Post Oak Private Wealth Advisors

ADVISORY, CONSULTING & INVESTMENT MANAGEMENT

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Quarterly Market & Economic Commentary

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We are a little over one year out from the 2020 presidential election, and it's looking like the next 13 months will be long and exhausting. As the campaigning and electioneering ramps up, the national press will likely by preoccupied by contentious Democratic primary debates and a White House gripped by a siege mentality over impeachment proceedings. All the associated political maneuvering should suck the oxygen out of the room and limit any meaningful or thoughtful discussions. That's a shame because there are many other issues on the front and back burners—issues that may get buried in the avalanche of political drama.

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Among the more worrisome issues is economic growth. The bond market flashed a blaring red light in Q3 as long-term yields tumbled back to historic lows. The benchmark 10-year U.S. Treasury rate dipped below 1.5% in August, the lowest rate in over three years. By quarter-end, the 10-year rate had recovered some ground to close at 1.68%. A brief inversion of the yield curve between the 2- and 10-year rates also raised investor concern; there is some correlation between an inverted yield curve (when short-term interest rates are higher than long-term rates) and a potential recession, although the curve is not the absolute indicator some financial reporters believe.

The yield curve is already inverted between the 10-year rate and very short-term rates (one year and lower), but the recession signal historically has been strongest in the spread between 2-year and 10-year rates. At quarter end, this spread was still positive, meaning no inversion, but just by 5 basis points (five-hundredths of a percentage point). Even if the yield curve does invert for a significant period, a recession won't likely start right away. That being said, the situation with the yield curve and interest rates does bear close watching.

What drove bond yields lower in Q3? Primarily, it was a surge in demand from foreign investors on a "flight to quality" to the traditional safe haven of U.S. government securities. (Strong demand increases bond prices, with an inverse effect on bond yields.) Economic growth in many international markets appears to be stalling, including in Germany (the powerhouse of the European economy) and China (which turbocharged global growth in recent years.) The slowing trend led the Organization for Economic Cooperation and Development (OECD) to downgrade its global growth forecast for all of 2019 to 2.9% in September, down from 4% earlier this year. The European Central Bank took drastic action to pump stimulus into the E.U. economy, cutting their deposit rate to -0.50% and restarting their quantitative easing program of bond purchases.

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In a further sign of global economic worry, yields went negative on many fixed income securities—government, corporate and private debt—in several advanced economies, such as

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Germany and Japan. As of the end of August, over $17 trillion in global debt (sovereign and corporate) traded at negative yields, including 30 percent of global investment-grade bonds. Business have found it hard to resist the opportunity for free and cheap money that low and negative-yielding bonds represent. As a case in point, September was a record month for global bond issues, with companies selling $434 billion in debt to investors during the month. The idea of negative interest rates essentially flips capitalism on its head—with a negative-yielding bond, investors pay borrowers for the privilege of lending them money. Not only is are negative rates unusual and backwards, they're also troublesome. Yet investors have snapped up these securities, even though they're locked in for losses if they hold the bonds to maturity.

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Yields for U.S. fixed income securities may be low, but at least they're on the positive side, reflecting the generally positive outlook for the U.S. economy. This past July, the current phase of growth became the longest U.S. expansion since 1854, surpassing the boom years of the 1990s. But there are signs growth is starting to slow here on our shores. Data from the Institute of Supply Management (ISM) showed steep drops in U.S. manufacturing during August and September, hitting the lowest levels since the early days of the current expansion. Uncertainty about trade has not only dampened production activity but also business confidence, and by extension capital expenditures.

The annualized growth rate for Gross Domestic Product (GDP) dipped to 2.0% for the 2nd Quarter, a steep deceleration from the 3.2% growth rate in Q1. The weaker GDP number may be more about the year-over-year comparison with the same quarters in 2018, when growth surged on the stimulus of tax reform and government spending. The growth we are seeing now is coming primarily from U.S. consumers, thanks to continuing tight labor markets and rising wages. But even as America's shoppers and spenders have powered U.S. economic growth, signs of weariness are emerging. For instance, personal consumption expenditures slowed in August and inflation measures are falling short of the ideal 2% target range.

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Which brings us to the Federal Reserve. The Fed followed through on two quarter-point rate cuts in the 2nd Quarter, both of which were largely expected by the market. The first cut at the end of July was positioned as a "mid-cycle adjustment" to sustain the current spell of growth. Many Fed watchers saw that decision as more of a psychological move than a real jump-start for the economy. The second cut in September came as data confirmed slowing global growth, but also with a Fed statement that aimed to quash expectations for more rate cuts for the rest of 2019 and possibly 2020.

One Fed watcher who may disagree with this view is President Trump. Before the September rate cut, the president suggested via tweet that the Fed should get more aggressive on rate cuts, dropping the Fed funds target rate to "ZERO, or less". (Trump's all-caps emphasis, not mine.) The message was in line with the pressure President Trump has continued to apply to the central bank (along with less subtle messages to the "clueless" and "bonehead" Federal Reserve governors.)

In my view, Trump is turning the screws on the Fed to ensure the central bank has his back as he seeks a sweeping trade deal with China. It will be interesting to watch how Fed chairman Jerome

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Powell threads the needle between the president's combative tweets and conflicting data on the U.S. economy. The Fed may find itself in a tough spot as the tides seem to shift in the U.S. and in the broader global economy; on one hand they are patiently waiting for data to confirm stronger trends, but on the other they may find their hand forced by rapidly changing conditions in the global economy. Even former Fed chairwoman Janet Yellen thinks the central bank may be too optimistic about their current expectations for U.S. growth.

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Fed moves in the 3rd Quarter weren't limited to rate cuts. In September, the New York Federal Reserve Bank stepped in to provide liquidity support to the market for overnight repurchase agreements (or "repos"), a critical piece of the financial market's infrastructure. The cash infusion, which occurred over the last two weeks of the quarter, was an unusual but not unprecedented move—the last time the Fed intervened in the repo market was during the peak of the global financial crisis in 2008. While the episode only harkened back to the financial crisis, it did underscore the fragility of the financial markets and Federal Reserve's broader role as guardians of financial stability, ready to expand its balance sheet to safeguard the financial system.

Looking to market activity, 3rd Quarter performance for stocks was uneven—higher in July, then more volatile in August, before a September recovery. The benchmark S&P 500 Index closed the three-month period up 1.7%. Among market sectors, technology stocks continue to drive overall performance with modest contribution from consumer staples stocks. Both the energy and health care sectors detracted from performance for the quarter. Oil prices spiked briefly over $60 per barrel in mid-September following a drone strike on a Saudi Arabian oil facility, but a quick recovery in Saudi production saw WTI prices retreat to $54 by September 30. Energy prices are expected remain range-bound in the near term as the global slowdown reduces demand and supply increases with growing U.S. domestic oil production, including new pipelines connecting the Permian Basin to export terminals in the Gulf of Mexico.

Stock investors grew concerned about the drag a global slowdown would have on corporate earnings, but many of the warnings on corporate profits were centered around trade. The whipsaw between hope and pessimism in expectations for a U.S.-China trade deal continued in Q3. Reacting to a stalemate in trade negotiations, President Trump re-imposed a 10% tariff on $300 billion in Chinese imports to the U.S., which was scheduled to take effect September 1. The Chinese government retaliated with trade restrictions of its own, along with allowing its currency to value below the critical value of seven yuan to the U.S. dollar. Stocks tumbled in reaction to these tit-for-tat measures, recording their worst daily loss for the year so far on August 5.

But not too long after that, tensions on both sides simmered down. After an agreement to resume trade talks later in the quarter, the president postponed the September 1 tariff increase, and China agreed to a limited purchase of U.S. agricultural exports. In September, Bloomberg reported high-level U.S. administration officials have considered offering an interim trade deal to China, which would include a delay in new U.S. tariffs and potentially rolling back tariffs previously imposed in March 2018. In return, China would be expected to import more U.S. agricultural goods and comply with previous Chinese commitments on control of intellectual property. President Trump said he is not averse to an interim deal but would prefer a more comprehensive agreement, something he can tout while out on the campaign trail.

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Sitting presidents aren't likely to do much to upset the economy as they approach their re-election campaigns, and I would expect the same from Trump in the coming months. If anything, he'll enact what measures he can to ensure the economy continues to hum along up to Election Day 2020. That would include hammering the Federal Reserve to keep the pressure on interest rates and brokering deals that help key GOP constituencies, such as Midwestern farmers. But there's only so much a president can do; the economy and the markets are largely beyond executive office control, especially if growth continues to slow down around the world.

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The risks of a recession continue to build as the expansionary cycle stretches out. Many ultra-high-net-worth investors are already taking these risks seriously; a recent UBS survey found a majority of uber-rich households (average wealth of $1.2 billion) believe the U.S. will fall into recession in 2020. 45 percent of these investors are shifting their portfolios to relatively safer assets, such as bonds and real estate. 42 percent are raising cash as a protective measure.

Our view is mostly the same: we are gradually building cash in our own portfolios while we play out potential bull and bear market scenarios in the immediate term. The Powell "put" is definitely on as the Fed appears keen to use interest rate policy and other stimulus to support economic growth and to hopefully prevent the market from going into freefall. Our longer-term outlook remains strategically bullish on equities, as we seek attractive opportunities for total return wherever we find them.