DANN ASSET ADVISORS, LLC

Interim Update
Recent Market Volatility
August 29, 2019

The market (as measured by the large company S&P 500 index) has been volatile over the past month, falling as much as 6% from its late July high before rebounding recently. While we appreciate that no one really knows what moves markets over the short term, our guess is that the immediate causes of the current volatility are the escalation of the U.S.-China trade dispute and the inversion of the yields of the two and 10-year Treasury notes (the two-year Treasury recently has been yielding more than the 10-year, usually a good indicator of a recession coming within the next six to 24 months).

Background. We began writing this piece in early August after President Trump announced his intention to levy an additional 10% tariff on Chinese imports beginning in September. At that time, we were less concerned about trade and more concerned about the substantial decline in interest rates during 2019 and the lagging of broad sectors of the stock market since fall 2018. With respect to rates, we note that the yield on the 10-year U.S. Treasury dropped from 2.67% at December 31, 2018 to 2.02% on July 31 (the day before the most recent tariff escalations) and since to a further low of 1.45%.

With respect to stock market sectors, small cap stocks and transportation stocks (groups often believed to reflect the strength of the U.S. economy) have declined 12% and 11%, respectively, since September 30, 2018 while the technology-led S&P 500 is down only 1%. Declining interest rates and poor performance of economically sensitive sectors are usually reliable indicators of upcoming economic weakness.

While market fluctuations in response to tweets from President Trump are disconcerting, we continue to believe that the most important factor for the stock market is the U.S. economy and its impact on corporate earnings. From second quarter earnings conference calls we listened to over the past several weeks we heard that Chinese business activity is continuing to slow (more relevant for U.S. multinationals than U.S. small cap companies) but that the U.S. economy is holding up reasonably well. Europe on the whole continues soft. Trade and Brexit-related uncertainties are having a dampening impact on business spending.

Current thinking. Last Friday's announcement of further increases in tariffs and Fed chair Powell's speech at Jackson Hole combined to make us a lot more concerned about trade's potentially negative impact on the economy. It seems inevitable to us that further trade uncertainty will cause business leaders to defer investment decisions and potentially cut back spending, both of which are negative for the economy. And without trying (or wanting!) to get into the head of President Trump, it seems clear to us that's he's trying to set the Fed up as the fall-guy if the economy weakens.

We see two potential outcomes on trade. One is that President Trump in his desire to keep the economy going and be reelected caves on the important trade issues (in essence, having China play more by the rules of other large developed economies) and China is willing to strike a low-substance, face-saving deal. However, with U.S. elections only 15 months away, we also could see China taking a longer-term view, bearing some pain for now and hoping that they'll be dealing with a different President in early 2021. Under this scenario there's no near-term resolution of the trade dispute. We're increasingly viewing this as the more likely outcome.

Like everyone else, we don't know what's going to happen with the big picture issues. We understand that markets dislike uncertainty and that an apparent resolution of trade issues likely would be perceived positively and cause the market to rise. Still, given our skepticism of a substantive deal being reached near term and our concern over the economy, we believe it makes sense to be conservatively positioned currently.

For most clients, our strategy for dealing with potential market declines has been to supplement indexed exchange traded funds with actively managed mutual funds that have done better than their respective indices over full market cycles (with much of their relative outperformance occurring when the market is falling). In addition, at times we've held small amounts of cash. Of course, it's been more than 10 years since the last substantial bear market, so the jury is out on whether our strategy will provide some downside protection relative to the broad indices in a declining market.

In our opinion, the more important near-term issues that will impact the market include:
- Whether and how trade issues with China are resolved – important for business sentiment/spending and increasingly for the economy
- U.S. employment remaining strong with wages continuing to grow – both providing support for U.S. consumer spending and thus the economy and corporate earnings
- Level of interest rates and whether lower rates keep the economy expanding
- Brexit resolution

In time we'll know whether the current period is the beginning of a significant downturn. If it is, we expect that what we own will go down, as nearly everything does in a bear market. However, we also strongly believe that what we own is high quality and will come back in time. Overall we're very comfortable with our current holdings and confident in their long-term prospects.