Market Perspectives: Third Quarter 2019

DÉJÀ VU ALL OVER AGAIN?

Global capital market outcomes have exceeded expectations YTD, begging the question of what is ahead for investors. Will markets – and investors – enjoy an encore in 2020? Will markets reprise 1998 or 1974 (the last two times when a sitting President faced possible impeachment)? Are we destined to replay the capital markets environments and outcomes of 2008's Great Financial Crisis or those of 2000's Dot Come Bust? Or would it be more prophetic (if perhaps unwise) to proclaim that "This Time It's Different" despite elevated prices for almost all asset classes?

Making predictions – about the economy, about capital markets, about politics – is fraught with pitfalls. The most critical trends in the economy (is an expansion continuing, picking up speed, or ending?) are mostly only identifiable after the fact. Major capital market trends like interest rates, corporate profit margins and earnings, and equity prices are loosely linked to economic trends, sometimes leading and sometimes lagging such trends. And making portfolio decisions based on politics or potential political outcomes? That is neither an uncontroversial business strategy nor a winning investment approach. But having an informed perspective – one that contextualizes and balances potential risks and rewards – is what investment professionals strive to "bring to the table" on behalf of their clients.

RECENT ECONOMIC TRENDS

Recent economic news has been mixed, with some data supporting the thesis that the U.S. economy is slowing down and other information suggesting that a mid-year weak patch may only have been transitory. Strong consumer spending is still fueling economic growth; wage increases and a tight labor market (the unemployment rate remains at a 50-year low) continue to buoy consumer sentiment. However, the picture has become more mixed on the business front, with manufacturing weakening and business confidence trending somewhat lower. On balance, the rate of U.S. GDP growth is projected to slow across the year's second half. Outside the U.S., a general economic slowdown has adversely impacted European economies generally and German manufacturing activity in particular. Likewise, the export-heavy economies of Japan and China are feeling the negative effects of on-going trade disputes.

Optimism/pessimism about a U.S. trade deal with China waxes and wanes on a near daily basis. Striking a deal before year-end could produce a short-term global equity market bounce; higher tariffs, further delays or settling for a partial deal would likely produce the opposite effect. Were a deal reached, current consensus is that it would have little economic impact in the U.S. across the balance of 2019 or in early 2020 and would not materially affect corporate earnings in the short run.

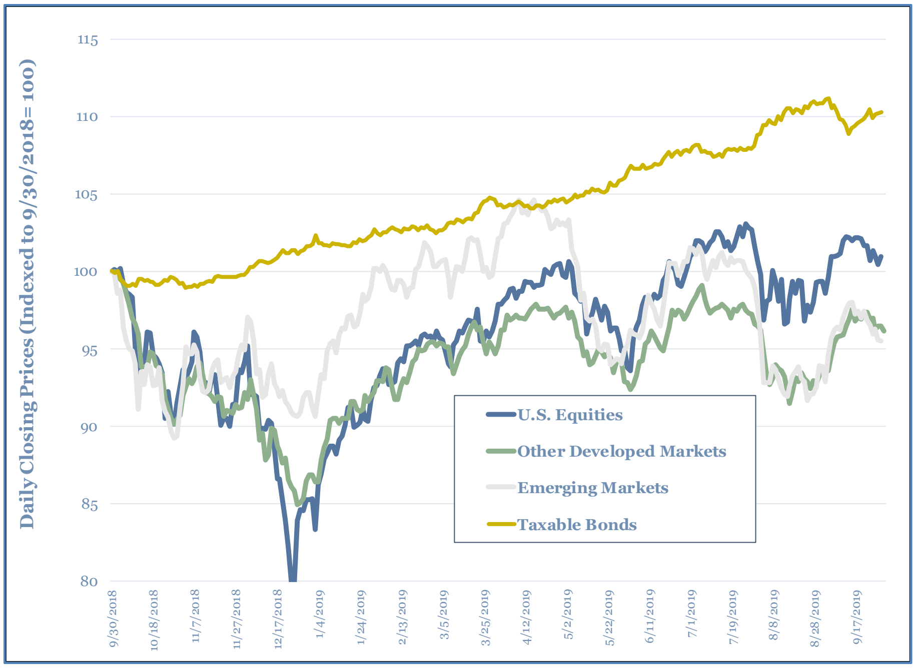
Dysfunction in the U.S. and U.K. political systems is likely to be with us for the balance of the year, if not longer. The U.K. will likely miss the October 31 deadline for BREXIT, adding to the uncertainty that since June 2016 has riven its populace, complicated economic activity in that country, and sent the British Pound to its lowest value versus the U.S. Dollar since 1984. In the U.S., it is too early to know how the nascent impeachment process plays out and whether the process or its end-result produce any significant impact on U.S. capital markets (see brief discussion that follows). It is unlikely that any meaningful policy decisions (on healthcare, on infrastructure, on government deficit spending and indebtedness) get legislated prior to the November 2020 election.

The Federal Reserve, by cutting its benchmark Fed Funds rate twice last quarter (to 2.00% currently), legitimized consensus views from earlier this year that accommodative monetary policy was needed to counter a budding economic slowdown. Markets are continuing to expect a further cut in the benchmark rate before year-end. A wary Fed will be looking closely at the relative firmness/weakness of U.S. economic and price data across the next few weeks before deciding on next steps. More broadly, with most of the world's major central banks pursuing quantitative easing (and, consequently, record totals of global government bonds currently offer investors negative yields), concerns are being expressed as to whether low-to-negative interest rates are an effective policy tool for low-growth, low-inflation global economies.

BOND AND EQUITY MARKETS

U.S. Treasury Bond prices rose sharply in August, as increasing signs of slower economic growth pushed overall yields down to their lowest levels (e.g., 1.53% for the Treasury market as a whole) since late 2016. A recent firming of some economic data – producing ammunition against bearish views that flat yield curves are predictive of an imminent recession- resulted in a modest back-up in yields and lower bond prices in September. With both investment grade and high yield credit spreads remaining comfortably below their long-term historical averages, global bond sales hitting records, and investor appetite strong for higher yielding securities, the bond markets continued to signal confidence in borrowers.

Equity and Bond Market Prices, September 2018 -September 2019



Harkening back to the 2008 financial crisis (a brief déjà vu moment, if you will), there was a spate of extreme volatility in the U.S. money market in mid-September. The overnight repurchase ("Repo") rate that is applied to borrowing and lending between financial institutions briefly soared to levels (10%) last reached during the financial crisis. While many observers theorized as to the causes -- most market participants believe it was the combined result of the Fed's shrinking balance sheet, an ill-timed Treasury bond issuance and large corporate tax payments that drained cash out of the banking system – a series of short-term liquidity interventions facilitated by the Federal Reserve has resolved the issue for now.

The tax-exempt bond market experienced particularly heavy new issue supply during the third quarter as issuers sought to take advantage of near-record low yields. This dynamic helped to push yield ratios tighter - causing muni bonds to under-perform comparable maturity Treasury bonds last quarter. But with bond market yields still lower on balance YTD and relative to last September, taxable and tax-exempt bonds have produced better-than-anticipated total returns for investors.

Current Bond Market Metrics and Recent Total Returns

	Yield to	Total Returns, Periods Ended 9/30/19		
Market Segment	Maturity	3 Months	YTD	12 Months
Taxable Bonds	2.26%	2.3%	8.5%	10.3%
Tax-Exempt Bonds	1.54%	0.8%	4.7%	6.4%

source: Bloomberg

Equity market investors have also been well-rewarded YTD, with gains in excess of +16% on global equities (*MSCI All Country World Index*) and over +20% on U.S. equities (*Russell 3000 Index)*. These outcomes are not, in our opinion, markers that a new bull market has begun. Rather, much of this year's equity market advances are making up for the sharp downturns that occurred last fall. As shown in the table below, returns since the end of last year's Third Quarter the 2018 3Q have been materially less generous.

Current Global Equity Metrics and Recent Total Returns

	Total Returns, Periods Ended 9/30/19			Dividend
Equity Markets	3 Months	YTD	12 Months	Yield
United States	1.2%	20.1%	2.9%	1.89%
Developed Markets	-0.8%	14.2%	-0.3%	3.47%
Emerging Markets	-4.2%	6.1%	-1.7%	3.04%

source: Bloomberg

It will possibly surprise many people (given growth stocks' +23% YTD returns) to see that value stock and growth stock returns were undifferentiated across the last 12 months The table below compares returns and "decomposes" the drivers of these outcomes on various sub-segments of the U.S. equity market. It reveals, for example, that higher valuations (+4.4%) were the primary driver of one-year returns for growth stocks; and that earnings growth and higher dividends are what combined to produce similar returns for value stocks. And it shows that earnings of companies comprising the widely followed S&P 500 Index – a benchmark constructed using different criteria than the value versus growth sub-segmentations of the U.S. equity market –have not grown materially. More than two-thirds of this renowned benchmark's returns have been the result of higher valuations (i.e., a 12 month increase in the S&P 500's Price/Trailing Earnings Ratio from 19.2x to 19.6x) and cash dividends. And for small cap stocks, a sharp valuation contraction resulted in their underperforming most U.S. and non-U.S. equities.

U.S. Equity Market Return Drivers, 12 Months Ended 9/30/2019

	Lg. Growth	Lg. Value	S&P 500	Small Cap
Earnings	-1.9%	0.9%	0.6%	0.9%
Valuations	4.4%	0.4%	1.6%	-11.0%
Price	**2.4%**	**1.3%**	**2.2%**	**-10.2%**
Dividend Yield	1.1%	2.4%	2.1%	1.4%
Total Return	**3.5%**	**3.7%**	**4.3%**	**-8.9%**

Investment returns on non-U.S. Developed Market equities have not kept pace with their U.S. counterparts, though for reasons that have varied somewhat across major market sub-segments. Unlike U.S. companies, non-U.S. firms' earnings have collectively declined year-over-year. In European markets, marginally higher prices (+1.9%) mean that valuations have risen despite weak earnings; investors have also benefited from these markets' comparatively higher dividend yields. But the on-going strength of the U.S. Dollar against nearly all European currencies curtailed total returns to U.S. investors in these markets. Poor earnings and comparatively unchanged valuations created lower stock market prices in Japan that were only partly offset by dividends and a stronger Yen. Emerging Market stocks collectively have likewise lagged, mostly due to flagging earnings and declining currencies across the 26 country markets that comprise this sub-asset class.

Non-U.S. Equity Market Return Drivers, 12 Months Ended 9/30/2019

	Dev. Mkts	Europe	Japan	Emerging
Earnings	-7.2%	-7.3%	-12.1%	-8.6%
Valuations	6.7%	9.9%	1.0%	6.4%
Price (Local Currency)	**-1.1%**	**1.9%**	**-11.3%**	**-2.7%**
Dividend Yield	3.6%	3.8%	2.6%	3.0%
Total Return	**2.5%**	**5.8%**	**-9.0%**	**0.0%**
Currency	-2.8%	-5.6%	5.1%	-1.8%
Total Return (USD)	**-0.3%**	**-0.1%**	**-4.3%**	**-1.6%**

THE POLITICAL ENVIRONMENT

Although having already said that a discussion on the topic of how politics impact investments is ordinarily best avoided, the possibility of an acrimonious impeachment process unfolding across the months immediately ahead already has some investors asking questions (e.g., what has happened in markets when this has occurred previously; should portfolio asset allocations be changed in anticipation of even greater political tensions). This is one of the few times that we are comfortable asserting that situationally, "This Time It's Different". Mostly, we have come to this conclusion because there are only two prior modern examples (impeachment proceedings of Presidents Nixon and Clinton) upon which to draw for relevant guidance. Capital markets in the high inflation, oil crisis macro-economic environment of 1974 were nothing like those of the high growth, technology boom environment of 1998; and neither of these earlier periods have much in common with the low-inflation, low interest rate globalized environment of 2019. Relevant comparisons are difficult at best, so we think it is a stretch to seek out historic parallels to inform investment decisions based on current political turmoil.

A FORWARD LOOK

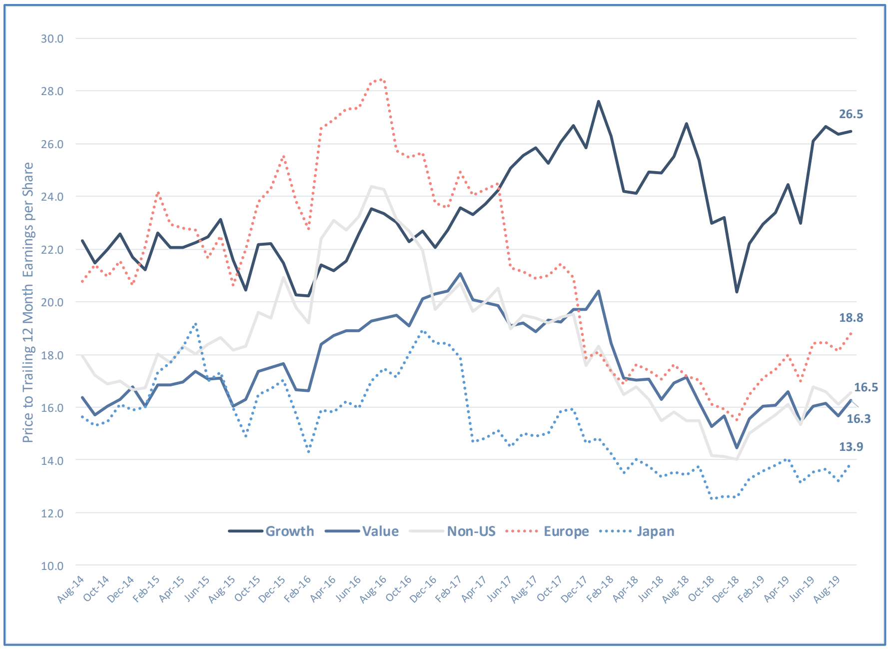
There is ample data supporting the consensus view that rates of global economic growth generally, and in the U.S. economy in particular, will remain tepid into 2020. There is little reason to believe that an unexpected catalyst – a surge in consumer sentiment and spending, a ramp-up in private investment (i.e., higher business spending on equipment and structures) – will trigger better-than-anticipated growth. Whether the U.S. and China reach a comprehensive agreement on trade seems a bit moot for the economy in the short run. And history does not augur well for adopting policies that adversely affect consumers during Presidential election years. So, implementing threatened widespread and substantial tariffs on imports from China and risking a U.S. economic recession in 2020 seems unlikely. Although the Federal Reserve wants to avoid being perceived as having lost its independence by kowtowing to Trump's demand for lower rates, it likewise wants to avoid blame for tipping the economy into a recession by not proactively lowering interest rates further. The bottom line: the economy is vulnerable but, we think, not yet at risk of its first recession in 12 years.

In our view, investors with portfolios that strike a balance between returns and risks (e.g., an asset allocation of 60% global stocks, 40% bonds) should expect less generous returns in the short-run than the 11%+ blended portfolio results produced so far this year. The bond markets will most certainly not reprise their equity-like returns. Interest rates, given a slowing economy and attendant Fed rate policy, are more likely to trend downward than rebound higher. Given current bond market yields (1.5% to 2.3%), low single digit one-year returns are the most that investors should expect from this portion of their portfolios.

The short-term challenges for equities are two-fold: earnings uncertainty and elevated valuations. As illustrated above, companies listed in non-U.S. equity markets have recently logged earnings declines in the face of slowing global economies. Although we are not expecting to see a decline in U.S. profits, it is concerning that trailing 12-month earnings are currently virtually unchanged currently versus at the start of 2019. In our opinion it is more likely than not that consensus U.S. earnings estimates for 2019 (for the S&P 500, +9% versus current EPS) and for 2020 (+11% over 2019) will be ratcheted downward in the month immediately ahead as third quarter earnings roll in and companies start setting expectations for lower future results.

Investors' reaction to slower actual and forecast rates of earnings growth is unpredictable. This year, investors have collectively been unwilling push overall valuations above the highs (P/E of 18.1x) of Fall 2018. In 2019, at one point in May valuations fell nearly -7% to a YTD low of 16.5x. The risk presently: if the economic expansion slows and profit margins and earnings growth weaken, investors could extrapolate this trend into the future and re-value stocks downward. With most U.S. stock P/E ratios already above-average (especially large cap growth stocks, the 26.5 P/E on which is a 60% premium to value stocks and is nearly 20% above the sector's long-term median valuation), a valuation correction produced by rising investor pessimism could quickly trim broad market prices -20% or more. Such a fate has befallen over-valued U.S. stocks and stock sub-sectors in the past; it struck European, Japanese, and Emerging Markets as recently as 2016-2018. The long history of financial markets, particularly periods in which elevated valuations and rising earnings uncertainty coincide, push us more toward concluding "It's Déjà Vu All Over Again" than "This Time It's Different".

Changes in Equity Market Valuations, 2014-2019



These cautionary – if perhaps worrisome – recitations of the above-average risks to which diversified portfolios are currently exposed are not intended to scare investors. Rather, they are intended to remind them that the pace with which portfolios produce longer-term returns (we project a 5-year annualized return of roughly +5.5% on a 60/40 balanced portfolio, based on our current forward-looking capital market estimates) is never steady and is rarely as "satisfying" as these first 9 months of 2019.

INVESTMENT STRATEGY TEAM
OCTOBER 4, 2019

DISCLOSURES

Past performance is no assurance of future results. This publication has been prepared by Mill Creek Capital Advisors, LLC ("MCCA) and is provided for information purposes only. The information contained in this publication has been obtained from sources that MCCA believes to be reliable, but MCCA does not represent or warrant that it is accurate or complete. The views in this publication are those of MCCA and are subject to change, and MCCA has no obligation to update its opinions or the information in this publication. While MCCA has obtained information believed to be reliable, neither MCCA nor any of their respective officers, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this publication or its contents. **Unless otherwise noted, all market and price data are through September 30, 2019. Unless otherwise noted, the primary data source for the tables and charts herein is Bloomberg LP.** Other sources of data used in the preparation of this report was drawn from a variety of sources, including Barclays Capital, Citigroup, the Bureau of Economic Analysis, the Bureau of Labor Statistics, HFRI, MSCI, the U.S. Federal Reserve, and Informa/Zephyr Associates.