—New Albany—
Investment Management

June 10, 2019

Riding the BEAST
The Fed to the Rescue… AGAIN?

Happy Summer. It's time to ride the coasters. And, you don't even need to go to an amusement park to get the thrill of the riding the BEAST! Instead, experience the virtual reality of it by watching the markets whip around the wild loop. As crazy as that sounds, in truth, the price action in both the Bond and Stock market continues to mimic that of a wild roller coaster. The markets have swung hard, both up and down, from the on-again-off-again threats of a trade war, tech security & regulations, and even rare earth minerals. Just when it felt like there was no bottom, the Fed swooped in (again) to pull the market higher, hinting of a possible rate cut. Crisis averted, at least for now, and the coaster is back on the assent. Whew! It's been a doozy ride!

THE BEAST: Stock Market Roller Coaster!

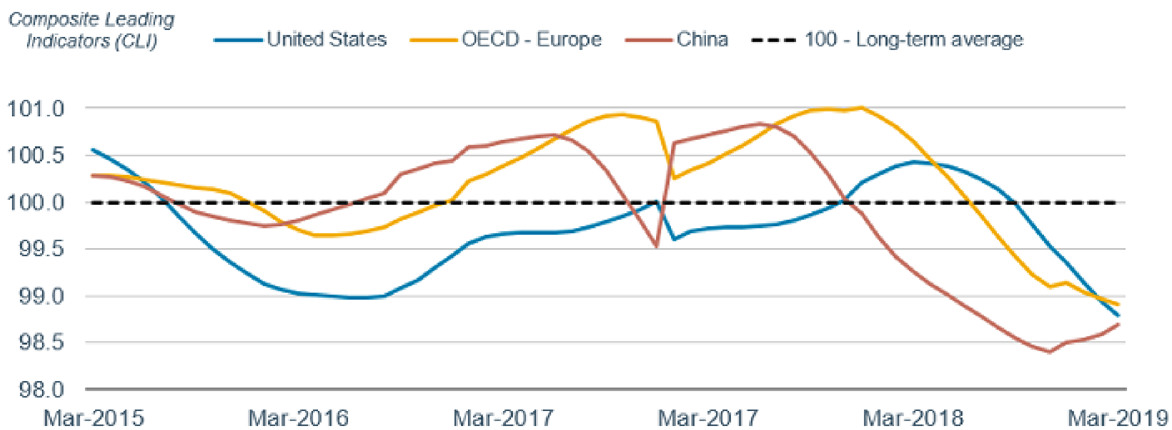
The 'headline drama' is at fever pitch resulting in a market that is ever so much dependent and driven by the latest tweet, two sentence comment, or newspaper article dropped in from our President, the Federal Reserve, or China. Thus, trying to predict the next near-term market moves is futile. Though I do believe good will eventually be hammered out of the trade disputes, the volatile headlines have created a very uncertain global business and market environment. In this environment, it is best to step back from the headlines and instead, look at the big picture(s) to understand the broad trend in growth and ultimately the direction of the markets.

Global Trade: How Much? Trade tensions between the U.S. and China have escalated significantly over the past month, with no resolution in sight. It is important to understand the **significance of China trade as they export over four times as much to the U.S. as the U.S. exports to China, and their GDP has grown from 20% of US GDP in 2006 to 65% by last year. Thus, China swings a big stick on the global economic stage**, which means, despite mounting pressure from the U.S., China is not likely to capitulate easily. Net take away, a prolonged trade dispute could well be the new normal. This means companies dependent upon China for parts, trade, technology, etc. will need to devise a plan "B", and in the **net near term, this disruption will put downward pressure on an already declining economic slowdown.**

Slowing global growth: How Much?

Leading indicators point to softness in growth in other major countries. Europe's growth rate has fallen to about 1% in the past year, due to a decline in manufacturing activity and trade. Japan is barely positive at 0.5%. China's growth rate has also slowed, along with much of the rest of Asia.

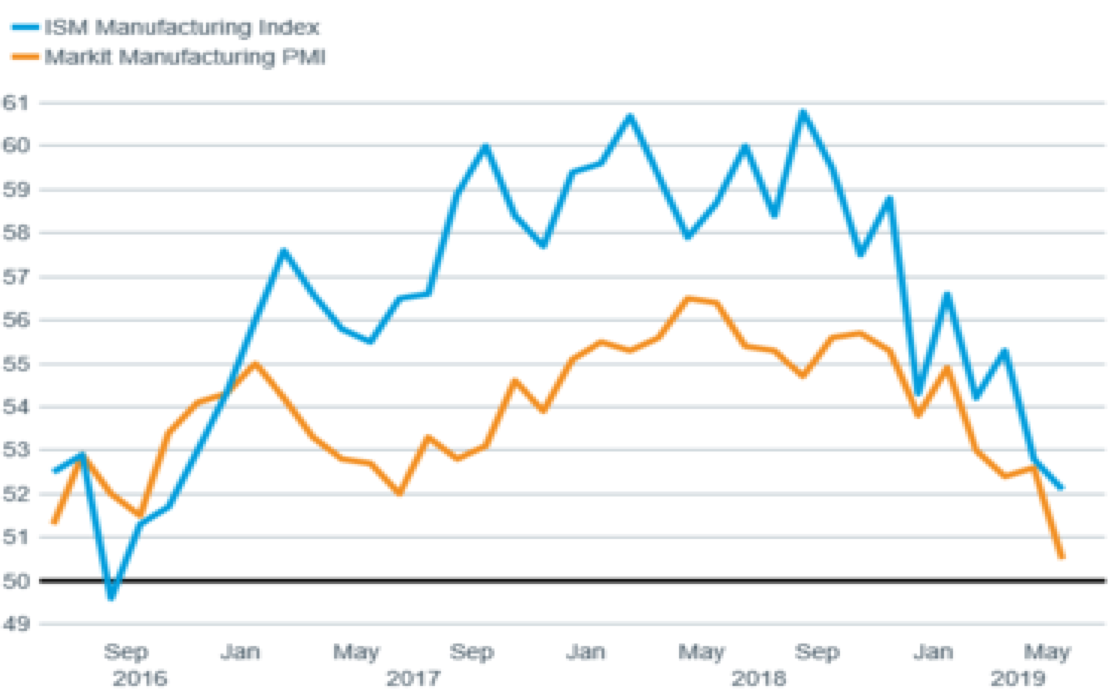
The OECD Composite Leading Indicators Index has shown slowing growth



Note: The Organisation for Economic Co-operation and Development's (OECD) work is based on continued monitoring of events in member countries as well as outside OECD area, and includes regular projections of short and medium-term economic developments.

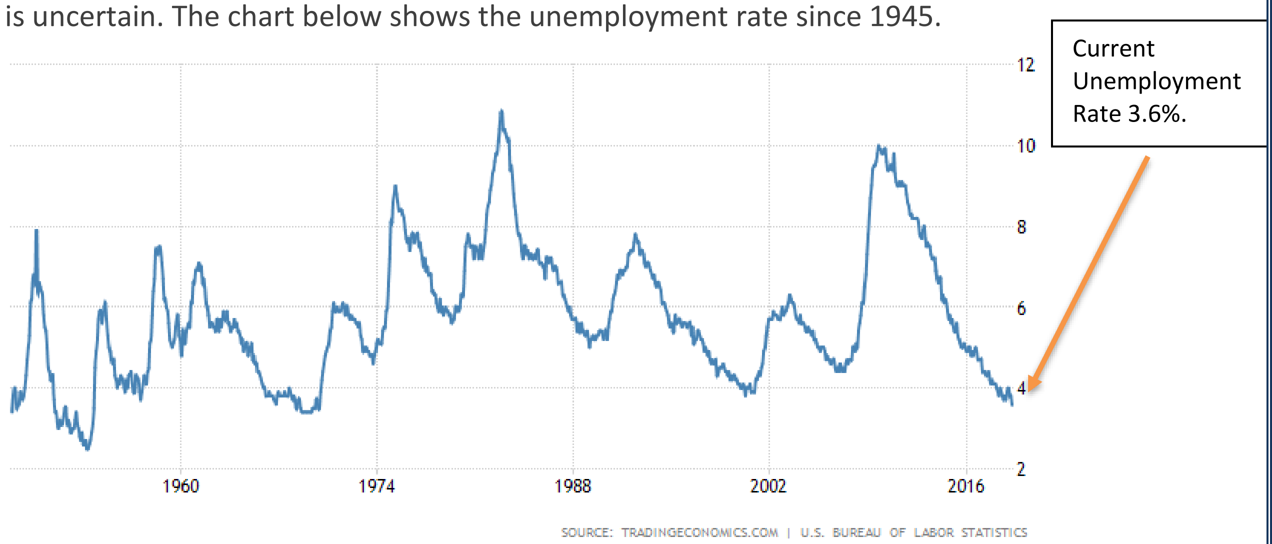
Source: OECD as of March 2019.

US Growth Is Slowing too… Manufacturing data has weakened significantly,



Source: Charles Schwab, Macrobond, Institute for Supply Management (ISM), IHS Markit as of 6/7/2019

But there are **pockets of strength, most notably the labor market**. **The US Unemployment rate is currently at 3.6%, the lowest in 49yrs.** With the consumer representing nearly 70% of GDP, low unemployment indicates a solid footing for the economy. However, the unemployment rate is a lagging indicator so confidence about future growth is uncertain. The chart below shows the unemployment rate since 1945.

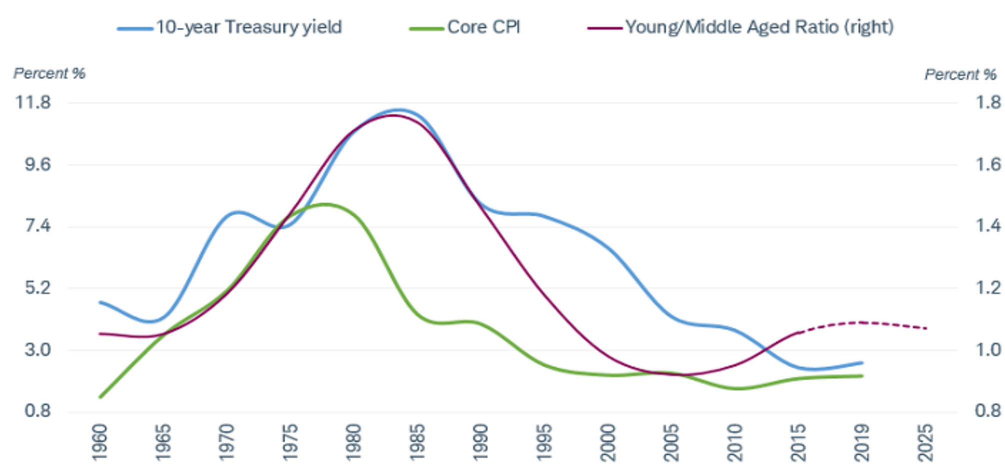


Demographic changes holding down interest rates and indicate slower growth ahead.

Aging population in the developed world is pushing down growth and interest rates. According to Charles Schwab, 'Consumption tends to slow as a population ages, which results in slower economic growth. Younger consumers tend to spend more, while older people usually save more, increasing the demand for bonds and keeping inflation pressures in check. Japan is the most extreme example of this trend. Its population is not just aging, but also declining, as deaths outpace births. Consequently, its central bank has been fighting deflation for many years with very easy monetary policies, but bond yields remain near zero.'

Schwab goes on to say, **'In the U.S., the aging of the workforce has been correlated with declining inflation**. As the ratio of young to middle-aged workers has fallen, so have interest rates. Based on population projections, the trend may have hit its trough, but any increase is expected to be modest over the next few years, suggesting limited upside in bond yields.'

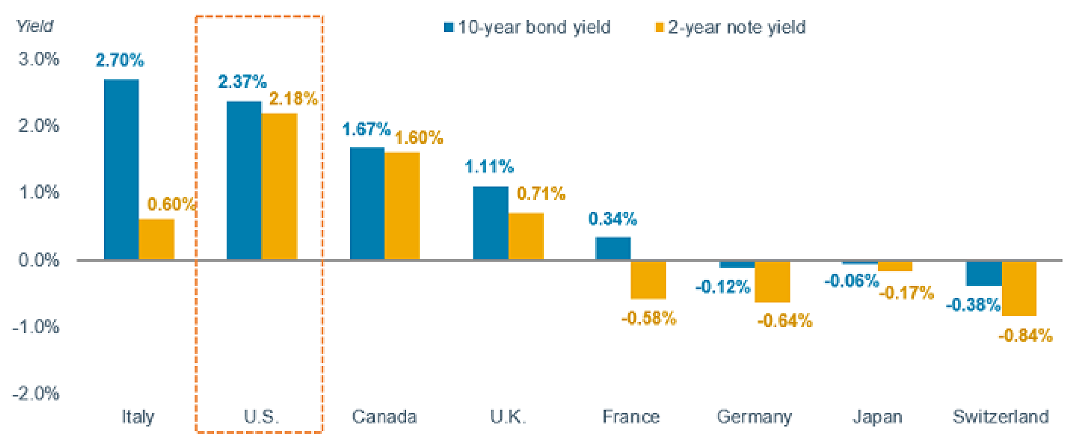
As the ratio of young to middle-aged U.S. workers has fallen, 10-year Treasury yields and the Consumer Price Index (CPI) have declined



Source: Bloomberg, USGG10 and CPI XYOY, annual averages through 12/2018. OECD historical population data and projections, annual averages, projections 2015-2025. The ratio of 25-to 34-year olds ("young") to 45- to 54-year olds ("middle-aged"). **Past performance is no guarantee of future results.**

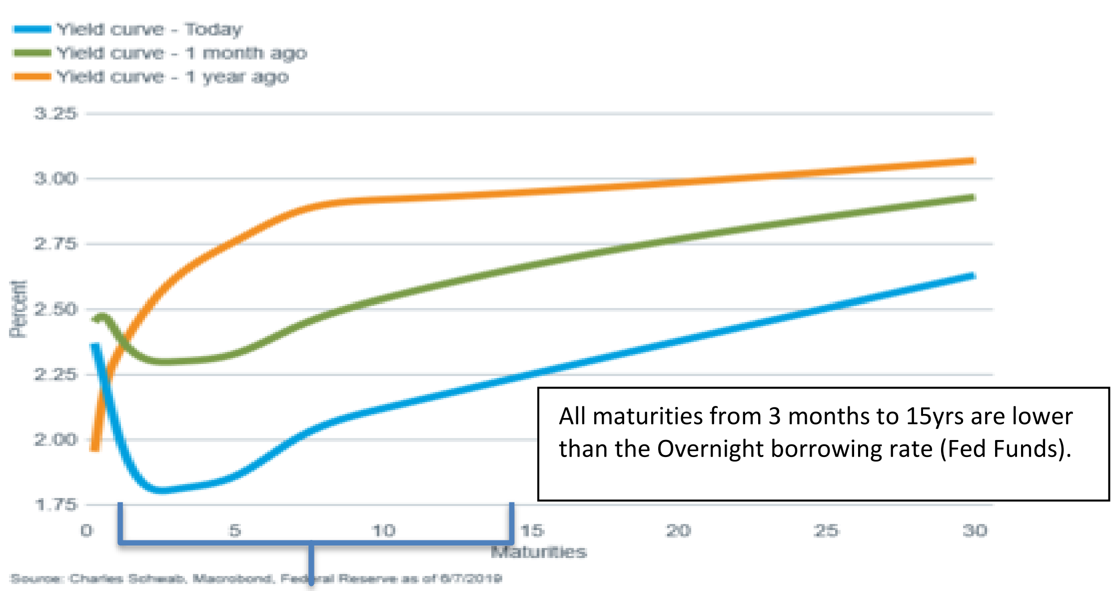
Central Bank monetary policy is getting easier in most of the developed countries. This is good news. Rates have fallen and yield curves have flattened (the spread between short term and long-term rates). However, it also <u>indicates the markets are expecting slower growth and low inflation for the foreseeable future.</u> The 10-year government bond yields are drifting into negative territory in many countries, signaling that investor demand for relatively safe assets is strong while inflation concerns are low. In that kind of environment, central banks have few alternatives to keeping rates low.

U.S. yields are higher than other major countries' bond yields



Source: Bloomberg. Data as of 5/13/2019. **Past performance is no guarantee of future results.**

US Yield Curve Inverted: A rapid shift in the US yield curve from positive to inverted demonstrates the sea change in both the Fed and investor confidence about the future. The orange line shows a positive sloped yield curve (long term rates are higher than short term rates) a year ago. The green line shows the curve slope a month ago where 3- 7 yr. rates where slightly below the Fed's overnight borrowing rate. **The Blue line shows where rates are today and a significant curve inversion, which in the past, has proved to be a powerful recessionary indicator. It also means the market is expecting an imminent move from the Fed to lower rates.** **Will the Fed move or wait? If the Fed does not move, the markets (both stock and bond) will be sorely disappointed.**



Earnings Growth has slowed as real economic growth has declined from 3% back down to 1.5% - 2%. In other words, economic growth has declined by 30%- 50%! That is significant! Much of the decline is due to the waning effect of tax cuts and government spending. With this decline, **earnings growth is expected to be only 3% this year, yet the stock market is up nearly 12 -15%.** The market is always forward looking, so the hope or expectation is that growth will pick up next year. The question remains, **what will be the new impetus for growth?**

In sum, global stock prices are once again back on the upswing. Hopes are high the Fed will deliver (rescue) the market with a rate cut soon and the trade disputes will get resolved. At the same time, the Bond market is betting on a recession. This **wide chasm in the outlook will continue to foster a very volatile market environment. THE BEAST will continue to deliver a wild ride.** Enjoy your Summer!

Investment Strategy: Balanced, low volatility, broadly diversified. The portfolio strategy is working very well in current volatile market environment. Both stock and bond exposure remain in the neutral zone. Please contact me with questions or concerns.

These are my thoughts. Your feedback is always appreciated.

Best Regards,
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