COMMENTARY

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"In reality, no one knows what the market will do." – Seth Klarman

U.S. stocks continued to grind higher in the third quarter despite elevated bouts of volatility along the way. This now familiar pattern of market selloff followed by market strength has resulted in very strong YTD performance for most broad U.S. stock indices, but only modest returns on a 1-year basis. Trade related headlines, the actions of the Federal Reserve, and manufacturing data remain among the biggest drivers of markets at this time.

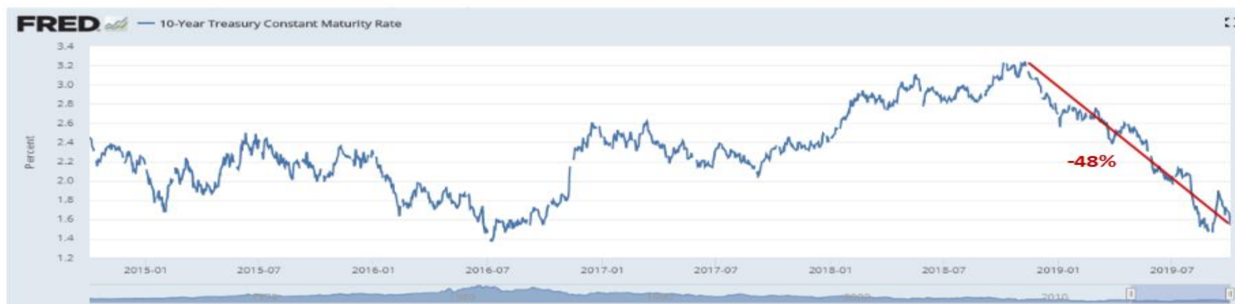
S&P 500: 1-Year Performace

Source: Yahoo Finance. Blue line represents S&P 500 price return over trailing 12 months as of September 30, 2019.

While U.S. stocks have generally provided positive returns over the trailing 12 months, the returns of U.S. bonds during this period have been even better. Consider a 1-year return on the S&P 500 of 4.25% at quarter-end, versus the 1-year return on the Barclays Aggregate Bond Index of 10.30%. The significant fall in interest rates for the period has been a major tailwind for bond returns, as bond prices move opposite rates.

The benchmark U.S. 10-Year Treasury yield hit a 5-year high of 3.24% last fall, compared to 1.68% at the end of the recent quarter, representing a nearly 50% decline in yield. Declining rates have lowered financing costs for many borrowers, including homebuyers. The rate for a 30-year mortgage now sits 1.3 percentage points below the year ago high of 4.94%, a 26% drop. These levels are among the lowest rates of the past 10 years.

10-Year Treasury Constant Maturity Rate: Trailing 5 Years



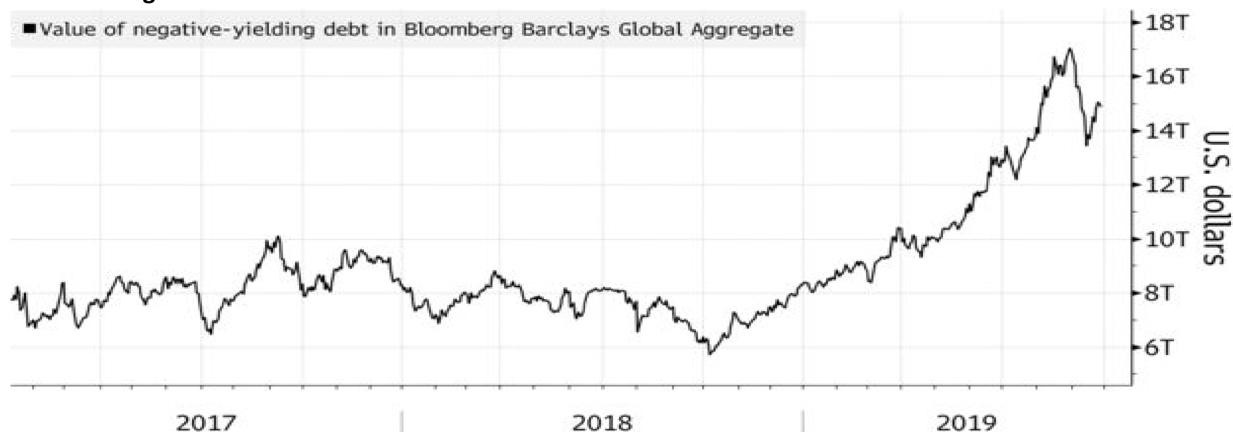
Source: Federal Reserve Economic Data as of September 30, 2019

Slowing global growth and muted inflation have driven rates lower across the yield curve and resulted in renewed central bank action. The Federal Reserve cut rates twice in the third quarter—the first cuts since 2008—in an effort to sustain the current record-long expansion. The Fed Funds rate now stands at a range of 1.75%-2.0%, with the futures market pricing in at least one more 25 basis point rate cut before year-end. Notably, rates have declined during a period of increased treasury supply, a condition that should normally lead rates higher.

While rates remain low but positive in the U.S., negative rates in Japan and across Europe continue to make headlines. German government bonds turned negative across the yield curve earlier this year. Japanese bonds are likewise negative through 10-year maturities, while remaining marginally positive for longer dated notes. One of the latest extremes involves negative interest rates in Denmark on residential mortgages, a scenario in which Danish borrowers are getting paid to take on mortgage debt.

How did we get here? Negative interest rates were introduced in 2014 when the European Central Bank decided to pay commercial banks a negative rate on deposits that were held at the central bank. The Bank of Japan followed suit. Negative rates, effectively a charge for holding excess reserves, were intended to encourage bank lending and thereby promote both growth and inflation. The negative interest rate policies of foreign central banks have since spread across the financial system and affected borrowers and lenders of all types. The value of negative yielding debt in the global bond markets has more than doubled over the past year, primarily driven by global macroeconomic concerns and the demand for perceived safe haven assets at any price.

Sub-Zero Surge



Source: Bloomberg

Economists also attribute the increase in negative yielding debt to market forces and momentum. Many investors who have bought bonds, even at negative rates, have made significant returns over the past year as rates have continued to fall. This has been especially true for investors buying longer dated assets that have greater sensitivity to changes in rates. Strong performance has attracted more money to the asset class, creating further gains, and driving rates even lower.

Positive interest rates reward those who save or invest (lenders), and penalize those who want to buy something now but don't have the cash (borrowers). Positive interest rates are logical and easily understood. Negative interest rates, however—where lenders pay borrowers—are not economically rational, and in our view, not sustainable over a longer period of time.

To return to a more normal rate environment, economic growth and sentiment would need to improve fairly significantly. This would represent a positive path out. The negative path out would likely involve a breakdown in

the financial markets that results in a spike in yields and a major correction to bond market prices. This is a credible risk to markets and something we continue to watch closely.

U.S.-China trade talks are scheduled to resume in October in Washington. These meetings represent the first substantive talks since negotiations reached an impasse in early May. The talks are expected to focus on key U.S. demands related to forced technology transfer and intellectual property rights, along with lesser issues such as agriculture and enforcement. If progress is not made, additional U.S. tariffs are scheduled to go into effect in mid-October. Another deadline looms in mid-December, effectively tariffing all remaining Chinese goods imported to the United States. Many of the products scheduled to be tariffed in the coming months will be consumer goods such as cellphones, laptops, shoes, and clothing. So far consumers have been largely insulated from trade-related price increases, but this could change if talks don't move forward.

Tariffs and the uncertainty created by the 15-month old trade war have started to flow through to business confidence and corporate spending, especially for U.S. companies with critical Chinese supply chains or for those impacted by the higher cost of raw materials such as aluminum and steel. Weaker demand, tariff-related inflation, and excess capacity have been noted by many firms. These conditions set the stage for weaker corporate profit expansion and GDP growth. These factors may also start to impact employment, an area which has remained a bright spot throughout the current expansion.

Both the U.S. manufacturing and U.S. services sectors have been slowing throughout the year, though both remain above the neutral measurement of 50, signaling positive economic growth. On a global basis, the story is similar, but with global manufacturing readings showing a slight contraction over the past 5 months (see chart below). Global composite indices, which provide a weighted average of manufacturing and services, continue to signal modest expansion. This data is widely followed given its importance as a leading indicator and correlation to GDP.

J.P. Morgan Global Manufacturing PMI

Source: J.P Morgan, IHS Markit. Readings > 50 indicate expansion, readings < 50 indicate contraction.

In summary, the significant decline in interest rates over the past year represents a strong vote of no confidence from the bond market regarding global economic growth. While the near-term risks of a U.S. recession have clearly risen, the good economic data continues to marginally outweigh the bad. For now, the general picture is one of slowing, but still positive growth across much of the U.S. economy. Companies continue to hire workers, real wage growth is positive, consumers are spending their paychecks, and interest rates and inflation remain low. As consumer spending makes up almost 70% of GDP, these factors remain key to extending the current cycle.

We remain focused on investing across a diversified and balanced portfolio of assets. Given increased market uncertainty and an aging bull market, we maintain a strong preference for high quality and lower volatility securities,

including a below-average stance on bond market duration. We also favor non-traditional assets such as structured notes and private placements where appropriate.

The Private Capital Management Team

By the numbers…

Index	YTD
S&P 500	20.55%
Dow Jones Industrial Average	17.51%
Russell 2000	14.18%
MSCI EAFE	12.80%
MSCI Emerging Markets	5.89%
Barclay's US Aggregate Bond	8.52%
Bloomberg Commodity	3.13%

Source: Morningstar as of 9/30/2019

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