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Investment Market Review
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The topics discussed in these letters have become somewhat repetitive over the last few quarters; the Fed, trade tension, and slowing global growth. And so it was that Fed rate cuts, the unresolved trade war with China, and a spreading global economic slowdown dominated the headlines during the third quarter. Developments related to trade and the Fed, in particular, continue to influence the direction of the market.

Add the impeachment inquiry unfolding in the U.S. House of Representatives to these other items, and it becomes clear why measures of uncertainty are approaching or have reached record levels. While it is true that markets never operate in an environment totally free of uncertainty, the current elevated levels of uncertainty surrounding policy direction are notable.

Corporate leaders are tasked with assessing the current business and political environment and that which will prevail in the future before making important investment decisions. A difficult task under the calmest of conditions, it has become perilously difficult recently, especially as it relates to trade policy.

Despite the backdrop of elevated uncertainty, the S&P 500 index of large-cap stocks managed a modest gain for the third quarter. That makes three consecutive quarters of positive returns and puts the index up just over 20% for the year. While most of the gains were registered in the first quarter, the index has continued to trend upward and actually hit a record high in July before pulling back slightly to end the quarter.

Indices other than those comprised of large-cap U.S. stocks have not fared as well recently. Small-cap U.S. stocks, many developed international markets, and emerging markets declined during the third quarter and trailed their large U.S. counterparts by, on average, 10% over the first three quarters of the year.

The tremendous return for the market so far this year is masking the more modest, single-digit return that has been realized over the past 12 months. Recall that stocks fell sharply during the fourth quarter of 2018 as the Fed continued to forecast additional interest rate increases that investors no longer believed were warranted by prevailing economic conditions at the time. It was that episode in late-2018 that is responsible for the gap between the 9-month and 12-month returns. It was not until the Fed reversed course on its plan to hike rates that stocks resumed their upward climb.

The Fed twice cut the interest rate it controls during the third quarter. After holding the interest rate steady over the first four meetings of the year, the Fed embarked on this new period of rate

reductions in July. The two cuts were made in an effort to support the domestic economy given an uncertain global economic outlook. It was the first rate cut since 2008.

Most of the economic weakness has been isolated thus far to countries outside the U.S. More recently, signs of weakness have started to emerge in some domestic economic indicators, raising investor fear that the probability of a recession is rising. While a recession does not appear imminent, it is within this context that the Fed is attempting to inoculate the U.S. economy from further weakening by lowering interest rates. In other words, the Fed is not responding to an economy that has fallen into the depths of a recession, but has rather taken out an insurance policy of sorts against such a recession occurring in the first place. It is a confidence-inspiring sign that preemptive steps are being taken to reduce or soften the potential impact of future market risks.

It is difficult to envision a near-term moderation of the policy uncertainty that has, at times, whipsawed the stock market. With that said, as we enter the final 12 months before the next election, it behooves an incumbent administration to present a stable and growing economy to the electorate. Therefore, at least with respect to those policies directly under the control of the administration, perhaps we will see a more conventional approach that is less disruptive to the markets as we approach next November. If that turns out to be the case, we can then turn our attention to the force ultimately driving the stock market, corporate earnings.

Despite its ambiguous nature, excessive market uncertainty tends to manifest itself in stock market volatility. The psychological effect of uncertainty is largely driving short-term market volatility and is the common theme of the major economic topics discussed herein. Presidential election years can magnify the volatility. That being said, it bears repeating that the market is up around 20% for the year as of this writing. Some “reversion to the mean” of market returns is normal and usually healthy. Additional short-term volatility is a fair concern. However, longer-term, the time frame on which we should all be focused, the stock market is driven by earnings growth and the outlook for growth is healthy.

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