



### **Q3 2019 Market Synopsis**

#### **Economic & Market Update:**

The third quarter of 2019 was a very volatile quarter, with US stocks ending marginally higher while other risk assets were generally negative. The US stock market (measured by the SP500) returned 1.7%, while foreign stocks and commodities were down between 1.9% and 6.3% respectively. Bonds and other interest rate sensitive securities had another very strong quarter with all bond classes up between 1% and 3.5%. The SP500 ranged from an all-time high of 3025 to a low of 2844 before recovering to around 3000 at the end of September. Although the period was volatile, the 6% - 7% drop from all time highs fell short of an official ‘correction’.

The 10-year Treasury yield continued its extreme drop, and decreased from 2.0% to 1.68% in the period, after recording a low of 1.45%. The historic downward move in rates that started in September 2018, is catapulting normally stable assets upward.

<b>Select 2019 YTD Asset Class Returns (9/30/2019)</b>	
<b>DJ US Real Estate (US Real Estate)</b>	<b>+ 27.5%</b>
<b>Nat Gas/Oil Pipeline Companies (TPYP)</b>	<b>+ 21.5%</b>
<b>S&amp;P 500 (US Stock Market)</b>	<b>+ 20.5%</b>
<b>MSCI EAFE (Foreign Developed Stock Market)</b>	<b>+ 13.0%</b>
<b>High Yield Bonds</b>	<b>+ 11.3%</b>
<b>US Mid/Long Treasury Bonds</b>	<b>+ 9.7%</b>
<b>TIPS (Treasury Inflation Bonds)</b>	<b>+ 7.5%</b>
<b>Private Farmland, Timberland, Infrastructure (VCRRX)</b>	<b>+ 7.0%</b>
<b>MSCI Emerging Market (Emerging Stock Market)</b>	<b>+ 5.2%</b>
<b>Alternative Lending (LENDX/RMPLX)</b>	<b>+ 2.4%</b>
<b>Insurance Linked Securities (XILSX/SRRIX)</b>	<b>+ 2.4%</b>

A large driver of returns and market sentiment in Q3 continues to be FED policy. The FED has now reduced the benchmark Fed Funds rate a quarter point three times in 2019 to the current level of about 1.6%. In addition, the FED has now started to increase the size of the balance sheet (a type of quantitative easing) to the tune of \$185B just in the month of September.

**Below: 5 Year history of the 10 Year Treasury Note Yield**



**The major factors which impacted markets in Q3 2019 are highlighted below:**

Much like the 2<sup>nd</sup> quarter, lower interest rates and headlines around trade and specifically the volatile ‘China trade war’ continued to dominate the markets. Because of these factors, bonds and other interest rate sensitive securities (real estate) continued to perform very well.

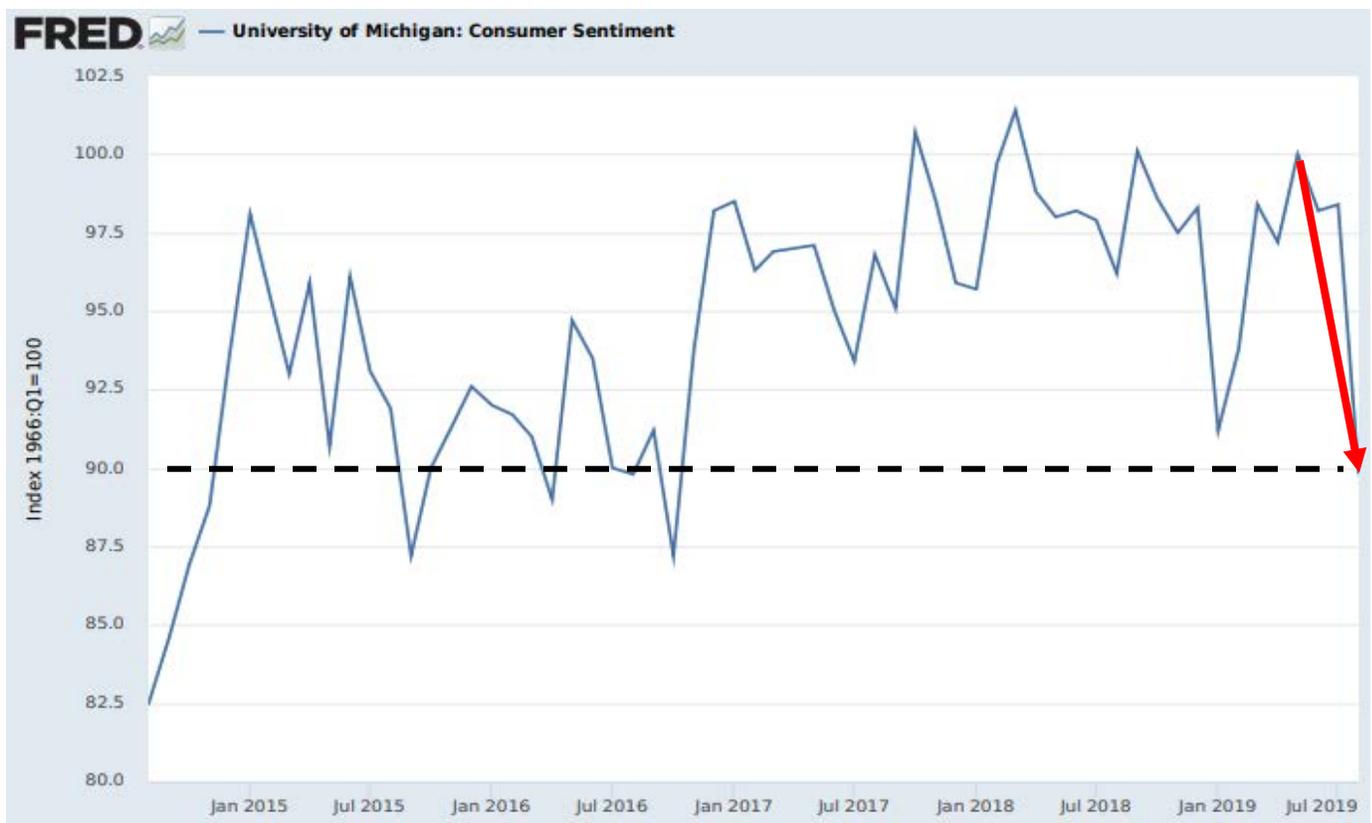
The trade war with China largely caused the volatile quarter for all risk assets, with the largest drawdown being a 6%-7% drop in August and the choppy recovery thereafter. It is becoming more unlikely a comprehensive trade deal with China will be completed in the near term, and in fact new tariffs were placed on Chinese consumer goods and even certain European products over the past month. However, as we write this update, there are signs of progress on what is being called a ‘phase 1 deal’ that could be signed with China by year end. This is certainly a positive development, and with Trump postponing further tariff increases based on the deal, this is certainly pointing to at least a pause in escalation.

Latest developments aside, during Q2, we noticed two things we have not seen prior. One, when CEO’s and other business owners are surveyed on their optimism about the future, they are citing the trade war and trade uncertainty as a major worry. This seems to

be having an impact on how they are planning their operations. There is evidence that the combination of new tariffs placed on many Chinese sourced consumer goods and uncertainty around any definitive long term trade resolution is causing many businesses to take defensive actions in terms of hiring new workers, investing in technology, or expanding operations (especially overseas).

The second change involves US consumers getting more cautious as well. Below is a five year graph of consumer sentiment. Although still at relatively high levels (as to be expected with unemployment at 50-year lows), there is growing concern on several fronts.

**Below:** *Five year chart of University of Michigan Consumer Sentiment Survey. Recent steep drop seems to be related to political & trade uncertainty.*



Another issue that emerged towards the end of the quarter was the impeachment inquiry of President Trump. This is likely to be in the headlines and on the minds of many investors for at least the next 2-4 months until a vote is held in the House of Representatives and a final vote is held within the Senate. We do not see this process having any direct impact on the economy, but this just adds to overall uncertainty. Looking back at prior impeachment stock market performance (Clinton & Nixon), we see a mixed result depending on the time you start measurement. Overall, we view this as

more of a side-show in terms of actual economic impact, rather than a significant risk factor.

The much more meaningful event remains the 2020 election. It is way too early to predict or couch any outcome, but over the next 13 months this will likely be the number one event we will be monitoring. The ultimate resolution could have a meaningful impact on the overall tax regime, trade, corporate profits, regulation, and healthcare should there be a change in presidency and senate control.

### **Traphagen 2019 Portfolio Changes & Performance Update**

After a tough 2018, 2019 is an excellent year across the board for risk assets, bonds, and alternatives. Bonds continue to have the best year in more than a decade with the historical drop in long-term rates from 3.2% on the 10-year Treasury to 1.5% currently.

Almost all risk assets have also responded favorably to the drop in long-term rates and the change in FED policy. This very accommodative and supportive FED gave investors support to bid up stocks, real estate, and commodities.

All of our alternative investments are performing near or exceeding return expectations. As a group, the alternative assets are poised to return between 5% to 6% for the year with very little volatility or relation to any other financial assets.

This combination of positive performance across the portfolio has made 2019 one of the best for our clients in the past decade. Most of our client portfolios (depending on portfolio risk level) are up between 8% and 15% on the year.

#### **Below you will find a summary of recent changes we made to portfolios (mid 2019):**

- **Introduction of sector rotation fund:** Over the past 2 months we allocated to a sector rotation fund in many portfolios (DSEEX or DSENX). This is a DoubleLine fund that analyzes each sector within the stock market on a monthly basis and invests in the preferred four sectors based on long term valuation and behavior. In addition, because of the structure of the fund, there is a fixed income yield component as well. This fund has performed well since it was incepted in late 2013, with about a 3% per year advantage over the SP500 and a 2019 return of 22%.
- **Elimination of Emerging Market Stocks:** We have eliminated all direct exposure to emerging market stocks over the past couple months. This comes on top of the 50% trim we completed in the asset class during January of this year. We decided to completely eliminate our position for two reasons; better US

prospects/strong US Dollar and a move to be more defensive in response to a slowing of global economic growth.

- **Elimination of Biotech Overweight:** With the introduction of the new sector rotation fund and the increased political risk through the election we decided to eliminate our direct exposure to the biotech sector (BBH).

### **2019/2020 Market and Economic Outlook Update:**

We continue to hold a mix of short and intermediate term bonds due to the flat yield curve and higher or comparable yields available on short term bonds vs. longer. As mentioned prior, we have made other changes, that while maintaining roughly the same level of stock exposure (except in conservative portfolios), shifted to a slightly more defensive stance. We continue to allocate to a wide range of alternative/private investments, as they are performing well and have had very low volatility and correlation to traditional financial markets.

**Mixed signals for the US economy and more cautious data points for the global economy persist.** On the plus side, unemployment now stands at a near 50 year low of 3.6%, consumer confidence remains relatively high (despite the recent decline), consumer spending is robust, and interest rates are very low. Because of very low unemployment and interest rates, real estate (which represents a large percentage of many investors total wealth) remains in a strong position.

In addition, after the historic shift in FED policy at the end of 2018, investors believe Chairmen Powell, the FED, and most global central banks will be accommodative to risk assets for the foreseeable future.

On the other side of the coin, US and foreign economies have slowed and US corporate earnings growth looks to be near 0% in 2019. In our last newsletter we stated the majority of stock returns for 2019 were likely in the books, and so far that certainly has been the case. Since that time we have seen a 1% increase in US stocks and material down moves in foreign stocks.

From this point forward, Traphagen will be paying special attention to the 2020 election and the likely impacts from it's outcome. Again, at this time we are not making any portfolio moves due to the election, but as we get more clarity that is certainly a possibility.

The TRI (Traphagen Recession Index) can be interpreted as the chance of a recession beginning over the next 12 months. This measure had been gradually rising over the past two years, but did reverse course over the past couple of months and now sits just below 50%. We still consider this metric somewhat elevated, and over the past month we have

taken some defensive action in response to this. We will continue to monitor for any further significant movements, but we are happy with portfolio positioning at the current time.

As always, we greatly appreciate the privilege of providing financial guidance and managing your portfolios. We hope you all have a wonderful end of the year and holiday season.

Best regards,

**Your Traphagen Investment Team**