Market Review & Outlook: How Low is too Low? How Slow is too Slow?

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Executive Summary

- *Global economic growth is expected to slow as trade concerns and political uncertainty persist.*
- *Central bank accommodation will likely have limited impact on economic growth but be supportive of investment grade fixed income and risk assets such as equities.*
- *The U.S. economy will face headwinds but is expected to grow with support from the U.S. consumer.*
- *Despite the recent softening of tone in U.S. / China trade negotiations, meaningful progress on key issues will remain elusive and is likely a long time away.*
- *We encourage clients to maintain long-term perspective on financial goals, investment fundamentals and portfolio risk.*

The International Monetary Fund (IMF) has reduced its 2019 global growth forecast to 3% from 3.2% as recently as July which stands in contrast to its more robust 2017 forecast which approached 4.0%. The IMF attributes the slowdown to trade disputes, but there are other factors in play notably heightened political uncertainty both domestic and abroad. Central bankers around the globe are doing their best to reverse the slowdown in a web that recognizes domestic issues as well as the interconnectedness of global economies. Compared to the United States' second quarter annualized GDP growth of 2.3%, 3% global growth sounds pretty good; however, smaller emerging economies need faster growth to improve the standard of living for the citizens who live there. There are two questions about the slowdown in global growth for investors to consider. First, how much will things improve if a trade deal is struck between the United States and China? Second, what are the other headwinds and is it possible to compensate for them?

Interest rates in the U.S. have fallen in 2019 with two Federal Reserve (Fed) rate cuts and persistent downward interest rate pressure on longer maturities. The significant decline in rates in 2019 has resulted in strong price appreciation in bonds of all stripes. Currently, the yield on the 10-year U.S. Treasury stands at 1.74%, only slightly above the 1.58% yield on the 2-year U.S. Treasury note. At this time last year, the 10-year U.S. Treasury yield was 3.14%. The U.S. yield curve is flat

Equity Market Index Returns

As of September 30, 2019

Asset Class	Index	Latest month (%)	Latest quarter (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
Large Cap U.S.	S&P 500 Index	1.87	1.70	20.56	4.26	13.40	10.84	13.24
	Russell 1000 Large Growth Index	0.01	1.48	23.30	3.71	16.90	13.40	14.94
	Russell 1000 Large Value Index	3.57	1.36	17.83	4.02	9.43	7.79	11.46
	DJ US Select Dividend Index	5.05	3.57	17.70	6.31	10.00	10.71	13.72
Mid Cap U.S.	S&P 400 Mid Cap Index	3.06	-0.08	17.87	-2.50	9.38	8.88	12.56
Small Cap U.S.	S&P 600 Small Cap Index	3.34	-0.20	13.47	-9.34	9.33	9.89	13.02
Developed International	MSCI EAFE Index	2.87	-1.07	12.81	-1.34	6.48	3.27	4.91
Emerging Markets	MSCI Emerging Market Index	1.91	-4.25	5.89	-2.02	5.98	2.33	3.37
Commodities	Bloomberg Commodity Total Return Index	1.17	-1.84	3.13	-6.57	-1.50	-7.18	-4.32
Real Estate	NAREIT Equity Index	2.93	7.79	26.96	18.41	7.35	10.25	13.03
Global Market Cap Weighted	MSCI World Index*	2.81	-0.93	13.57	-0.96	6.49	3.07	4.78

**The U.S. represents about 51% of the MSCI World Index.*
All returns greater than one year are annualized. Source: Greenhill Market Index Review as of September 30, 2019

and rates are low. Why? Employment growth in the U.S. is healthy, the consumer remains confident and the unemployment rate is at record lows. While GDP growth is down from 2018 levels of 3%, the economy seems stable around 2% growth led by the consumer. While there is some concern about declining optimism in the manufacturing sector, on balance, the near-term economic outlook for the U.S. appears pretty good; but we don't live in a vacuum. Negative interest rates in many/most international markets are fueling demand for positive yielding assets, especially fixed income instruments of a high-quality nature. Some combination of higher relative interest rates and healthier anticipated growth domestically is driving a stronger U.S. dollar relative to other major currencies, which is also attracting capital to the treasury market. Recent interest rate activity across the globe suggests that investors are concerned about growth.

Negative rates, like so many monetary policies right now, are an experiment. European and Japanese central bankers remain desperate to push capital into the economy to drive growth. Negative rates (coupled with central bank bond purchase across maturities – a process known as quantitative easing or QE) are an extreme disincentive for banks to take earn risk-free returns vs. making loans. So far, the evidence suggests that the experiment has been limited in its effectiveness. Trade friction has compounded an already difficult situation driving many European economies, some of which are heavily dependent on exports, to the edge of recession…again. The latest addition to the European monetary regimen is a new program of QE with no end (coined "QE Infinity"). There is some recent evidence that European governments are recognizing that the fiscal restraints, established and imposed to make the Eurozone experiment sustainable, are stifling growth. Germany has indicated an uncharacteristic willingness to spend more / tax less in the interest of restoring economic growth. Meanwhile inflation is benign. Eurozone employment is healthy at 7.4% unemployment with modest wage growth of 2.7%. Japan has almost full employment. So why is the greater rate of growth seen as so critical? In our opinion, it comes down to standard of living. The basic formula for standard of living in any given region is GDP per capita. In order for a significant majority of a region's people to live better, it has to grow. There are a number of factors at play including aging populations, globalization, the appropriate level and role of regulation and many more. For now, suffice it to say that until Europe starts to grow, the phenomenon of negative and low interest rates will likely persist.

In the face of global growth concerns, U.S. markets finished slightly higher in the third quarter 2019. The trigger points continue to be the Fed and trade. The U.S. joined pretty much every other nation on earth with a negative reading for the ISM Manufacturing Purchasing Managers' Index (PMI) in September and October. While imperfect, the best evidence that we have suggests that U.S. economic growth will likely slow and while not entirely out of the question, avoid contraction. In this case, it is relatively easy to identify the culprit: trade. To some degree, the tariffs imposed on China and Europe have hurt demand for finished products to be imported. These goods were either pulled forward or the new tariff loaded prices are unpalatable to consumers. There is also the impact of uncertainty on these producers' willingness to transact with others for capital equipment, services and intermediate goods. The good news is that the tariff issue can be resolved with single agreements. Is there relief in sight? Recent U.S. / China discussions indicate a willingness to, at least temporarily, cease further escalation with a mini-trade deal for the U.S. to freeze tariff rates on Chinese goods at 25% in exchange for increased agricultural purchases by China. There is speculation that this small agreement decreases the likelihood of further U.S. tariffs scheduled to go into effect in mid-December. We can expect further intermittent bouts of trade uncertainty between the U.S. and China as the big-ticket items, intellectual property rights, market access and enforcement mechanisms will likely require an extended period for meaningful progress.

September saw a lower than anticipated addition to non-farm payrolls and a deceleration in the rate of wage growth. Non-farm payrolls saw an additional 136,000 personnel in September versus the expectation for 140,000 and below the 12-month average of about 170,000. Average hourly earnings growth declined to 2.9% from a consistent trend of growth above 3% throughout 2019. The unemployment rate has fallen to a record low of 3.5%. Rather than lamenting the softening statistics, investors were encouraged by the flexibility this slow growth provides the Fed: a phenomenon many have characterized as "Goldilocks" where we enjoy modest growth and limited inflationary pressure, allowing the Fed to remain accommodative in its posture, which is generally supportive of risk assets such as stocks.

Rates matter and they always will, but it does seem odd that the market is this excited about Fed intervention this late in a cycle while most hard data looks pretty good. We have dealt with modest growth just fine over most of the past ten years. Can the Fed be relied upon to drive a continuation of the long, but slow growth economic cycle? For now, the market places about 84% probability on an additional 0.25% rate cut in October and the consensus seems to be additional cuts beyond that. The Fed says it is data dependent and few Fed Governors forecast a long series of rate cuts. Forecasts for global growth and corporate earnings call for renewed growth in 2020. Do these numbers need to come down? It depends on whether central bankers and politicians can solve the immediate problems and find the right balance to drive economic activity in the face of persistent headwinds.

Frustrations with the status quo are showing up in yellow vests in France, new political parties throughout Europe and numerous other forms around the globe. The old policy prescriptions are not working well because they are designed for a world in which things overheat driving the primary risk of inflation. We are confronted with a world in which we struggle to maintain growth and the petri dishes are full of experiments to address a new reality in which the primary risk is deflation in mature economies. We are optimistic about the capacity of human ingenuity but we remain vigilant for tipping points that might drive global economies into recession. Despite the uncertainty, we believe that the U.S. consumer is on solid footings offering support for moderately paced growth. We believe equities are reasonably valued and continue to offer the best potential for returns that outpace the rate of inflation. Within equities, we maintain a more conservative posture and maintain our long-term perspective seeking companies with attractive valuations, durable business models and strong free cash flow potential in all environments. We also believe it is important to correctly assess risk tolerance with personal financial goals and allocate appropriate funds to investment grade bonds to maintain standard of living through negative cycles which will come at some point. ■