RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

THIRD QUARTER 2019 MARKET COMMENTARY

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STATE OF THE MARKETS

Equity markets gyrated in the third quarter with the S&P 500 correcting approximately 5% in August only to rebound in September to near all-time highs. Trade uncertainty continued to be a major contributor to the equity market volatility. In response, the Fed cut interest rates to provide insurance against further economic weakness. At the end of the third quarter, the S&P 500 closed up ~ 19% for 2019 and a modest 1.2% for the quarter.

Investors fearing a recession in the 2020-2021 timeframe are increasingly pointing to weakness in economic conditions in Europe, as well as a slowdown in international trade, as signs of the nearing end of the economic cycle. Recent economic data in Europe, combined with the lingering uncertainty over Brexit, has reflected that global economic conditions are weakening somewhat. In response, the European Central Bank has returned to a policy of lowering interest rates and increasing other forms of monetary stimulus. In the U.S., the Fed twice lowered the Fed Funds rate in the quarter, but Fed officials diverge on whether interest rates should be lowered further to support the economy.

The upcoming presidential election next year has ratcheted up the political tension and uncertainty in Washington. At the end of the quarter, the House of Representatives launched an impeachment inquiry into President Trump's communications with the Ukrainian president over Joe Biden's prior dealings with Ukraine as Vice President. While we view this political uncertainty as a serious distraction for investors likely leading to market volatility, ultimately it not likely to lead to an impeachment conviction of the president in the Senate.

Review of the Third Quarter

Pressure Grows on the Fed to Support Economy While Trade War Continues

Amid signs of weakening economic conditions, interest rate cuts abroad and constant pressure from President Trump, the Fed voted to lower interest rates twice in recent months. The Fed characterized the cuts as "insurance" cuts in that the purpose of the cuts was to be proactive in the face of threats to the economy. In particular, the ongoing global trade wars have chilled some business investment and reduced global manufacturing activity. Rather than wait until a recession is imminent, the Fed determined it would be prudent to cut rates as a preventative measure.

While the Fed's decisions are understandable in light of geopolitical uncertainty, trade wars and the like, we feel that there is little benefit the economy will gain from lowering rates further at this point given the already low-rate environment, other than to prevent U.S. rate policy from diverging too much from Europe and the rest of the world. Liquidity is ample in the U.S. economy and corporations can finance debt at rock bottom rates compared to historical rates. This is why the consensus of most economists is that the trade conflicts are a bigger cause of economic instability rather than interest rates that are too high

Many observers point to the recent "inversions" of the treasury yield curve as indicia of a looming recession, however we feel that this indicator is not very reliable today given the extraordinary monetary contortions of the Fed and other central banks around the globe. Historically, an inverted yield curve has been a reliable indicator of an imminent recession at times when the Fed raised short-term rates in an overheating economy while investors began to fear the long-term outlook for the economy and accept lower long-term rates. However, the Fed rate hikes of 2018 were not in response to an overheating economy as inflation has remained moderate and GDP has not cracked 3% in recent years. Additionally, compared to foreign nations like Germany and Japan where comparable sovereign yields are negative, many investors seeking safe haven treasury investments for the medium to long term are likely to turn to U.S. treasuries, thereby further suppressing long-term yields in the U.S.

It's also important to note that the recent deceleration in economic growth in the U.S. in 2019, and likely to continue into next year, is reflecting an economy that is growing slower than it did in 2018 in response to a major fiscal stimulus package – i.e. the Trump tax cuts. Given the current headwinds for the U.S. economy presented by global economic weakening and the ongoing trade wars, the short-term boost from the Trump tax cuts was not sustainable and some slowing in economic growth was expected.

Nevertheless, we recognize that, by any measure, the U.S. economy is certainly closer to the end of the economic cycle than the beginning. We feel that this is a positive for value stocks in the short-term as investors prioritize safety of principal and dividend income. While any recession is negative for all investors, a typical cyclical bear market is an opportunity for long-term investors to bargain hunt. Short-term investors like retirees should re-visit their retirement financial and investment plan to ensure that retirement income needs are allocated to assets outside of the most vulnerable segments of the marketplace.

Political Uncertainty Heightens

With the U.S. presidential election just over a year away, it is no surprise that political theater in Washington has heightened recently. However, even by modern political standards, 2019 has been a dramatic year in Washington. We will not re-hash the much-publicized circumstances surrounding the Ukraine corruption investigation that led to the current impeachment inquiry, however we will point out the implications of the inquiry for investors.

Political uncertainty, particularly at the highest levels of government, is never a positive for investors. Uncertainty in Washington leads to economic policy uncertainty that causes investors to wonder whether any needed economic reforms will be made, the extent of any fiscal stimulus, whether any trade deals will be ratified by Congress, among other questions. Most importantly for investors, could the president be impeached and replaced with Mike Pence, and if so, would he prove to be a more or less business and investor friendly leader? Thus, the current uncertainty in Washington serves as a headwind for the stock market and the economy because it is difficulty for investors and business owners to make investment decisions confidently in such an environment.

Regardless, we feel that it is unlikely that President Trump will be impeached because he would need to be convicted by a two-thirds vote of the Republican controlled Senate in an election year. The inquiry would ultimately have to lead to articles of impeachment and a trial in the Senate. This would all take a good deal of time, at which point an election will be imminent. Further, in an election year within a highly divisive partisan climate, it was already assumed by most investors that the president and a divided Congress would not accomplish much. Political stalemate was the likely base-case scenario for 2020 prior to the impeachment inquiry and is even more likely now. Counter-intuitively, political stalemate is often a good result for investors as equities historically tend to perform well with a divided presidency and Congress and in election years when few drastic economic policies garner enough political support.

Outlook for the Fourth Quarter

Looking ahead to the fourth quarter, we expect many of the same themes that have dominated 2019 to continue – i.e. trade and rate uncertainty, political drama and recession forecasting. As we have reminded clients before in these market letters, while we are currently in the longest economic expansion on record, it is also one of the weakest expansions in terms of cumulative GDP growth. Therefore, the expansion should have room to run, all else being equal. A resolution to the trade war with China would greatly aid the economic outlook both domestically and abroad.

We expect interest rates to remain low around the globe as central banks respond to the economic uncertainties with continued low rate policies and monetary stimulus. However, recent history has proven that monetary stimulus absent fiscal stimulus has limited efficacy. The persistent low-rate environment will cause fixed income and fixed income alternatives to remain relatively expensive vis a vis equities as investors hunt for yield in all corners of the market. We look for equities to remain choppy as the impeachment process progresses and depending on developments in trade and interest rates during the quarter. Within equities, we see the rotation from growth to value that has begun to emerge to continue as investors become more risk averse and look for the relative safety and stability of value stocks in a late cycle market.

As always, all comments are welcome and appreciated.