DANN ASSET ADVISORS, LLC

Third Quarter 2019 Update

October 11, 2019

3Q19 Highlights

- Stock and bond markets send conflicting signals on the economy
- U.S. stocks register modest gains with increased volatility
- Fed cuts rates a second time but board members become more divided on outlook
- International stocks continue a prolonged period of significant underperformance

The table below summarizes the performance of some key indices during the third quarter and year to date:

Market Performance		
Index	% Ch. 3Q19	% Ch. YTD
S&P 500	1.7	20.6
MSCI Developed Markets (excl US)	-1.1	12.8
MSCI Emerging Markets	-4.3	5.9
MSCI All Country World	-0.0	16.2
US Aggregate Bond	2.3	8.5
Liquid High Yield	1.3	11.6
US Dollar Emerging Markets Bond	1.6	13.7

Source: Morningstar, iShares

Equities. After a very strong first half, U.S. stocks as measured by the large company S&P 500 index registered more modest gains in the third quarter. The quarter also saw more volatility, with a roughly 6% dip beginning late July followed by a rebound to near record levels in mid-September. We believe the dip was caused by the U.S. escalation of trade tensions with China and signals from the bond market that a recession might be coming. Concerns over both these issues seemed to moderate in September, leading to the market's recovery.

The quarter also had some interesting changes below the surface of the broad market. Several of the large company technology stocks that had led the market over the first half (and much of the past several years) declined in the quarter (Facebook, Amazon and Netflix, for example). And small company value stocks, which had lagged over the first half, had a very strong rebound in September before falling back toward quarter end. The market's unusually large intra-quarter swings between growth and value may be the beginning of a move away from the large cap tech stocks that have been so strong in recent years. Increased political/public scrutiny of several of these companies also may be taking a toll on this group.

The S&P 500's year to date return of just over 20% occurred even though earnings for the year are expected to be up only low single digits (Yardeni Research). Consensus earnings estimates for 2020 currently reflect a gain of 11% (Yardeni Research) which may explain why stocks, which usually anticipate future earnings, have been so strong year to date. More likely in our opinion is that much of 2019's gain is due to the year's significant decline in interest rates, with lower rates making stocks relatively more attractive investments. The S&P 500 ended the third quarter trading at a 16.4x multiple of 2020 estimated earnings.

As shown above, international stocks had another poor quarter relative to the U.S. To put this in a longer-term perspective, over the past three, five and 10 year periods ending September 30,

international stocks (as measured by the MSCI All Country World ex U.S. index) compounded at annualized rates of 6.3%, 2.9% and 4.5%, respectively, compared with 13.4%, 10.8% and 13.2% for the S&P 500 over the same timeframes. There are many reasons for international stocks' significant underperformance, but we believe that the main cause has been weaker economic growth, the result, at least in part, of less efficient/flexible economies.

Fixed income. The 10-year treasury yield declined to 1.68% at quarter end from 2.01% at June 30 and 2.67% at the end of 2018. Two-year treasury yields declined a less substantial 12 basis points (a basis point is 1/100 of a percent), during the quarter, ending at 1.62%, but still down significantly from 2.50% on December 31, 2018. Several times during the quarter the yield was higher on the two-year than the 10-year. This particular inversion of the yield curve has been a good predictor of recessions, although the time from inversion to recession varies and has taken as long as two years(1). With the further decline in rates, bonds had another good quarter with very strong year to date returns.

Market sectors. Utilities and REITs, two of the three leading sectors during the third quarter, are considered beneficiaries of falling interest rates and rose as rates declined. Consumer staples stocks (Procter & Gamble, PepsiCo, etc.) were the quarter's third best performing group. This sector often does relatively well when investors are concerned about the economy weakening. Due to a very strong first half, technology was the leading sector over the first three quarters. REITs were a close second, followed by utilities.

The third quarter's worst performing sectors were energy, healthcare and materials. Energy and materials clearly are economically sensitive, and their declines likely reflected concerns over the economy. Healthcare stocks are much less dependent on the economy and earnings in the sector have been decent. The sector's weakness likely stems from political rhetoric during an election cycle and the market discounting the possibility of one of the more liberal Democratic candidates winning in 2020. These same three sectors were the worst performers over the first three quarters of the year.

Portfolio Positioning

We made no significant changes in fixed income during the third quarter. For nearly all clients with fixed income we remain 70% or more in short duration (which we define as three years or less) and 80% or more in investment grade funds. To the extent we added fixed income exposure, we focused mostly on very short-term durations in the one-year range. On equities, for most clients, we sold parts of two mutual fund positions – one focused on Asian markets and the other on U.S. growth stocks. Proceeds were put mostly into existing positions.

Economy

Second-quarter GDP growth slowed to 2.0% compared with 3.1% during the first quarter. Consumer spending rose 4.6%, the strongest growth since the fourth quarter of 2014, but this was tempered by negatives from trade and lower business investment and inventory building. The numbers show the consumer side of the economy strong, underpinned by near record low unemployment, and businesses more cautious, likely due to trade uncertainties but also due to margin pressure from increasing wages and some raw materials. Third-quarter GDP will be reported in the next couple of weeks and is expected to grow around the same pace as the second quarter according to a recent Wall Street Journal survey of economists.

At its recent September meeting, the Fed cut rates by a quarter point, the second cut since July. The Fed was clear that it believes trade uncertainties are hurting business sentiment and

investment. It was also clear that the volatility around trade policy (and the potential impact on the economy) makes determining next steps even more difficult, with the result that the Fed may be on hold until it has a clearer sense of the economy's direction.

In our view, the key to the U.S. economy is whether the U.S. consumer can offset current weakness in the manufacturing/industrial sector of the economy and eventually pull that part of the economy back into stronger growth. We note that this scenario occurred in 2015/16 when oil prices made a big move down, but the economy overall continued growing even as manufacturing went into a meaningful downturn. The key difference this time seems to be trade uncertainty which to date is having a more pronounced impact on international economies but could eventually also hurt the U.S.

(1) Reuters March 22, 2019 article on yield curve inversions.

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