C Y P R E S S

ASSET MANAGEMENT, INC.

MARKET COMMENTARY **October, 2019**

If the S&P 500 manages to close out the year right where it ended the 3Q 2019, it will be up 19% in 2019. The headline number is somewhat misleading, however, because stocks plunged in the 4Q 2018. In reality, the market has been a battleground and stocks have demonstrated resiliency but made limited progress since the S&P 500 made new highs in January 2018. The S&P is up only 4% over the past 21 months. The 3Q 2019 was more of the same, as the S&P 500 index rose just over 1% amid an escalation of tariffs on China announced in early August and fears of a looming recession.

While little changed in the global economic and geopolitical landscape during the quarter, on the margin the economic outlook may be improving from the recent easing of monetary policy while geopolitical risks may have increased. The market continues to grapple with a range of challenging issues:

- *Global growth is slowing*
- *U.S. capital spending and manufacturing are weakening*
- *The U.S. China trade war. The conflict is proving difficult to de-escalate and has been further complicated by the ongoing Hong Kong protest movement.*
- *A sharp decline in bond yields and inversion of the U.S. yield curve*
- *The Fed and global central banks are easing monetary policy and cutting rates*
- *Impeachment Risk.*

  We note that perhaps the most important change in the last quarter is the political challenge faced by a sitting president. A Russian collusion investigation has disappeared only to be replaced by an impeachment investigation in the Democrat-controlled U.S. House of Representatives. Both added volatility to any market projections.
- *2020 Election. A potentially game changing presidential election is approaching, daily coming into sharper focus.*

The Aussie Playbook

The good news is that against the backdrop of rising geopolitical uncertainty and weakening growth, there has been a decided shift to a more accommodative global monetary policy. Central Banks have cut rates and aggressively eased policy to shore up growth.

As we have written about before, Australia is in its 29th year without a recession and still moving ahead. The Royal Bank of Australia (RBA) recently cut its policy rate to just 0.75%, an insurance cut and something that may have caught the attention of the Fed. Not only did the Fed cut interest rates twice in the third quarter (25bp in August and in September), it just announced that it is going to start growing its balance sheet again. The Fed has begun buying short-term Treasury debt at an initial pace of $60 billion a month to maintain ample liquidity in the markets. Whether or not this marks a return of "quantitative easing", it certainly represents an easing of financial conditions. We expect the Fed to follow the lead of the RBA at least once more before year end and to do whatever it takes to sustain the U.S. economic expansion.

A Recession Is Not on The Horizon

We don't know when the next recession will start. It might be in two years. It might be in seven years. But it is not on the horizon today. In fact, there are already indications of "green shoots" emerging from the recent easing of financial conditions.

The manufacturing sector has been a casualty of the trade wars and a weak global economy, but the U.S. consumer is in good shape, and consumer spending represents 67% of the U.S. economy. Wages and spending are both growing. The unemployment rate continues to decline (3.5%) and the unemployment rate for blacks, Hispanics, and "less than high school education" all declined to record lows. To say the least, the economic expansion has broadened out.

The message from the housing market is the same. Historically, housing has clearly weakened before recessions start. At the moment, housing remains stable and single family is strengthening thanks to lower rates.

As global central banks have eased, Global Short-Term Rates have declined significantly during the course of 2019 and are now at the lowest level in three years. Global Short Rates typically increase before a recession is on the horizon. Moreover, the Global Easing Cycle has helped stabilize market valuations, narrowed credit spreads, reduced concerns about deflation, and calmed recessionary fears.

Return to Positive Yield Curve: One of the biggest recession risks has been an inverted yield curve. A persistently inverted yield curve has been a harbinger of recession. That risk has been significantly reduced. The 10-year bond yield has recently recovered to 1.74%, roughly 16 basis points above 2-year yields at 1.58%.

A Pick Up In Earnings: The range bound U.S. Stock market of the past 21 months has corresponded to a stagnation in earnings growth. Corporate profits are influenced by many factors, but markets follow the direction of earnings. Earnings appear to be coming in better than expected in the third quarter and earnings growth is forecast to increase to mid-single digits in 2020.

Conclusion

We think it is important to point out that while market returns and economic trends appear relatively ordinary with little changed, we are constantly monitoring the many layers of the market. As noted, in the last quarter, the Fed cut rates twice, the presidential election process started to pick up steam amidst grueling opposition party battles and the China deal seemingly careened closer to the danger zone. We are reminded of the duck analogy: the numbers look benign (like the duck viewed calmly swimming above the surface of the water) while the underlying market and political dynamics are, at times, roiling (a duck's web feet thrashing below the surface). Our response to the situation has been resolute, we are hard at work making adjustments to the portfolios: some de-risking of the holdings, maintaining -if not enhancing –diversification and balance and a continued search for true growth stocks with a reasonable valuation given their long-term prospects. As always, we continue to seek out the stocks of companies that may offer enduring, meaningful growth that can make a real difference in the financial futures of our clients.