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QUARTERLY MARKET UPDATE

WEALTH MANAGEMENT by BerganKDV

October 2019

STOCKS SIGNAL HOPE

Name	YTD 2019 Return (%)
S&P 500 TR USD	20.6
Russell 2000 TR USD	14.2
MSCI EAFE	12.8
Barclays US Credit	12.6
Barclays US Corporate High Yield	11.4
Barclays US Aggregate Bond	8.5
MSCI Emerging Markets	5.9

Data Source: Morningstar Direct

Equities have exhibited impressive strength and resilience through the first three-quarters of the year. The Standard and Poor's (S&P) 500 index is up over 20% year-to-date (YTD), not too distant from its all-time high. There are numerous potential reasons:

- Economic data continue to show the US consumer is in good shape. As most everyone understands, with consumption accounting for approximately 70% of U.S. Gross Domestic Product (GDP), this is significant.
- Despite increases in the recent past, interest rates remain extremely low.
- Global central banks continue to provide extreme monetary policy accommodation.
- There exists optimism that political considerations will compel the US and China to accelerate a reduction in trade tensions resulting in lower and/or the removal of tariffs.
- Decelerating global economic growth rates will foster additional fiscal stimulus.
- Expectations that earnings growth will resume in 2020.
- Generally favorable financial conditions. Chart 1 demonstrates the relatively advantageous setting. Readings below 0 indicate loose financial conditions.

These circumstances have led to broad based strength in US equities. The Standard and Poor's (S&P 500) is comprised of eleven sectors. All of them are positive for the year.

Name	YTD 2019 Return (%)
Information Technology	31.4
Real Estate	29.7
Utilities	25.4
Consumer Staples	23.3
Industrials	22.6
Consumer Discretionary	22.5
Communication Services	21.7
S&P 500	20.6
Financials	19.6
Materials	17.1
Energy	6.0
Health Care	5.6

Data Source: Morningstar Direct

Chart 1 – Aggregate Financial Conditions
Source: St. Louis Federal Reserve

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The information technology sector is up 31.4%, with the health care sector bringing up the rear, up only 5.6%. This relative "underperformance" is due primarily to political uncertainty, less related to underlying fundamentals.

The Nasdaq Composite is up 21.5%, the S&P 500 is up 20.6%, the Russell Mid Cap Index is up 21.9%, the Dow Jones Industrial Average is up 17.5% and the Russell 2000 Small Cap Index is up 14.2%. The point is, the stock market's results are being widely distributed at the index level.

This year's great performance aside, the full year results are far less impressive. That sounds counter-intuitive as we discuss a 21% move, yet the S&P 500 is only 4.3% above where it stood a year ago.

That's not bad given the swoon seen during the fourth quarter of 2018 and considering just how far the stock market has come over the past ten years. It does highlight that registering consistent outsized returns going forward may be difficult.

Bonds Signal Caution

Securities in the fixed income universe have also posted exceptionally solid results YTD. As bond markets are generally more pessimistic, this occurrence highlights the macroeconomic challenges in the current landscape, where this emphasis on caution has led to fixed income price appreciation (or a flight to safety dynamic). Examples include:

- Earnings growth in non-existent YTD. According to FactSet, first quarter earnings were down 0.2%, second quarter earnings were down 0.4%, and third quarter earnings are projected to be a negative 3.7%.
- The US and China have raised tariff rates on many imported products. The US could yet increase the tariff rate on $250 billion worth of imported Chinese goods to 30% from 25% on October 15th while the tariff rate on a $160 billion tranche of imported goods will increase to 15% from 10% on December 15th.
- The ISM Manufacturing Index fell into contraction territory for the first time in three years in August.
- Germany's economy contracted in the second quarter.
- China's second quarter GDP growth of 6.2% was the lowest it has been on record.
- Saudi Arabia's oil and refining facilities were attacked; the US blames Iran.
- The UK's Brexit issues remain unresolved.
- An inverted yield curve, which we are frequently reminded is a solid predictor of recessions.

Recession Signals?

Does that mean recession is indeed inevitable? In 2019, it's not a stretch to posit that there exists a consensus among "experts" that economic recession will have started by 2020, not only in the US but globally. Trade frictions and weak growth in China and the European Union will prove too difficult to overcome. Repetition of this meme has indeed permeated public opinion. About 60% of Americans say they expect a recession next year, though inconsistently, almost the same number view the economy positively.

An economic recession can be defined in general as a significant decline in spending and in economic activity lasting more than a few months, evidenced by decreases in several indicators: real GDP, real income, credit availability, employment, industrial production, and retail sales, to name a few.

It is manifest that the free market system is characterized by periods of recession. Changes in consumer demand and business activity are not always controlled by the levers of fiscal, monetary and regulatory policy. The economic system is cyclical, with fluctuations of recession, depression, recovery, and expansion, depending on many exogenous factors (social, political, economic).

There is no question that our current economic conditions are bifurcated. The service economy is large and growing, evidenced by strength in education, health and professional services. Conversely, the manufacturing sector growth has been more anemic, partially due to the impacts of tariff issues. The manufacturing sector exports a larger share of its products than other sectors and is dependent on suppliers overseas.

Undoubtedly, world manufacturing and investment have demonstrated reduced growth or even contraction. However, the service sectors are resilient, and the International Monetary Fund (IMF) predicts that the world economy will grow at a 3.5% pace in 2020. If these numbers are remotely accurate, a US or even global recession seems distant.

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Mindful of Value

In addition to the outlined positive and negative forces impacting the economy, there are numerous unknowns for the capital markets to also consider:

- A trade deal between the US and China might be reached. However, this may well be predicated on China acquiescing to structural changes to its business practices, which is no guarantee.
- While still in good shape, tariff impacts and contagion effects of slower growth abroad could destabilize their psychology and real ability to sustain consumption trends.
- The ongoing effectiveness of prospective rate cuts by the Federal Reserve (Fed) are in question, given the extended duration of the cycle.
- The unprecedented volume (approximately 18 trillion dollars) of negative-yielding bonds globally.
- The age of the economic expansion in the US brings the furcated earnings rebound prospects in question.
- Lower tax rates and deregulation have been incorporated into equity prices. The approaching 2020 presidential election season will create uncertainty pertaining to these issues and others.

Regardless of how these issues develop, it has been increasingly noticeable that investors are becoming more value conscious. There have been periods during this market expansion where this has not been the case; the primary focus was on price action predicated on the ultimate fulfillment of lofty growth prospects. This dynamic works well until it doesn't. The reignited focus on relative value seems a natural development as things don't seem as easy as they have been in the recent past.

That's not to imply the valuation for the S&P 500 is excessive, yet the index is not on sale either. It trades at 17-times estimated forward twelve-month earnings, which is a 15% premium to its 10-yr average.
That premium can be justified given the low level of interest rates, and while stocks aren't cheap, they still offer a better relative value than bonds do. The forward 12-month earnings yield of 5.88% is 420 basis points greater than the current 10-yr note yield of 1.68%. The five-year average of this difference is around 370 basis points.

Stocks would be an even more attractive proposition if earnings growth were more robust, but as it currently stands, the stock market's valuation looks to be full given skepticism that higher growth estimates will be realized next year.

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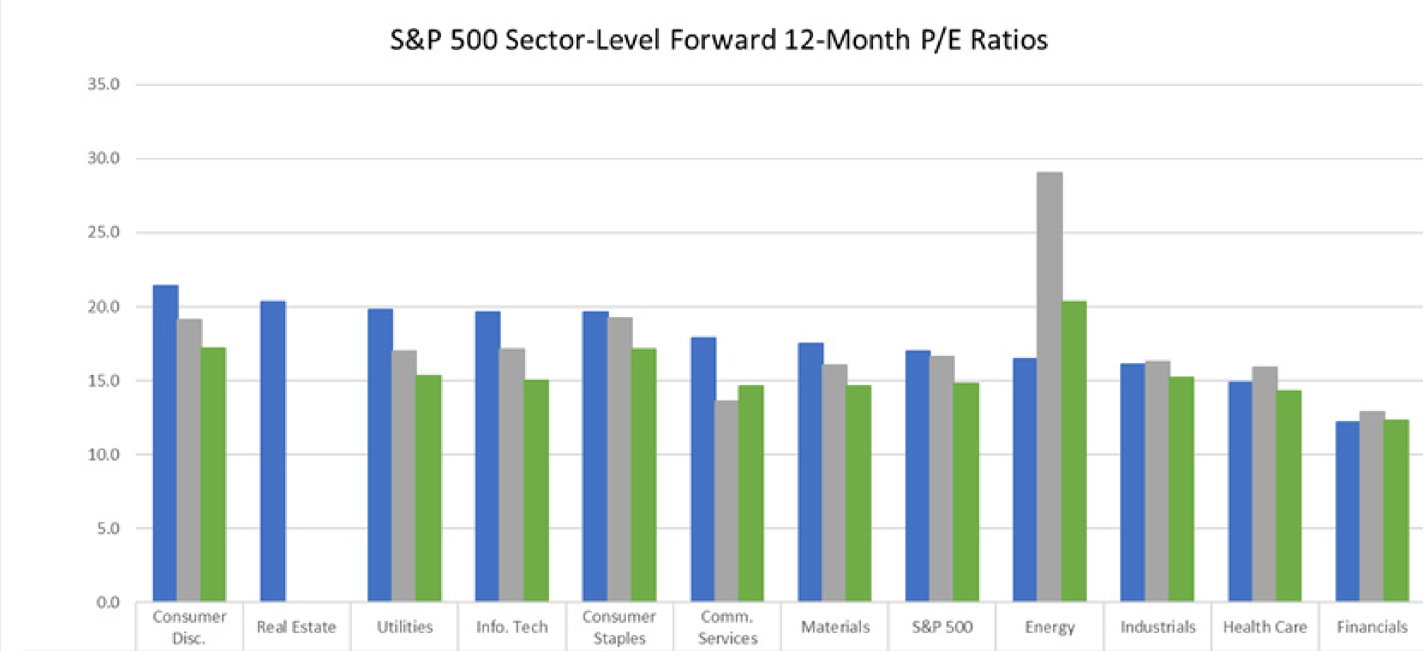
Chart 2 – Sector Valuations



	Consumer Disc.	Real Estate	Utilities	Info. Tech	Consumer Staples	Comm. Services	Materials	S&P 500	Energy	Industrials	Health Care	Financials
Fwd P/E	21.4	20.3	19.8	19.6	19.6	17.9	17.5	17.0	16.5	16.1	14.9	12.2
5-Year Avg.	19.1		17.0	17.1	19.2	13.6	16.0	16.6	29.0	16.3	15.9	12.9
10-Year Avg	17.2		15.3	15.0	17.1	14.6	14.6	14.8	20.3	15.2	14.3	12.3

Source: FactSet

Earnings Matter

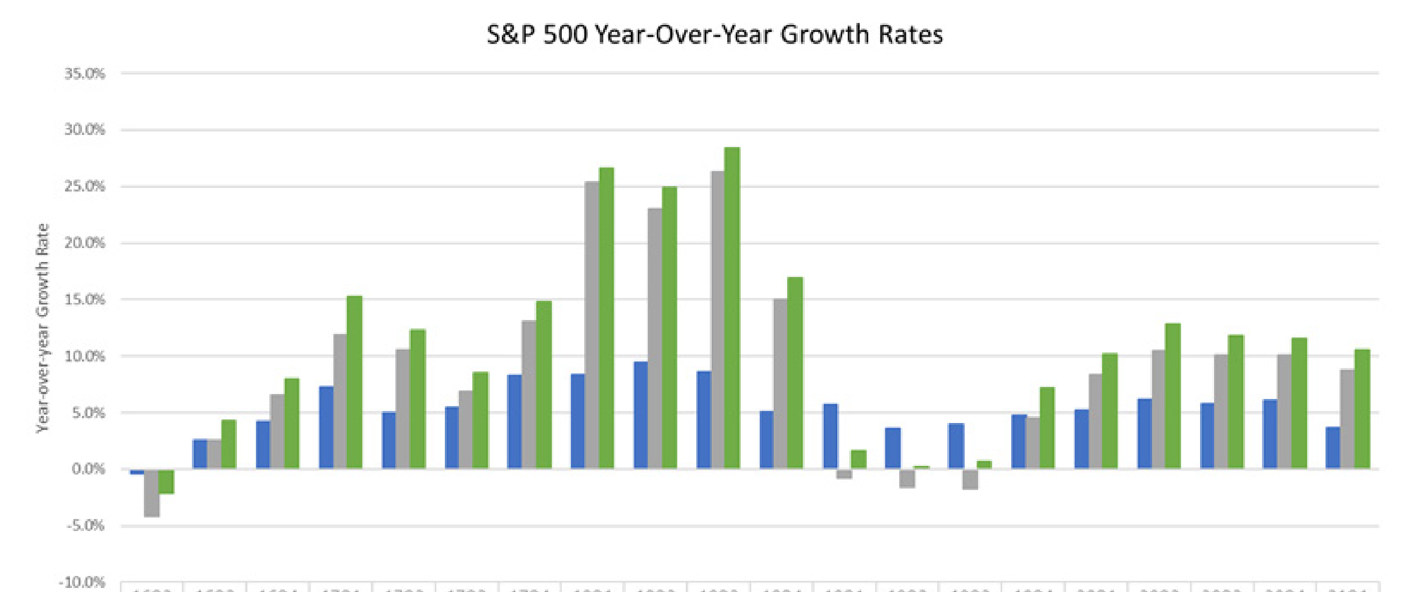
That's not to say that they won't be. It simply means that a greater level of importance is being placed on the realization of forward earnings estimates. That is, equity prices will be much more sensitive to earnings misses and downward revisions than at previous points in this bull run. The market will be less forgiving.

Currently, though, consensus estimates for the fourth quarter of 2019 and beyond look solid. That's not surprising given many of the underlying fundamentals supporting the consumer and the service sectors of the economy. The average earnings-per-share (EPS) growth estimates register over 10% over the next six quarters. That's well above the historical average of about 6%. So, while the market will be sensitive to underperforming expectations, there is a bit of a cushion built into estimates that allow for wiggle room to the downside while still outperforming historical averages.

The equity markets still afford solid return potential. Economic fundamentals remain, on balance, supportive of corporate profitability. It's just that investors collectively will likely continue to become more discerning in their security exposures. It increases the importance of embracing the stocks of companies that are profitable, have good cash flow trends, solid balance sheets, and in some cases pay a healthy and secure dividend. Investment portfolios that aren't well diversified and which have favored story stocks, as opposed to quality stocks, increase the probability of experiencing adverse outcomes during periods of a risk-off nature.

Ultimately, even if positive expectations are realized, return prospects of investment portfolios need to be tempered, as do any anticipations that extremely low volatility will remain a permanent condition of the market. There will likely be increased periods of downward movements contributing to long-term annualized returns more consistent with historical (reduced) norms.

Chart 3 – Earnings Estimates



	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	21Q1
Revenue	-0.4%	2.6%	4.2%	7.3%	5.0%	5.5%	8.3%	8.4%	9.5%	8.6%	5.1%	5.7%	3.6%	4.0%	4.8%	5.2%	6.2%	5.8%	6.1%	3.7%
Net Income	-4.2%	2.6%	6.6%	11.9%	10.6%	6.9%	13.1%	25.4%	23.0%	26.3%	15.0%	-0.8%	-1.6%	-1.7%	4.5%	8.4%	10.5%	10.1%	10.1%	8.8%
Earnings	-2.1%	4.3%	8.0%	15.3%	12.3%	8.5%	14.8%	26.6%	24.9%	28.4%	16.9%	1.6%	0.2%	0.7%	7.2%	10.2%	12.8%	11.8%	11.6%	10.6%

Source: I/B/E/S data from Refinitiv

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