittedly opaque official statistics). We think much of the global economic malaise can be attributed to the aforementioned struggles in the Eurozone.

Germany, Europe's largest economy, sets the policy tone for the bloc with its strict balanced-budget orthodoxy. German GDP actually shrank 0.1% in the second quarter. Should this continue, already growing populist pressure from both the left and right may persuade the current government to loosen the purse strings and fund public spending projects. While still unlikely, if this were to occur, other European governments would be inclined to follow suit. Coordinated fiscal stimulus could easily tilt the global economy toward a more solid growth path.

A stronger global economy might encourage investors to take more risk. For U.S. markets, that would likely mean a shift in leadership from defensive sectors to more cyclical ones. Small-cap stocks, which have lagged this year, might return to favor. International and emerging market equities, which currently trade at a discount (deserved in our opinion) to U.S. stocks, might attract attention.

Political or economic surprises may cause us to make portfolio adjustments at the margin. However, to be clear, writing and investing are two very different enterprises. When it comes to the latter, whether for ourselves or on your behalf, we stay true to our most firmly held beliefs. Whether stocks or bonds, the specific attractiveness of individual issues is paramount. We endeavor to identify solid businesses with durable competitive advantage, shareholder friendly management and financial structure that can withstand challenging environments. We hold onto those investments as long as the market prices them appropriately. Of course, we make mistakes along the way, but we do our best to address them and move on. So far, 2019 has been a good year to be invested in financial assets in general, and particularly our portfolios of high-quality stocks and bonds.

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