

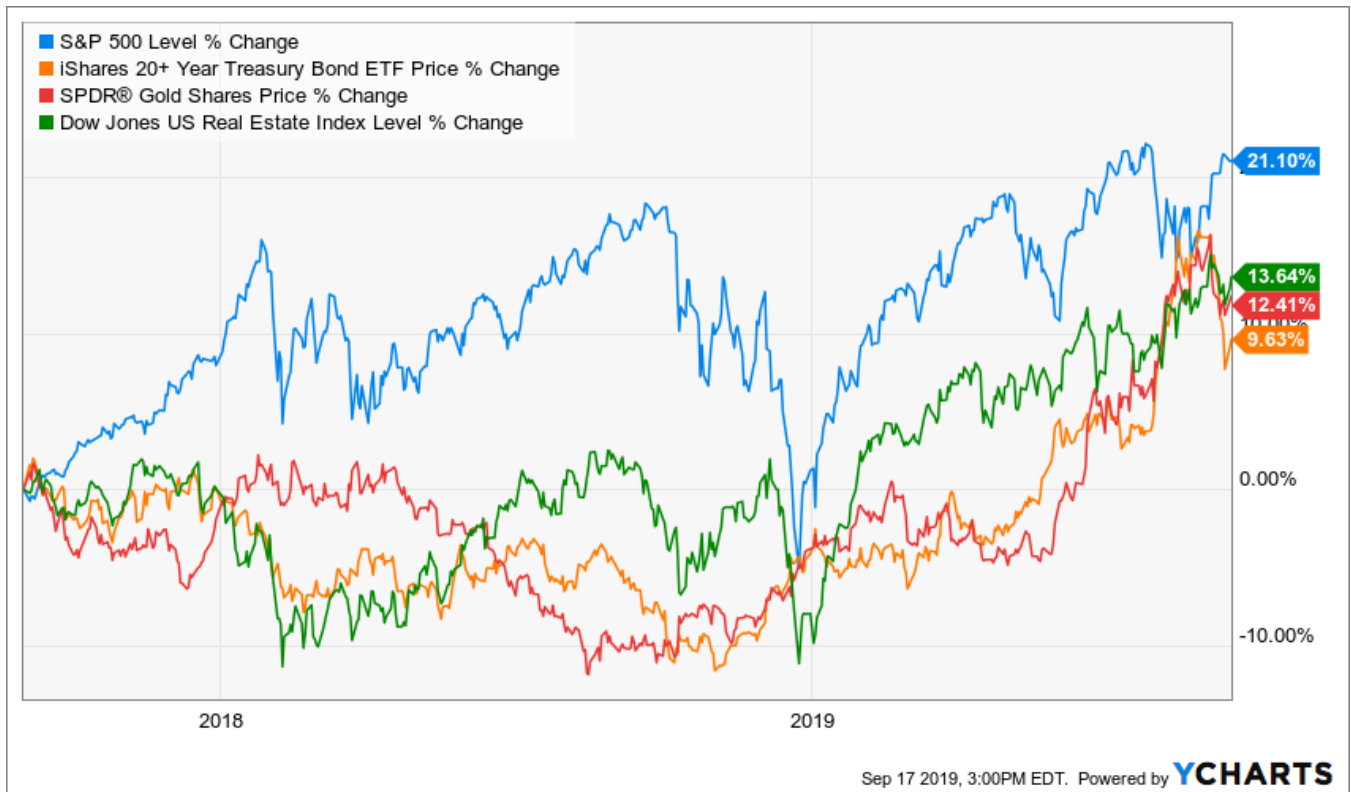
Market Update

September 17, 2019

Something Else is Also Impacting Rates and the Yield Curve

- There was good news in the trade negotiations between the U.S. and China last week, as the President announced a postponement of tariffs, and China exempted key agricultural goods (pork and soybeans) from existing tariffs.
- The European Central Bank lowered its key policy rate further into negative territory this week, and announced a plan to restart asset purchases, that will continue “for as long as necessary” to bring inflation back to target.
- U.S. core inflation picked up in August and retail sales beat expectations. Even so, the Fed is likely to cut rates by 25 basis points when it meets next week, likely citing global growth and trade headwinds.
- US Equities markets are close to all time high levels again and oil prices spiked and then retreated over attacks in Saudi Arabia.

U.S. Equity prices are proving to be more resilient than popular anticipation. This is likely attributable to still decent economic indicators in the U.S., good news on the China negotiations and International markets experiencing struggles. The chart below shows a recent convergence in the pricing of Long U.S. Treasuries, Gold, and U.S. Real Estate with Equities, compared to the longer-term path prices took in this two-year chart. However, many fears have, in the short term, subsided and we see, toward the end of the chart, Equities rising and Long U.S. Treasury, Gold and U.S Real Estate prices moving in opposing directions.

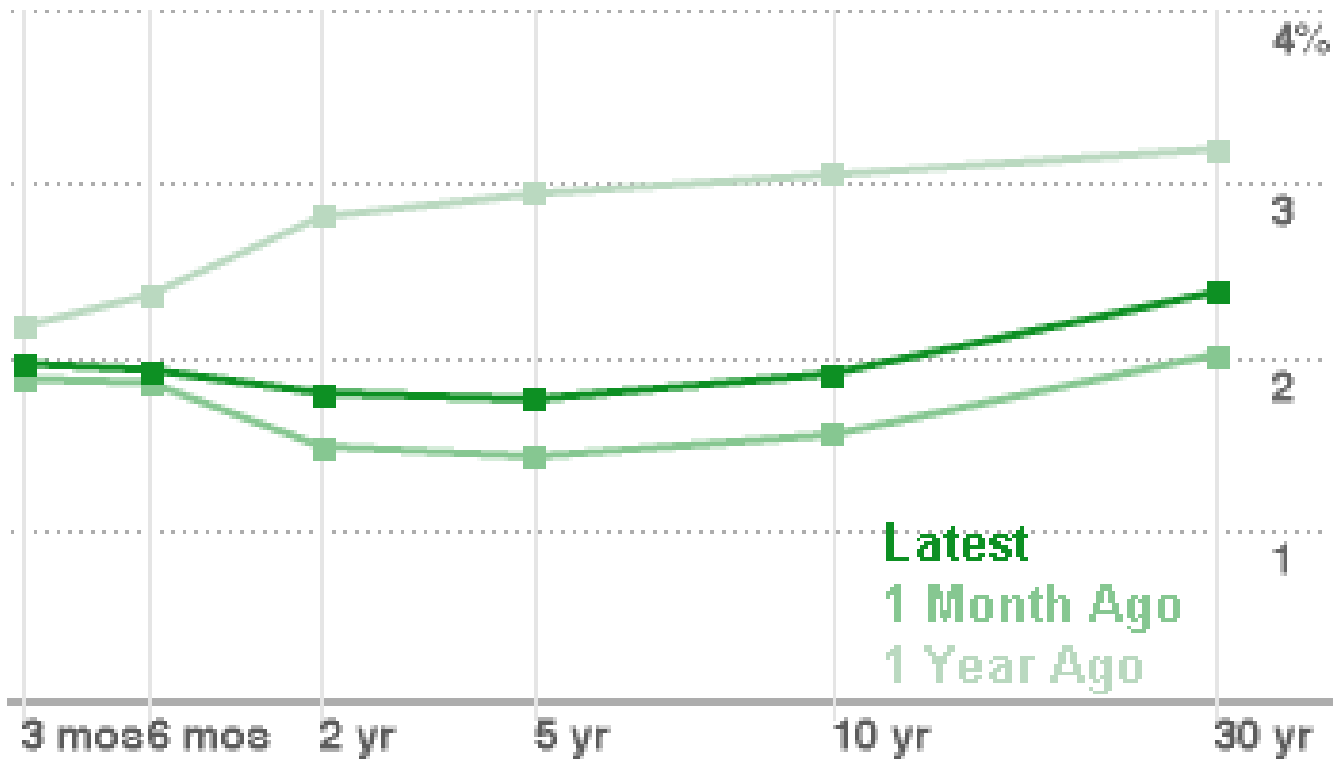


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The U.S. yield curve, as seen below, flattened out from the prior month, as rates started climbing back up. A few immediate reasons for this would be more optimistic news on China trade negotiation, decent U.S. economic data and the potential for the use of a 50-year treasury. However, one of the more under examined and talked about aspects of what is affecting the U.S. yield curve is the existence of negative interest rates for many other countries. The ECB introduced negative interest rates in 2014. The bank of Japan adopted negative interest rates in 2016. Germany established negative interest rates, as well. This is important because it forces investment managers, sovereign wealth funds and governments around the world to find positive yields in their investment holdings. The U.S., considered the safest place to invest, is seeing money flow into treasuries. When this happens, Treasury rates move down and prices of bonds move up. This is the inverse relationship between bond prices and bond yields that is often discussed. As investors, we need to understand that this has an impact on our yields and the yield curve. The yield curve has inverted, which is often considered a leading indication of a recession, that may occur several months to a few years out. However, it is also important to note that negative interest rates may be helping this yield curve inversion and providing some reason to be skeptical, of this indicator, or at least the depth of the potential recession to come. The use of longer dated 50-year U.S. Treasury bonds that is being discussed, could provide a mechanism for stabilizing and reshaping the yield curve back towards a more positive slope. In the meantime, lower rates could be helpful to the consumer and the real estate markets, by helping the consumer with lower debt cost and making housing more affordable.



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Our belief is still that there are signs of a later stage economic environment. Any future recession we feel would be mild in comparison to others, at this point. It is worth noting that several catalysts are on the horizon, that could slow down the eventual arrival date of a recession, which is indicated by two successive quarters of negative GDP growth. We are a long way from that as of today, but must continue to watch the data as it comes in. The biggest concern for the economy in the next 12 months continues to be the Federal Reserve interest rate decisions. Chinese trade issues could quickly turn into a positive, if a deal is made. This would potentially create a reason for equities to rally. The Federal reserve also has some ammunition regarding interest rates and balance sheet management, that it can implement to help the U.S. economy work through the global issues, at the forefront of the inversion, in the yield curve. The Federal reserve dual mandate is to enact monetary policy decisions to combat inflation and maintain employment. A key factor missing right now is hyper inflationary pressures, commonly seen before recessions in the global marketplace. We currently view this as a positive. Fiscal policy decisions from the U.S. government are also elements that can come into play, should we need to see some type of further action, to augment Federal Reserve policy decisions.

Having a disciplined investment and risk management process, regardless of market action, is the foundational elements to our portfolio designs. It is this portion of the approach, of portfolio management, that helps consistently reduce the long run risk taken in a portfolio of investments. Speculating about near term directions in the markets can be and often is a difficult and risky proposition. We can control the risk and process we take in our portfolio construction, but we cannot control market performance.

Overall, we prefer domestic equities over international equities. We prefer more value-oriented stocks vs. growth stocks, currently. As we have stated in the past, value stocks tend to move more slowly in either direction, when the markets react to stimulus. In later stage economic environments, a tactical shift to overweighting value type stocks can reduce portfolio risk. As we watch interest rate policy decisions from the Federal Reserve, we will evaluate our stance and potentially look to opportunities that exist in more of the growth areas of the market. These are areas we are looking at, to continue to make tactical changes, over the course of the coming months. We are currently neutral on fixed-income and interest rates. It is important to maintain discipline regarding long-term strategic asset allocation. However, as market conditions dictate, we are looking at tactical opportunities to reduce risk in portfolios, if necessary.

If you have questions or would like to discuss this further regarding your personal portfolio, please contact me at 310-469-7254.



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