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Monthly Market Commentary

MCF CAPITAL MANAGEMENT

Recession fears, data indicates otherwise

August & September 2019 | Marco Fragnito, Managing Principal | Robert R. Fragnito, Chief Operating Officer

KEY POINTS:

- We continue to believe that the direction of the financial markets largely lies in the hands of global central banks and more specifically the US Federal Reserve.
- Despite "recession talk" being distributed in the media, we believe economic data continues to make the case for economic expansion.
- Uncertainty in the market is still present, but future actions by the US Federal Reserve and a reestablishment of US-China trade talks will ease concerns faced by investors.
- Fixed income instruments are in focus and positions in the sector should be reviewed by investors as the likely possibility of rate cuts are shortly on the horizon.
- The next Fed FOMC meeting is taking place between September 17-18.

EQUITY MARKET

Equity markets in July performed well, driven by strong economic data and corporate earnings, yet August proved more challenging for investors. The gains from July evaporated in August due to weaker than expected global economic data, renewed trade tensions between the US and China and the uncertainty surrounding Federal Reserve monetary policy. Although volatility increased quite dramatically during August, actual price declines when viewed over the last two months amounted to less than 1% for the Dow Jones Industrial, S&P 500 and NASDAQ Composite. The declines were muted in stark contrast to what the financial media appeared to be reporting daily amongst all the talk of the US economy going to recession in the next year. We continue to believe that the direction of the financial markets largely lies in the hands of global central banks and more specifically the Federal Reserve.

The articulation of the Fed's monetary policy, in our opinion, has been poorly delivered by Chairman Jerome Powell over most of his tenure and as such has created a lot uncertainty in financial markets. President Trump has also contributed mightily to this uncertainty with his constant attacks on the Fed via Twitter and his approach to trade negotiations with China. Despite this, we believe both Trump and Powell continue to act the best interest of the US economy. The Federal Reserve did cut interest rates at their end of July meeting as expected and Chairman Powell did reiterate his pledge to "act as appropriate to sustain the expansion" at the central bank's symposium in Jackson Hole, Wyoming.

Although President Trump escalated trade tensions in early August by imposing a new 10% tariff which was set to take effect on September 1st on the remaining $300 billion of imports from China, he later delayed the imposition of the tariffs on most of the imports until December 15th not to hurt the US economy and in hope to work out a trade agreement with the Chinese government. As Trump and Powell both acknowledged that the risks to the US expansion have risen, they appear to be willing to take pragmatic actions towards helping sustain the US economic expansion and making sure the economy remains in a good place.

FIXED INCOME

In the US Treasury Bond market, we saw yields on 30-year US Treasuries drop to a historic low of 1.90%. We strongly felt in 2016 that the historic low yield set that summer of 2.09% would not be breached again for many years to come, we were proven wrong and gave us reason to reassess our expectations for long term interest rates. At the same time, the inversion of the Treasury Yield curve persisted and further raising concerns of a recession in the near term.

Signs of a slowdown both at home and abroad appeared. In Europe, the continent's largest economy Germany saw its GDP shrink in the second quarter while China saw its industrial output fall to its lowest level in 17 years. While US GDP grew at 2.0% in the second quarter, it continued to show slower growth since early 2018. Despite this slower growth on the domestic front, the economic data remained solid if not a strong as in 2018.

The US labor market added another 289,000 new jobs during the last two months, jobless claims remained at 50-year lows and wages were rising at the fastest rate in over a decade. While not all the economic data remained solid, especially in manufacturing where we saw the first monthly contraction in the PMI since 2009, the US consumer remained strong. Retail sales for the month of July rose .7 a percent on top of a gain of .3 of a percent in June. The US Consumer Confidence Index bounced back strongly moving from 124.3 in June to 135.7 in July. With continued job growth, wage gains, the Fed further cutting interest rates and continued negotiations on the trade front, we find it difficult to embrace the pessimistic economic outlook being signaled by the bond market. Recessions can and have sneaked up on the best economists and analysts, we however do not believe this to be one of those times.

MARKET OUTLOOK

We continue to remain bullish on US equities and are not only bearish on fixed income instruments but are very concerned investors may not fully understand the risks associated with longer term bonds at these levels. Historic low US bond yields drive in part our bullishness in equities and bearishness in bonds. While the economy may have slowed in 2018, we continue to grow, and while earnings have stalled, they still provide ample support for equity prices in a low and declining interest rate environment.

In today's markets, many high-quality companies provide higher dividend yields than can be earned on most US Treasury Bonds. We expect economic activity to pick up into year end and into the election year, and we believe many concerns faced by investors will be resolved over the coming year and will help remove much of the uncertainty plaguing markets.

We continue to believe the single biggest concern holding back the equity markets is the Federal Reserve's monetary policy. With the Fed moving from a restrictive monetary policy to at least a neutral and possibly simulative one, we expect equity markets to reap the benefits with higher P/E's leading to higher prices. We have always felt that with short term rates above 2% or the targeted rate of inflation the impact on growth would be negative both at home and abroad.

While much is made about the trade tensions between the US and China, nobody can truly measure their impact on our domestic economy. What we do know is that it creates a lot of uncertainty that can prove harmful to economic growth. We feel that an agreement will ultimately be reached, and it should

be one that is fair for all parties and will lead to more balanced and fair trade around the world. This will truly raise growth throughout the global economy. We continue to strongly encourage fixed income investors to speak to us, the risks of capital loss in US bonds are quite real. For our non-client readers, feel free to contact us to hear our views on the bond markets, we think you will find it helpful.

If you have any questions please contact us directly at 949.472.4579, and feel free to forward this report and our contact information to anyone who might be interested.

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SOURCES

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