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INVESTMENT MANAGEMENT

Third Quarter 2019 Commentary

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 and has posted a year-to-date total return of more than 20%, extending the longest bull market on record. 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, larger-cap U.S. stocks were up 1.8% and core bonds gained 2.3%. Despite a rebound in September, foreign stocks posted negative returns for the quarter. Developed international stocks were down 0.9% and emerging-market stocks lost 3.7%

In fixed-income markets, the benchmark 10-year Treasury yield dropped below 1.50% in early September as trade war and recession fears moved investors towards lower risk assets. The 10-year Treasury ended the quarter at 1.68%, down from a 2% yield at the end of the second quarter. The yield on the 30-year Treasury followed suit, dropping to record low levels in August. The amount of negative yielding government debt instruments around the world exceeded $15 trillion, continuing to confound investors in search of yield.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	1.8%	4.3%	11.1%
US Mid Cap Stocks	0.6%	3.7%	9.2%
US Small Cap Stocks	-1.5%	-3.8%	8.6%
International Developed Stocks	-0.9%	-1.3%	3.7%
Emerging Market Stocks	-3.7%	1.2%	2.9%
US Bonds	2.3%	10.3%	3.4%
Global Bonds	-0.6%	5.3%	0.9%
US REITs	7.4%	16.8%	8.7%

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD
US Mid Cap Stocks: CRSP US Mid Cap TR USD
US Small Cap Stocks: CRSP US Small Cap TR USD
Emerging Market Stocks: FTSE Emerging TR USD
International Developed Stocks: FTSE Developed Ex US TR USD
US Bonds: Barclays US Aggregate Bond TR USD
Global Bonds: Barclays Global Aggregate Ex USD TR USD
US REITs: MSCI US REIT NR USD

Global economic growth remains weak and consensus expectations are for further slowing. However, 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. 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. (That's what keeps all those Wall Street economists employed!)

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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.

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 (the first cut in rates in a decade) 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%. Investors are now expecting two more rate cuts this year.

At a time when U.S. stocks have continued to outperform, clients sometimes ask why we don't have more in U.S. stocks. (Interestingly, we rarely get asked why we don't have less.) The most important point we relay in those discussions is that a portfolio needs to maintain a balance because each asset has a defined role and no one knows how to time market tops or bottoms. Markets 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).

In today's macroeconomic environment, investors face some unique risk factors:

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. To the extent political pressure builds enough to produce actual tax or corporate governance changes, corporate margins would likely begin a path back toward their historic mean, thus lowering expected future earnings and investor returns.

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.

Our investment mandate is to compound our clients' wealth while remaining mindful of the risks we take in achieving that goal. We believe nobody knows exactly how the future will unfold. As a result, we focus our efforts towards listening to you, our client, when we review the asset allocation decisions for your portfolio. We customize our investments to match your tolerance for the risks that are a natural part of investing in the capital markets. Building a successful long term plan relies on balancing your circumstances with what the market has to offer.

All of us at Leavell Investment Management appreciate your trust and confidence in us as we assist you on your journey.

Timothy S. Healey
Chief Investment Officer

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Chief Operating Officer

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