October 2019

Third Quarter, 2019 Investment Letter

What Has Happened

US equity prices rose modestly in the third quarter, building on the spectacular gains in the first half of 2019. The S&P 500 Stock Index inched up 1.7% in Q3, bringing its year-to-date gain to 20.4%. Globally, the MSCI ACWI was flat for the quarter, but up 16.1% in 2019. Dogged by the escalating trade war with China, the MSCI Emerging Markets Index fell 4.25% in quarter, shaving its year-to-date gain to a more modest 5.9%.

Mounting evidence of economic weakness led to a sharp drop in interest rates and strong gains for fixed income securities. US bond indices all registered solid gains in the third quarter, as the bellwether 10-year US Treasury note yield fell from 2.0% to 1.67% at quarter's end.

Despite the strong rebound in equity prices in 2019, it might surprise investors to know that the S&P 500 has trailed the return of the 30-year US Treasury bond by more than 20 percentage points over the trailing twelve months ending in September! Owing to the cruel math of compound returns, the near 20% decline suffered by the S&P 500 in Q4 2018 requires a 25% rebound just to get back to even. As a result, even the sharp gains enjoyed by US equity investors this year has resulted in only a 4.25% return over the trailing 12 months, while the 30 year bond soared nearly 30% as interest rates sharply declined.

Other interest-sensitive asset classes, such as real estate investment trust (REITs) and infrastructure stocks continued to build on their first half gains. Both the Dow Jones Global REIT Index and the Dow Jones Global Infrastructure Index delivered gains in excess of 20% this year. Notably, energy prices made little overall progress in the quarter, despite extreme volatility in September after an attack on one of Saudi Arabia's largest oil processing facilities.

Trade Disputes & Interest Rates

As we enter the fourth quarter, investors are struggling with three dominant themes: 1) ongoing impacts of trade disputes between the US, China and our other major trading partners; 2) growing evidence of a decline in manufacturing activity and the probability of a resulting recession; and 3) the effectiveness of global central banks' ability to provide economic stimulus to offset the effects of the first two.

Up to this point, equity and fixed income investors have arrived at different conclusions as to the economic impact of these various forces. Equity investors seem to believe that, at some point in the not-too-distant future, the trade wars will be resolved with each side declaring a partial victory. This should provide at least a psychological boost to equity prices. In the meantime, the Fed stands ready to further lower interest rates should US economic growth stall.

On the other hand, fixed income investors are viewing the economic glass as decidedly half-empty. A near insatiable demand for the perceived safety of high-quality bonds has driven yields below zero on more than $15 trillion of global debt. At least part of the motivation for owning a security that is guaranteed to return less than your investment is the notion that rates are destined to fall further (typical in a recession scenario as credit demand evaporates), proving a capital gain to existing holders. While the 10 year US Treasury note flirts with decade-low yields, some observers are even warning of the possibility of negative yields on US debt.

What to Expect Going Forward

In their search for yield, fixed income investors have gravitated toward higher risk securities, including junk bonds preferred stocks, and emerging market debt. With the dividend yield on the S&P 500 exceeding the yield on treasury notes, some income-oriented investors have grudgingly moved back into the stock market. However, should market conditions deteriorate, these investors may exacerbate the volatility on the downside as they look to protect capital.

The signs of a global slowdown have been apparent to most observes for many months now. More recently, US manufacturing has succumbed to the weakness apparent in other economies, but the reliance of the US economy on manufacturing activity is relatively small. The US economy is powered by consumer spending, which has remained solid throughout 2019, buttressed by continued job growth and real wage gains. While we acknowledge the threat of slowing global growth, we believe the odds favor a slower growth, non-recessionary North American economic trajectory. As always, we remain very mindful of the risks.

Recommended Approach

We are reminded of the expression, we know what we know and with humility, we know what we don't know. What we at Our Family Office are most fearful of is, that we don't know, that which we don't know or the unknown, unknowns.

If you haven't already started thinking about the other "R" word, you should. In the late stages of any bull market, it's not return, but risk that should be top of mind.

We believe you should ask yourself these five questions:

1) How does the longest bull market in history end?
2) What happens if negative interest rates spread globally?
3) What are your capital market assumptions for the next 5 years?
4) How much risk do you wish to take in the future?
5) Are geo-political risks greater today than in the past?

We ask ourselves these questions on a daily basis. We are in unchartered waters and believe that for every unit of risk you take, you should understand what your future reward is expected to be. It's most important to understand the relationship between risk and return. We recommend looking forward; not only in the rear-view mirror.

As always, we thank you for your trust and confidence and appreciate your continued support.

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