CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

October 22, 2019

Financial Markets Commentary 3rd Quarter 2019

Summary

The third quarter of 2019 paled in comparison to the previous two quarters as global weakness and trade fatigue combined to depress returns. Even a widely expected September rate cut could barely elicit a "ho-hum" from investors. While corporate profits once again exceeded expectations for most companies, future guidance was not very encouraging. CEO's cited trade uncertainty and difficulty finding qualified job applicants as their biggest concerns. This was especially true among smaller companies, who seemed to have had a more difficult time attracting talent than their bigger rivals.

With this in mind, the large cap S&P 500 was able to post a 1.7% quarterly gain while the smaller cap Russell 2000 shed -2.4%[i]. As a sign of how much trade has impacted market performance over the past year, large company stocks are up 20.5% for the first three quarters of 2019 but up only 4.2% over the last full year (trade concerns hit the market hard in 2018's final quarter). Small cap stocks are up 14.2% year to date but *down* -8.9% over the past twelve months. Though all eleven S&P industry groups[ii] have gained year-to-date, three (energy, health care, and materials) were down last quarter. Energy's -6.2% decline was by far the worst. Technology's 31.4% gain is best for the year, but two interest rate sensitive sectors (utilities and real estate) were the big winner last quarter. Read this as a vote of little confidence in the economy – a rapidly growing economy consumes more energy and raw materials and its demand for credit to finance expansion usually drives interest rates up, which tends to hurt utilities and real estate the most.

With the point having been made about the importance of trade, it is no surprise that foreign markets lagged both last quarter and year-to-date. The -1.1% decline last quarter knocked foreign market returns down to 12.8%[iii] for the year in dollar terms. Japan, which is not currently in a trade conflict with the U.S., gained 3.1% last quarter. Europe and China, which obviously are, lost -1.8% and -3.8% respectively. Latin America, a major supplier of raw materials to China, dropped -5.6%. Canada posted a 0.4% gain. It has a strong 21.5% gain for the year.

Low interest rates continued to be a tailwind for the bond market. The Aggregate U.S. Bond Index rose another 2.3% last quarter, running this year's net gain to a stellar 8.5%[iv]. High yielding corporate bonds gained 1.3% last quarter, while much safer short-term U.S. Treasuries were up just 0.6%. Emerging market debt was all over the place last quarter, but according to Barclays the aggregate return was 1.3%. The key to return last quarter was to take as much interest rate risk as possible (in order words, long maturities). This is easiest to accomplish in the government and municipal sectors.

Activity

We did not make any substantial changes to positions last quarter. Interest rates trends continued to favor higher quality bonds, larger capitalization stocks, a growth over value bias, and U.S. stocks over international stocks. The few changes we made were along the lines of replacing lagging funds with better performing fund in the same category.

Outlook

Nobody knows what lies ahead for the financial markets. Not us, not Ken Fisher, not Jim Cramer; nobody has a crystal ball. Under the best of circumstances, forecasters have to try to predict the rate of economic growth and the direction of interest rates (which is a hard enough job as it is). Today our job is even more difficult. We have multiple trade battles and (as of this writing) an impeachment inquiry to try to predict the consequences of. There is really no precedent for the complexity and uncertainty we face.

That said, to have made portfolios defensive has thus far proven to be a recipe for under-performance. While the headline risks are well-known, the stock market has held up very well when you consider that investors have been, in aggregate, selling stocks and buying bonds. Markets might go sideways when investors are pessimistic, but we've never seen that lead to a double-digit decline. Plunges almost always happen when investors get overly optimistic about stocks and then get disappointed. Given investors' modest dislike for stocks today (relative to bonds) the worst we can foresee in the next few months is a period of moderate weakness -- and a surge to new highs would not surprise us at all. Of course, our crystal ball is still on backorder!

Commentary – Q&A

We'd like to address some of the questions we have received over the years:

1) **Why do you hold cash (given that money market yields are so low)?**

Answer: We like to hold some portion of every account in cash due to investor liquidity needs and for quarterly management fees. Beyond that, we hold cash because of its "optionality". In other words, it's ability to be deployed wherever we want at a moment's notice. One conceptual use of cash is as a hedge. Imagine there was a development that was an obvious and immediate negative for the market. The ability to immediately use cash to buy an ETF with a negative correlation to the market would enable us to quickly hedge part of the downside.

2) **Why doesn't the market always decline on bad news (and why does it sometimes drop when there is good news)?**

Answer: Markets do not move on news per se. They move on the news *relative to what the market was expecting*. An interest rate cut that everyone expected does not create a market rally. The information was already priced in. An interest rate cut that was merely hoped for can create a rally. If say 30% of investors did not expect the cut and were therefore positioned for disappointment, the cut forced that 30% to change their strategy (most likely to buy) which helped drive the market higher.

You may have heard the phrase "buy the rumor, sell the news". The meaning of this is that once news is out and absorbed by everyone, it has no more power to drive markets. It follows that if you sell into bad news, you are betting that others have not yet absorbed the bad news and will be sellers once they do, thus you are beating them to the punch. Either that or you are betting that the bad news is just the beginning of much more bad news to come.

3) **Why do you make small movements in response to market turmoil (why don't you just sell everything when markets are in decline)?**

Answer: Because we never know how bad the turmoil is going to be, and we cannot assess how fast authorities will act to restore confidence. There are times, perhaps 5-10 times per year, when we sense the market is vulnerable. Maybe there has just been a weak economic report. Job growth was less than expected or consumer confidence declined, for example. Or maybe it was something technical, like the stock market rallying to a point just short of its previous high, then selling off sharply. Most experienced market professionals will get a kind of "thin ice" feeling when things like this happen.

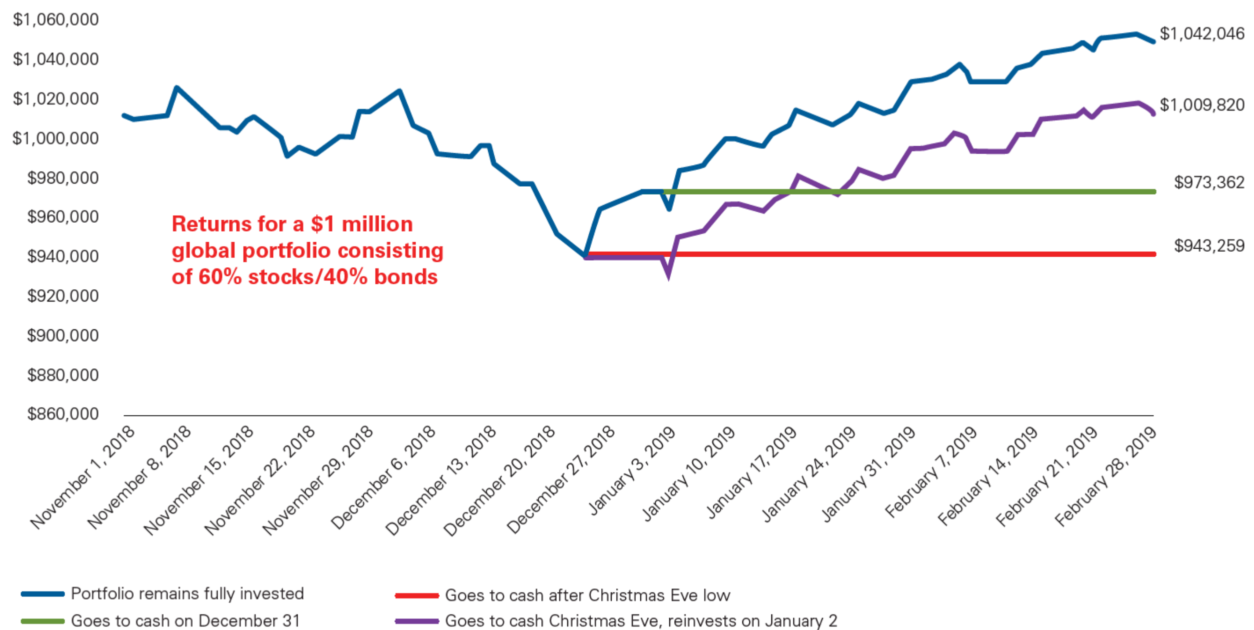
In our experience, however, these things lead to meaningful (10% or more) declines maybe only one time in five. The truth is that most 3% declines don't turn into 10% declines, most 10% declines do not turn into 20% declines, and most 20% declines do not turn into 50% declines. Statistically, selling into weakness is going to be wrong, and you will wind up buying back in at higher prices than you sold out at. Knowing this, we might want to trim or shed the position that we had the least confidence in going forward, but selling everything

just means I might turn a small mistake into a large one. Vanguard recently published some research on the effects of selling during periods of volatility. A hypothetical 60% stock 40% bond portfolio that stood at $1 million on the morning of November 1, 2018, would have lost -5.7% of its value by Christmas Eve. Yet selling the portfolio at the time and fleeing the markets, even briefly, would have cost an investor tens of thousands of dollars in two months, as stock recovered all of their losses by the end of January. See Exhibit 1.

Exhibit 1[v]

Staying the course can pay off; abandoning course can be costly

The global stock market drop in late 2018 offered a lesson in investor behavior



Source: Vanguard

The other reason we don't was hinted at in the first sentence of the last paragraph. Because the authorities have decided over the last decade or so that market declines were intolerable. It is important to note that this did not happen previously. The Federal Reserve was tasked, prior to 2008, with regulating the supply of credit to prevent depressions and inflationary outbreaks. Today when stocks decline more than about five percent, investors and the financial media scream for the Federal Reserve to cut interest rates. September's rate cut did not come in response to any *measured* economic weakness. Unemployment has trended down since 2008 and is at a five decade low of 3.5% for goodness sake! No, the recent rate cut came because many investors feared the trade war was slowing down global growth enough that the effects might spill over here. Stock investors needed pro-active reassurance that the Powell–led Fed "had their back".

Some of you may interpret this as a reason to be extra aggressive. After all, if the Fed is going to ride to the rescue of stock investors every time they get into

trouble, being aggressive may feel as though it just isn't that risky anymore. Certainly, that has been a profitable strategy over the last ten years. Those that have generally not taken extra risk (we count ourselves in that number) are concerned that cutting rates and "quantitative easing" would not be very effective if a full-blown crisis arrived. The best analogy is probably the forest fire. Years and years of putting out small economic "fires" may mean that the big one will be much worse when it finally occurs.

4) What is a reasonable rate of return expectation for the next ten years?

Answer: This is a very difficult question. As we referenced above no-one has a crystal ball and we definitely agree with Yogi Berra when he said, "it's tough to make predictions, especially about the future". We would approach it by asking what we thought we could expect from the stock and bond markets and then average those two returns. That said, we track market predictions from seven different highly respected asset managers, including Research Affiliates, MFS, Blackrock, JP Morgan and GMO. Each of those managers devote tremendous resources to estimating future market returns. At the end of 2018 their 10-year annualized return expectations ranged from -4.2% to 7.7%. That's a giant range. And remember, the people creating those forecasts are tremendously bright and work hard to make reasonable estimates. If we take the average of all their predictions, our 10-year return expectation is 3.5%, annualized. You might now ask, how helpful is that figure? We'd answer not very. It just strengthens our belief that no one truly knows where the market is headed and successful investors will remain invested in a globally diversified portfolio of stocks and bonds consistent with their unique risk tolerance.

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[i] Return data courtesy of S&P and Russell, respectively. S&P is the proxy used for large company stock returns and Russell for small companies.

[ii] Industry/sector returns are courtesy of S&P.

[iii] Foreign returns courtesy of MSCI international per Morningstar.

[iv] Bond returns courtesy of Barclays per Morningstar.

[v] U.S. stocks represented by CRSP U.S. Total Market Index. U.S. bonds represented by Bloomberg Barclay's U.S. Aggregate Float Adjusted Index. Global stocks represented by FTSE Global All Cap ex US Index. Global bonds represented by Bloomberg Barclay's Aggregate ex-USD float adjusted RIC capped index. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.