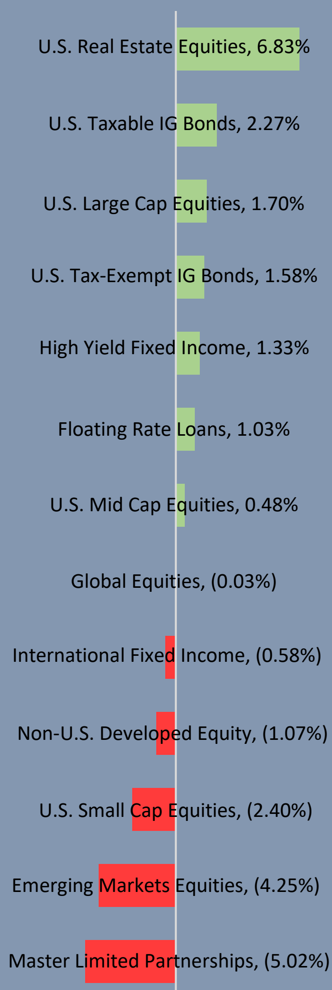
Independence Asset Advisors

MarketMatters

INDEPENDENCE ASSET ADVISORS' QUARTERLY GLOBAL MARKET JOURNAL

September 30, 2019

Third Quarter Results*



In this issue…

P.1 Market Overview & Themes

P.2 Global Yield & Asset Class Review

P.3 Market Outlook

*Source: eVestment Analytics

> "Downside risks have intensified since the April 2019 World Economic Outlook. They include escalating trade and technology tensions, the possibility of a protracted risk-off episode that exposes financial vulnerabilities accumulated over years of low interest rates, geopolitical tensions, and mounting disinflationary pressures that make adverse shocks more persistent."
>
> – International Monetary Fund

Third Quarter Market Overview & Key Themes

➢ **Key Takeaways**

- The Fed cut interest rates by 0.25% in both July and September, moving the target range down to 1.75%-2.00%.
- Value outperformed growth in September (3.6% vs 0.0%) and now leads over the past 12-months (4.0% vs 3.7%).
- Foreign equities bounced back in September but remain negative for the quarter and lag U.S. equities longer-term.
- Investment grade U.S. bonds outperformed U.S. equities in the third quarter.
- Headwinds continue to include the unresolved U.S./China trade negotiations, Brexit, and global economic deceleration.

➢ **U.S. Interest Rates**

The U.S. Federal Reserve ("Fed"), in an attempt to prolong the U.S. economic expansion, lowered interest rates by 0.25% in July and September, to a target range of 1.75% to 2.00%. Chairman Powell affirmed that "at present, the jobs and inflation pictures are favorable." He also noted that U.S. unemployment is at a half-century low, wages are growing, and while inflation is below the 2% target, it is firming. However, he cautioned that global growth has slowed and "uncertainties around trade, Brexit and other issues pose risk to the outlook." As of this writing the probability of another 0.25% rate cut at the October 29-30th meeting is 87%.

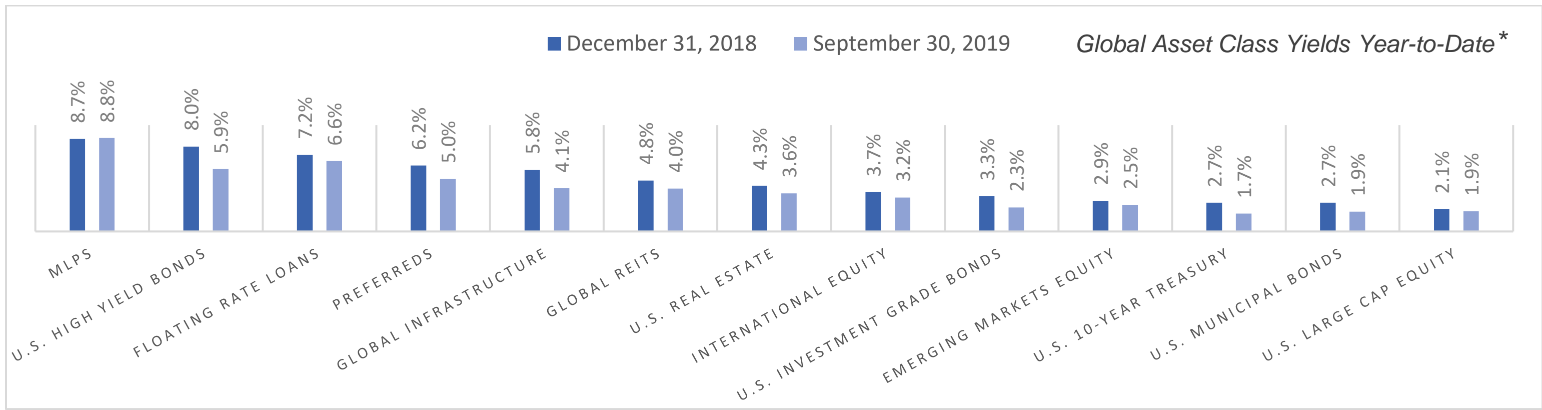
➢ **U.S./China Trade War**

The prevailing headwind throughout the third quarter was the ongoing trade war between the world's two largest economies. Economists estimate that the U.S.-imposed tariffs on Chinese goods could further slow the country's growth momentum, which has experienced its weakest industrial production growth in more than 17-years.

Trade disruptions could move China's third quarter GDP to below 6.0% (as low as 5.5% in 2020), which is well below guidance. However, China has imposed a round of fiscal, monetary and structure stimulus that it hopes will stave off a sharper slowdown.

Domestically, the impact of the trade war is being felt most by small businesses, with over 40% reporting a higher cost of doing business. U.S. manufacturing is in a recession with two quarters of negative growth. The Russell 2000 Small Cap Index fell 2.4% in the third quarter, and is down 8.9% over the past 12-months.

2019 Global Yield & Asset Class Review



➢ U.S. Equities

The S&P 500 Index gained 1.7% in the third quarter, improving its year-to-date return to 20.6%. Over the past three years, growth stocks have outperformed value stocks, but we have seen a shift over the past year that favors value. Performance during the third quarter was driven by interest rate sensitive sectors such as Utilities and Real Estate, which benefitted value indices and “low-vol” strategies with higher exposure to these high yield sectors. In August, value stocks gained 3.6% compared to 0.0% for growth stocks. In terms of valuations, core, value and growth stocks are all now trading above their historical averages, but only value is considered fairly priced at 14.1x (core and growth are at 16.8x and 21.4x, respectively).

➢ Midstream MLPs

Energy infrastructure investments gave up nearly 35% of their first-half gains after falling 5.0% in the third quarter. The sector, which has exhibited a higher correlation to oil prices in recent years, was negatively affected in August when WTI crude fell by 5.9%. Fundamentally, energy infrastructure equities are well positioned to offer capital appreciation and consistency of income, but the sector’s susceptibility to energy prices makes it an applicable asset class for long-term investors.

➢ U.S. REITs

U.S. REIT common equity was the best performing of the primary global asset classes in the third quarter, gaining 6.8%. This improved the year-to-date return to 24.6%. REIT dividend income growth continues to outpace inflation.

➢ Foreign Equities

Developed non-U.S. equities bounced back 2.9% in September after selling off in July and August. The September gain was not enough to offset the prior losses and the EAFE Index ended the quarter down 1.1%. Year-to-date, the Index is up 12.8%, which compares favorably against emerging markets equities, but lags the U.S. equity market by 7.8%. The Developed non-U.S. market has remained volatile all year, a direct result of headline risk. In Europe, the ECB responded to the weaker economic outlook by lowering its interest rate target further into negative territory. This temporarily bolstered returns, but markets quickly sold off again after yet another Brexit setback. In Japan, investors are mindful of the consumption tax that was recently implemented. This new tax poses a real risk to an economy that is already feeling the effect of the global slowdown in manufacturing. China’s economy has been most negatively affected by the trade war. The U.S.-imposed tariffs have resulted in a meaningful reduction of Chinese industrial growth, which has fallen from 7.0% at the beginning of 2018 to 4.4% at quarter-end, while retails sales have fallen 2.5%. Note that while China’s growth is slowing, it is still comfortably higher than U.S. growth, which is also slowing. With this fact in mind, it remains to be seen if China will concede to U.S. demands on trade.

Emerging markets equities fell 4.3% in the third quarter but are still up 5.9% year-to-date.

➢ U.S. Investment Grade Bonds

The Barclays U.S. Aggregate Bond Index gained 2.3% in the third quarter, a good result compared to the other primary fixed income indices. Credit attribution was barbelled, with AAA and BBB-rated bonds providing the majority of the quarterly gain. U.S. Treasuries were undoubtedly the best performing subsector, gaining 2.4%. The aggregate benchmark yielded 2.3% at quarter-end, a 0.6% spread to Treasuries, but these investment grade bonds are expensive to buy at a 6.2% premium to par.

➢ U.S. Municipal Bonds

U.S. tax-exempt bonds performed well also, gaining 1.6% in the third quarter. In terms of attribution, lower quality and longer-date municipals performed better. Supply has generally met demand and default rates remain very low. U.S. municipals continue to offer a favorable tax-equivalent yield, but they come at a hefty cost – an 11.8% premium to par.

➢ U.S. High Yield Bonds

High yield bonds gained 1.3% in the third quarter, a good return but the gain falls short of the average quarterly coupon rate. Default rates remain low. Below investment grade bonds are trading at a slight discount to par, and the correlation to stocks is 0.3%.

➢ U.S. Leveraged Loans

Floating rate loans gained 1.0% in the third quarter, defaults remain sub-2%, and they trade at a meaningful discount to par. The Fed’s interest rate cuts have not yet affected the yield, which ended the quarter at 6.6%.

*Sources: JP Morgan Guide to the Markets, Eaton Vance Monthly Market Monitor, Dow Jones Indices, FactSet.

2019 Global Market Outlook

Takeaways

- Advanced economies are forecasted to only grow 1.9% in 2019 and 1.7% in 2020.
- Developed and emerging market economies are forecasted to grow 4.1% in 2019 and 4.7% in 2020.
- Downside risks could derail or worsen forecasted global growth rates.
- Abrupt shifts in market sentiment have increased as trade negotiations intensified.

World Economic Outlook

Against a backdrop that includes a trade war and an uncertain Brexit resolution, global growth momentum remained soft throughout the first three quarters. According to the International Monetary Fund, the world economic outlook remains subdued.

Growth has been slightly better than expected in the U.S. and Japan, but business sentiment and surveys point to a weak outlook for manufacturing and trade; the outlook on new orders is pessimistic.

Core inflation has softened across advanced economies (U.S.) or remained well below target (Eurozone & Japan), and has fallen well below target across most emerging markets as well.

Global growth is projected at 3.2% for 2019 and improving to 3.5% in 2020. Importantly, 70% of the forecasted global growth pickup in 2020 is accounted for by the projected stabilization or recovery in stressed economies.

This low growth environment creates a tough setting for earnings growth that would drive stock markets higher.

Energy Infrastructure Equities

Alerian MLP Index's negative third quarter result reduced the year-to-date gain to 11.1% although it recovered most of the quarter's loss in September. This is still a fair result overall, but a poor relative result compared to U.S. common equities and REIT equities.

As written by Midstream MLP manager Chickasaw Capital, "U.S. oil, natural gas and natural gas liquids production and growth appear to be essential to a stable and growing world. This is not inconsistent with a move to wind and solar and a cleaner environment. The disconnect is current pricing of midstream energy securities. It is more than interesting to see that midstream energy shares currently being priced not only as if they have no future growth, but as if they are shrinking and declining from current levels of profits and cash flow, and not at a modest rate. Looking at the Alerian MLP Index, we estimate it trades at a 30% discount to the current value of its cash flow, implying that oil, natural gas and natural gas liquids are, or very soon will be, in sharp decline. This is in sharp contrast to the facts. Another recent EIA report does not see U.S. oil production topping out over the next 20 years, and if global petroleum use is growing through 2050, price will incent production to meet the demand. The global chemical industry is investing greater than $200 billion dollars in the U.S., mostly along the U.S. Golf Coast. The facts do not appear to describe an industry in its twilight, even though the shares are currently being priced as if this is the situation."

We continue to see a role for income producing infrastructure in diversified balanced portfolios.

Quarterly Focus: Brexit

The term Brexit is a linguistic blend, or portmanteau, of the words "British" and "exit." It refers to the expected withdrawal of the United Kingdom ("UK") from the European Union ("EU").

The EU serves as an economic and political union involving 28 European countries. It allows free trade and free movement between member countries, serves as a common market and a cooperative of various social and political policies (note this is different from the Eurozone, which created a common currency for 19 of the 28 EU member countries). The UK joined the EU in 1973, and if it leaves, would be the first member of the state to withdraw from the EU.

It has been more than three years since the UK narrowly voted to leave the EU predicated on three main issues:

1) Economics –The UK sends money to the EU, which gets redistributed across the member countries. The leave campaign is against this broad funding philosophy. The remain campaign argues that leaving the EU will wreck the British economy, as it will forfeit its free market ability to sell goods and services to EU countries.
2) Immigration – Any citizen of an EU member country can relocate and work in the UK without needing a work visa. Most economists believe this is good for the UK economy, but leavers argue this depletes already scarce public resources.
3) Identity – Most UK citizens do not identify as European, and the leavers believes that "*Brexiting*" would allow the UK to take back control over its laws and policies.

There are three options that will have vastly different implications for the global economy (probability by January 2020):

1) UK Remains (No Brexit 35%)
2) UK Leaves (Yes-Deal Brexit 26%)
3) UK Leaves (No-Deal Brexit 39%)

Predictions about the economic impact of the Brexit scenarios range from highly disruptive to no big deal. Most economists seem to agree that scenario 1 would likely result in positive economic effects, scenario 2 would minimize the imposition of tariff and non-tariff barriers between the UK and its largest trading partner, while scenario 3 would likely be an immediate economic shock to the economy that could result in a recession.

Markets seem to have priced in the down-side risks which may provide a significant upside should no Brexit or an orderly Brexit occur.

Disclaimer:
The views and opinions in this newsletter are solely those of Independence Asset Advisors (IAA).
IAA has made every attempt to ensure the accuracy and reliability of the information provided, but it cannot be guaranteed.
Past performance is no guarantee of future returns.