Market Recap

Financial markets were choppy in the third quarter, buffeted by some familiar themes: on-again/off-again U.S.-China trade war headlines, weak global growth, recession fears, and central bank monetary policy.

On a month-by-month basis, larger-cap U.S. stocks rose in July, fell in August, then rallied in September. The S&P 500 ended the quarter near an all-time high. Meanwhile, U.S. core investment-grade bonds were flat in July, rallied sharply in August, then dropped in September as interest rates rebounded from historic lows. For the full quarter, both major asset classes produced solid gains: larger-cap U.S. stocks (Vanguard 500 Index) were up 1.7% and core bonds gained 2.4% (Vanguard Total Bond Market Index).

September Benchmark Returns

	MTD	QTD	YTD
EQUITY BENCHMARKS			
Vanguard 500 Index	1.9%	1.7%	20.4%
iShares Russell 1000 ETF	1.8%	1.5%	20.3%
iShares Russell 1000 Value ETF	3.6%	1.5%	17.5%
iShares Russell 1000 Growth ETF	0.1%	1.7%	23.0%
iShares Russell 2000 ETF	2.0%	-2.3%	14.1%
Vanguard REIT	1.9%	7.4%	28.0%
iShares MSCI ACWI ETF	2.2%	0.1%	16.4%
Vanguard FTSE Developed Markets ETF	3.2%	-0.9%	13.2%
Vanguard FTSE Europe ETF	2.6%	-1.8%	13.6%
Vanguard FTSE Emerging Markets ETF	0.9%	-4.1%	8.0%
FIXED-INCOME BENCHMARKS			
Vanguard Total Bond Market Index	-0.6%	2.4%	8.6%
Vanguard Intermediate-Term Tax-Exempt	-0.8%	1.3%	6.1%
iShares TIPS Bond ETF	-1.1%	1.5%	7.7%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.3%	1.2%	11.5%
S&P/LSTA Leveraged Loan Index	0.5%	1.0%	6.8%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	0.4%	1.6%	5.9%
Bloomberg Commodity Index	1.2%	-1.8%	3.1%
SG Trend Index	-5.3%	5.8%	13.6%
3-Month LIBOR	0.2%	0.6%	2.1%

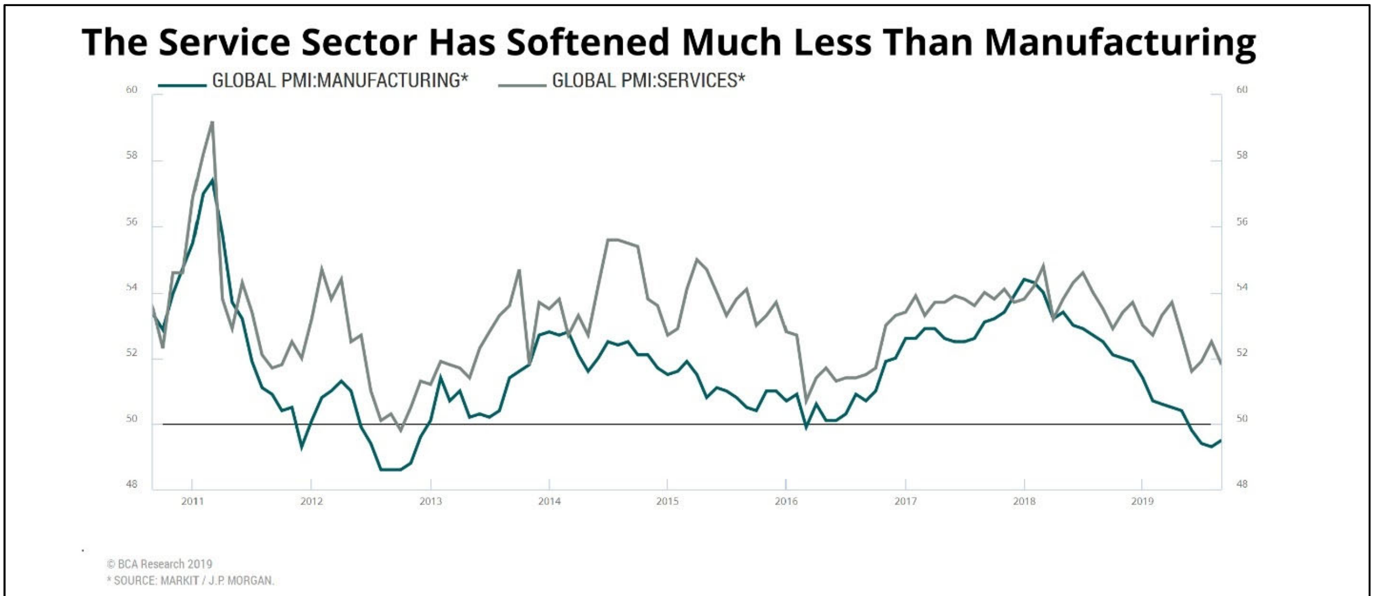
Despite a rebound in September, foreign stocks posted negative returns for the quarter. Developed international stocks were down 0.9%, European stocks were down 1.8%, and emerging-market (EM) stocks lost 4.1% (the Vanguard FTSE Developed Markets ETF, the Vanguard FTSE Europe ETF, and the Vanguard FTSE Emerging Markets ETF, respectively). The U.S. dollar appreciated 2% to 4% versus other currencies during the quarter, which was an equivalent drag on foreign stock market returns for dollar-based investors.

In fixed-income markets, the benchmark 10-year Treasury yield dropped to below 1.5% in early September as trade war and recession fears grew. It then sharply reversed, then dropped back, ending the quarter at 1.68%, down from a 2% yield at the end of the second quarter. Corporate bonds gained for the quarter, with floating-rate loans returning 1.0% and high-yield bonds gaining 1.2% (the S&P/LSTA Leveraged Loan Index and ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index, respectively). Core municipal bond funds were up a little over 1% (Vanguard Intermediate-Term Tax-Exempt).

Performance was aided in September when interest rates moved higher, catalyzed by an apparent détente (at least for the time being) in the U.S.-China trade war. Rising interest rates brought losses to core bonds. Better news on the trade front also boosted more cyclically sensitive international stocks as well as U.S. value stocks, all of which have lagged the S&P 500 market index the past several years.

A Brief Macro Update: Trade Policy vs. Monetary Policy Tug of War

Global economic growth remains weak and consensus expectations are for further slowing. For example, during the third quarter, both the Organisation for Economic Co-operation and Development and the International Monetary Fund cut their projections for 2019 and 2020 global gross domestic product (GDP) growth (again), citing the negative impact of the U.S.-China trade war on manufacturing, exports, and business investment spending.

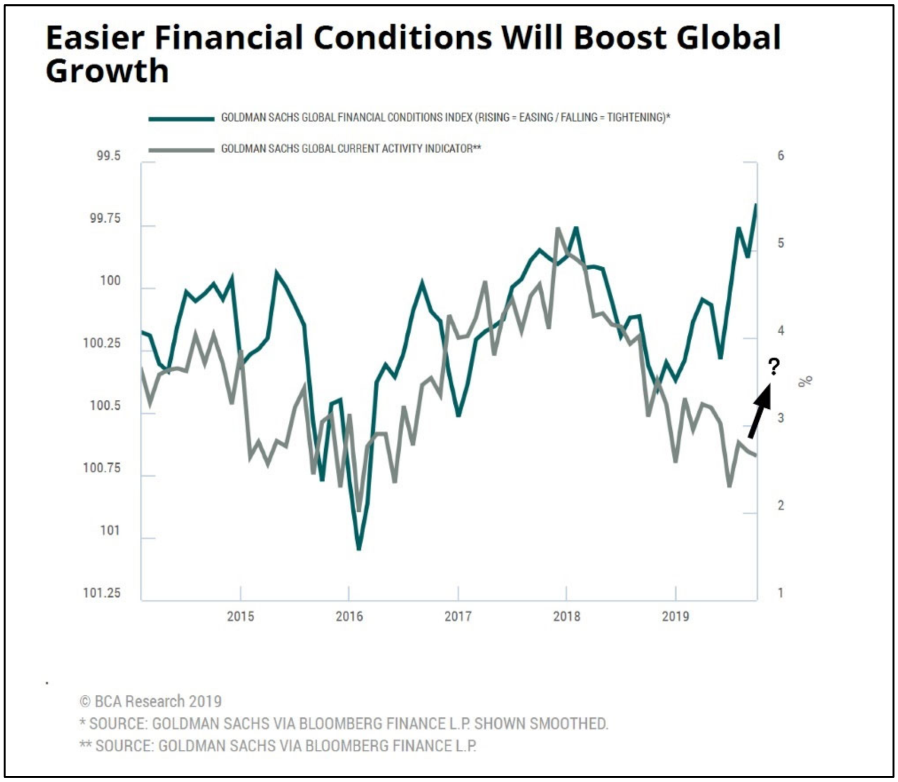


On the other hand, while measures of global manufacturing activity remain in contractionary territory, services (non-manufacturing) activity, which represents upward of 70%-plus of the global economy (and more than 80% of U.S. GDP), still looks solid, as shown in the chart above. (Note: PMI above 50 denotes expansion and below 50 denotes contraction.) Household balance sheets and consumer spending also remain healthy, supported by low unemployment and solid wage growth.

Of course, there are hundreds of economic data points that can be selectively marshalled to support almost any macro view. Suffice it to say, the data is “mixed.” But one might not be far off the mark boiling things down to a tug of war between the contractionary effects from U.S. trade policy and accommodative/expansionary global monetary policy. Expansionary fiscal policy may soon enter the picture in Europe and China, if not also the United States.

On the monetary policy front, global financial conditions have eased significantly this year, largely due to the sharp decline in bond yields. As shown in the chart below, looser financial conditions are positive for global growth. This, coupled with the potential for a trade deal between China and U.S. president Donald Trump have the potential for a rebound in global growth and, with it, strong performance from foreign and cyclical stocks. A weaker dollar would likely accompany a rebound in global growth, which would further loosen financial conditions, enabling a positive feedback loop between the financial markets and the economy. A weaker dollar would also boost foreign stock market returns for U.S. dollar–based investors.

In response to the weak global economic environment and the impact of trade policy on U.S. business sentiment and capital expenditure, the Fed followed its late July interest rate cut with another 25-basis-point (bp) cut in mid-September, bringing the federal funds rate down to a range of 1.75% to 2.00%. Also, earlier in the month, the European Central Bank (ECB) cut its policy rate 10 bps, to negative 0.5% and announced it would launch a new open-ended asset purchase plan (i.e., quantitative easing) at a rate of €20 billion per month starting in November. Departing ECB President Mario Draghi also implored Eurozone governments to undertake fiscal stimulus to boost the region's growth, signaling monetary policy may be reaching its effective limit.

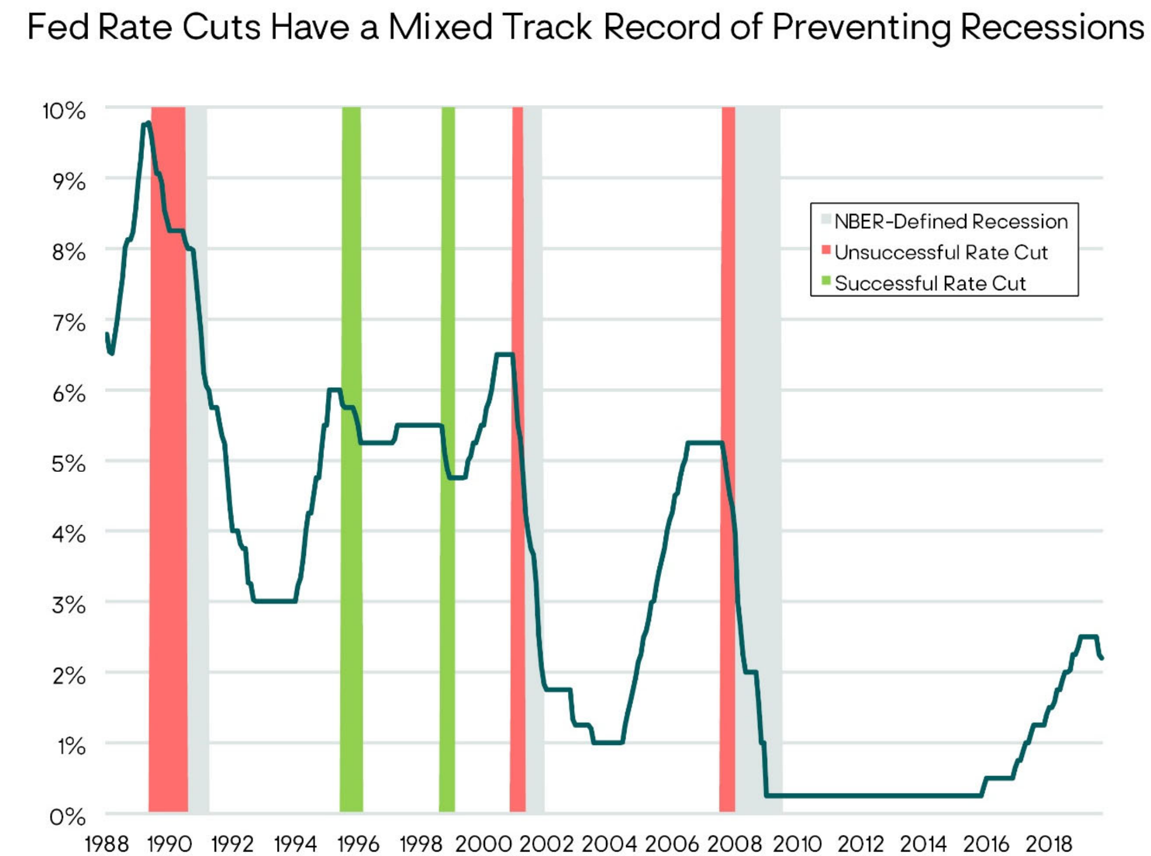


What does the second Fed rate cut mean for the stock market in the near term (next 12 months)? Not surprisingly, the answer depends on whether the economy is heading into a recession. What we know for certain, though, is *Fed rate cuts do not necessarily prevent a recession from happening*. The last three recessions—in 1990, 2000, and 2008—all occurred despite the Fed cutting rates prior to the recessions' start. Bear markets coincided with each of those recessions.

The history of the last five Fed rate cutting cycles is shown in the chart below. Based on Guggenheim Investments' macroeconomic analysis, they opine that, "This time around… it is a close call as to whether the Fed has cut early enough to help extend this expansion."

Looking further at monetary policy, Ned Davis Research analyzed Fed rate cuts going back to 1921. They concluded that when the Fed cut rates twice and the U.S. economy *avoided* a recession over the next year, the stock market *gained* an average of 18% in that year. This has happened seven times in the past. However, in the three instances (1990, 2000, and 2008) when two Fed rate cuts were closely followed by a recession, the stock market dropped 11% on average over that year.

So, based on history we see two widely divergent, if not binary, market outcomes. This again highlights why we believe it is important to incorporate a wide range of scenarios in our portfolio management process. The most effective way to do this is by analyzing multiple asset classes and investment strategies that have different risk exposures and different sources of return. Our portfolios are tilted toward asset classes - as well as individual stocks and bonds - that we believe currently offer attractive risk-adjusted returns over our five- to 10-year time horizon.



Source: Board of Governors of the Federal Reserve System. Data as of 9/24/2019.

U.S. Growth Stocks Are Priced as if History Is Irrelevant

At a time when U.S. growth stocks have continued to outperform, clients sometimes ask why we don't have more invested in momentum/growth U.S. stocks. The most important point we relay in those discussions is that a company needs to offer a potentially attractive return from a risk/adjusted perspective. Though overpriced, stocks however typically don't stop rising when they reach fair value. History has shown they overshoot both when they go up and when they go down because of investors' greed (or fear of missing out) and fear (of losses). To justify investing in U.S. growth stocks at present, we'd have to assume history is largely irrelevant. We will explain how we arrive at this conclusion.

First, we want to touch upon the basic components that make up U.S. stock returns. By analyzing each component, we can assess potential returns and the likelihood of achieving them. We rely on history as a guide because we believe economies and markets move in broadly repeating cycles of different durations. However, we also know history does not repeat exactly, so we pay close attention to forces that can lead to different scenarios or outcomes than observed historically.

Breaking Down Equity Return Components

There are only three drivers of equity returns:

1. *Dividend Yield*—the portion of earnings distributed to stockholders as a percentage of the stock price
2. *Earnings Growth*—determined by sales growth and by changes in profit margins
3. *Valuations*—how much investors are willing to pay for each $1 of earnings (P/E ratio)

The Situation Today

Dividend yields (currently around 2.2% for the S&P 500) tend to be stable over time and don't lead to a lot of variance in return outcomes. But earnings growth and valuations do. So, let's dig into these two components.

Earnings Growth

Since 2008, sales growth has been roughly 3%. This is in line with overall U.S. economic growth this cycle, but much slower than the 5% to 6% sales growth observed post-1980s. However, slow top-line growth has been more than offset by a sustained rise in profit margins—from an historical average of 6% to 10% in this cycle. This is an outcome due primarily to the confluence of two main forces: globalization and free trade, and corporations gaining a larger share of the economic pie than labor.

However, these two forces now seem to be turning negative, which may depress both margins and investor sentiment. The latter will also impact valuations—what investors are willing to pay for a dollar of earnings.

As we analyze and model expected returns for broader U.S. stock indices (driven primarily by large cap U.S. growth stocks), in our central or base case we give credence to the optimistic view that corporate margin structures have permanently shifted up; we assume margins of 8%, much higher than the historical average. With this assumption, we are essentially ignoring nearly 90% of historical outcomes.

We also need to make an assumption about sales growth over our five-year estimation period. We assume 6% growth, almost twice the level achieved this cycle—and this is despite U.S. monetary and fiscal stimulus unseen outside wars and recessions.

One could argue we are being generous with these base-case assumptions. That's partly our point. Even with margin and sales-growth assumptions that seem optimistic relative to what history and current and future economic fundamentals suggest, our model yields just 3% annual earnings growth in our base case.

Valuations

We consider a lot of factors when determining a reasonable valuation multiple to pay for a dollar of what we'd consider a *normal level* of earnings. We want to be compensated in absolute terms for the downside risk of owning equities. Since the end of World War II, we have seen market declines on the order of 20% to 50%, and we expect a decline of similar magnitude in the next bear market. We seek at least a high single-digit five-year expected return to fully compensate us for equity risk. Said another way, *we don't consider stocks attractive based simply on whether they will do better than core bonds (a much lower-risk* *asset), especially when bonds arguably are the most overvalued asset class in the world today, offering extremely low yield and expected return.*

In today's valuation regime, the key unique risk factors we believe we should factor in our analyses are the following:

- **Higher regulation and political risk**: Income and wealth inequality has widened this cycle to a point where historically high corporate profit margins are inviting greater regulatory and political scrutiny and actions against corporations and investors.
- **Protectionism risk**: While trade tensions may resolve in the shorter term, we think there is a good chance we will remain in a heightened environment of global trade friction for an extended period. This will weigh on business and investor sentiment and increase the cost of doing business for companies.
- **Inflation risk:** This risk may be higher for investors than in the past three decades. We believe we don't even need to make the case for inflation because "stagnation" or "*dis*inflation" appears to be fully priced into markets wherever we look—stocks, bonds, commodities, real estate, etc.

Thus, given these risks, instead of assuming an 18x to 19x P/E multiple for earnings, the post-1985 average, our base-case assumption is 17x, which is higher than the post-1920s average of 16x and in line with the post-1950s average. As of June 30, 2019, investors were paying 22x earnings for the S&P 500.

Many investors incorrectly assume that low interest rates justify today's higher valuations. It is true that permanently lower rates mean future cash flows are discounted at a lower rate as well. This should raise stock prices, all else equal, but all else is not equal. Interest rates are low because the Fed is concerned future growth will be low. If future cash flows grow at a slower rate, this offsets any lower discount rate, and higher valuations are therefore not justified. For current high valuation levels to be fair, rates must stay this low forever *and* growth cannot continue to disappoint as it has this cycle.

Finally, it's worth remembering low rates *do not* shield investors from an overvalued equity market. Case in point, the Fed was significantly cutting interest rates in the bear markets of 2000–2002 and 2008–2009 but could not prevent the nearly 50% declines in the stock market.

When we assume valuations revert from the current level to 17x P/E over a five-year period, it implies an annualized loss of –4.6% from contracting P/E multiples.

Putting it Together: What Our Analysis of U.S. Stock Market Return Components Tells Us

When we aggregate the three return components for the S&P 500 (dividend yield of 2.2%, earnings growth of 3%, valuations or P/E compression of negative 4.6%), future five-year expected U.S. stock returns are less than one percent, annualized, and this is despite our relatively generous margin and sales-growth assumptions. If we were to stretch on valuation multiples and assume 19x or 20x P/E, expected returns are a bit above 3%, which is still poor and well below what we require to be fully invested in U.S. growth stocks. In our bear-case scenario, where we give history more weight and assume 6% margins and 4% sales growth (the two determinants of earnings growth), returns are quite negative over our five-year time horizon.

So, to ask the question we get rarely: Why don't we have even *less* in U.S. stocks? Because there are scenarios where we can see U.S. stocks generate 8% to 10% annual returns over the next five years – particularly for our stocks which are much cheaper at lower multiples, offer attractive above average and growing dividend yields and offer the potential for global growth generation. We believe however that outcome would be more difficult for the S&P 500 as investors would have to assume profit margins stay at all-time highs, sales grow at more than twice the rate they have since 2008, *and* investors continue to accept the relatively high valuations of today, possibly paying even more during what remains an uninspiring real economic environment with heightened geopolitical and trade tensions. In our view, this outcome has a lower chance of playing out; however, it's a possibility we can't exclude from our thinking entirely, especially if the promise of technology (artificial intelligence, robotics, etc.) allows companies to continue to lower their operational costs in the next cycle and beyond. Thus, we have continued to hold a reduced allocation to U.S. stocks across our clients' balanced portfolios in favor of more attractive asset classes: non-U.S. stocks and high-yield bonds.

European Stocks are Relatively Attractive

Within foreign stocks, we have an overweighting to European stocks. We believe the risk-reward tradeoff for Europe continues to justify this weighting and offers an interesting juxtaposition to our view of U.S. stocks.

We have continued to add to Europe steadily since 2013. In 2015, the ECB followed the Fed in implementing a QE program to stimulate a Eurozone economy struggling with debt. The ECB's QE was thwarted by both external and internal factors. Due to these factors, Europe has been a value trap the past several years.

The external factors not in Europe's control were Trump's election in the United States and Brexit. The former ultimately led to trade wars and in turn a slowdown in global growth. Europe is more exposed to global growth and so was impacted more by trade wars. The latter remains an uncertainty and a "known unknown."

The internal factors were Eurozone's failure to recapitalize its banking system as quickly as the United States did, and the region's pursuit of austerity at a time of intense deleveraging because Germany insisted on maintaining fiscal discipline and rules.

The internal factors were not entirely controllable however. Politically speaking, the Euro construct places significant constraints on the region in that it's not easy to allow fiscal transfers in the right quantities to countries that need it, such as those laden with high sovereign debt. We knew this was a risk and factored this in by demanding a slightly higher valuation discount than we otherwise would have before adding the Europe equities position.

While some of these risks are still present, we are seeing country-level reforms and company-level restructuring that we think are significant positives. This is a normal adjustment to a crisis. A few notable reforms and adjustments have been

- labor reforms in Spain and France, allowing greater flexibility for companies to manage their costs;
- austerity, which while painful has helped right-size to a degree the real wage and productivity imbalance in some countries that contributed to Europe's debt crisis;

- and the many compelling examples of companies restructuring.

We believe these steps plant the seeds for future growth and profitability for Europe. The region has not entirely wasted a good crisis, as they say.

Weighing the risks and the positives above, we decided to haircut Europe's normalized earnings power by a total of 30% from what would have been the "old-normal" earnings level. We think the old normal can still be achieved, but it's now decidedly optimistic in our minds. We also lowered the trend growth rate of these earnings by about 10% (this becomes significant after compounding over many years). Finally, if we believe Europe's growth is going to be lower than it was before, its stocks should now deserve a lower valuation multiple. As such, we are increasing European stocks' valuation discount versus U.S. stocks from around 25% (which was the historical average) to 40%.

When we run the numbers, we find Europe remains attractive relative to the United States to a degree that—outside of this cycle so far—has paid off handsomely in the past. If global growth returns to healthy levels, as it started to in 2017 before trade war tensions contributed to a growth slowdown, we think European stocks are poised to do very well. Europe's limited policy options, however, also may mean their downside in a global recession is worse than U.S. stocks.

Weighing the risk-reward in different scenarios and their possible impact on the *overall* portfolio, we think our current overweight to Europe is appropriate.

The key point when thinking about U.S. stocks vs. European stocks is: *Our return expectations are very low for broader U.S. stock indices, even after assuming very generous assumptions, relative to history at least. Whereas in Europe, we are acknowledging their unique set of problems but not giving them the benefit of the improvements that we see being made at both the economy and corporate level. And yet we still get very attractive returns, at least relative to U.S. stocks if not in absolute terms.*

Closing Thoughts

We believe U.S. stocks are expensive and do not deserve a higher allocation in our balanced portfolios at present. In the short term, U.S. stocks may continue to outperform as they have for several years. However, this would only borrow returns from the future. We also know by stretching our horizon over 10 years and longer, U.S. equity returns should be decent. Thus, in our balanced portfolios we continue to have just over a quarter of our portfolios allocated to U.S. stocks versus the 40% we'd have in "normal times."

Our investment mandate is to compound our clients' wealth while remaining mindful of the risks we take in achieving that goal. We don't know exactly how the future will unfold. As a result, in our portfolio decisions we weigh various risks to which our portfolios may be exposed. We gauge risk by analyzing a wide range of positive and negative economic and market scenarios, the impact they may have on each client's portfolio, and the likelihood of them occurring given current fundamentals and how we see them likely evolving.

The current U.S. equity bull market has done the compounding part of our job well. But we believe we are now at a point where risks have gone up. We think it's prudent to be a *little defensive*, to preserve some capital so we can deploy it when valuations in relation to long-term fundamentals are more normal.

As always, we appreciate your trust and confidence in Altrius Capital, and we will continue to work hard every day to continue to earn it. Please don't hesitate to contact us with any questions regarding our outlook and strategy or your personal financial planning needs.

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