Record-Breaking Expansion is Being Tested yet Again

The Verdence View Forward

Optimism about the continuation of the longest economic expansion in U.S. history is being challenged once again. The lingering effects of the trade "war" between the two largest trading partners (e.g. U.S. and China) and a plethora of geopolitical noise (e.g. Middle East tensions, Hong Kong unrest, Brexit, impeachment in the U.S.) is resulting in a further slowdown of global economic growth. Manufacturing is contracting in five of the seven G7 countries (including the U.S.), China is growing at the slowest pace in at least 27 years, Germany is nearing a recession and Japan just raised its sales tax despite an economic slowdown. In fact, the International Monetary Fund is expecting 2019 global economic growth to grow at the slowest pace since the Great Recession. As we enter the final quarter of what has proved to be a volatile 2019, we offer our view on the current economic expansion and highlight our asset allocation recommendations in these highly fluid and volatile times.

Economy: U.S. Resiliency Being Tested

While the makeup of U.S. GDP shows that the U.S. can be more resilient (we are more consumer oriented) to a slowdown in global growth, our economy is not immune either **(chart 1).** Recent economic indicators on manufacturing, capex spending, production and business confidence warrant some concern. This has been illustrated by Economists raising the risk of a U.S. recession in the next 12 months from 15% at the start of the year to 35%. Being able to pinpoint the exact timing of the end of any economic cycle is impossible. Every historical recession has been unique in nature with different catalysts and most of the time we do not realize we are in a recession until we are well into the downturn. In these uncertain economic times, we focus on what we do know and try to balance the downside risks that are rising for the economic expansion.

At this time, our base case scenario is that U.S. economic growth will slow in the coming quarters and we do not rule out seeing one or more quarters with growth at or even below 1.0%. However, this economic expansion has been tested and proved resilient in the past. There have been several quarters of near or even negative economic growth in this expansion (e.g. European debt crisis in 2010-2012, Asian growth fears and oil collapse in 2014-2016) and they have not ended in a recession **(chart 2).** While we are not complacent, we cannot be overly pessimistic considering some of the factors that should keep growth supported.

Chart 1: U.S. GDP is Domestically Focused

Footnotes: Data is most recent as of September 30, 2019.
Source: Strateges Research Partners, Verdence Capital Advisors.

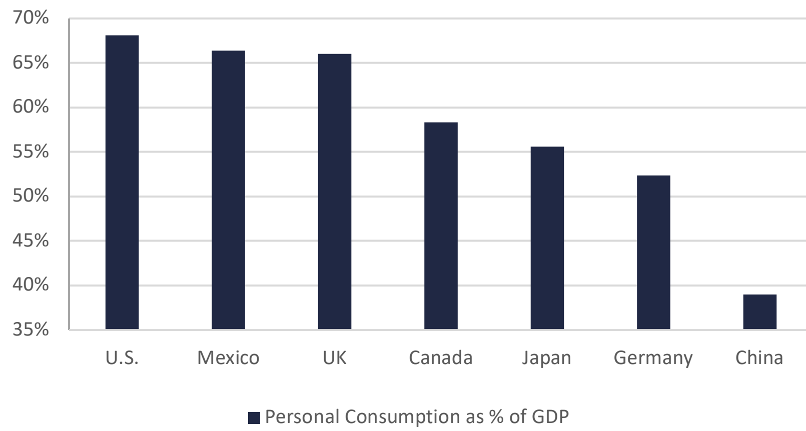
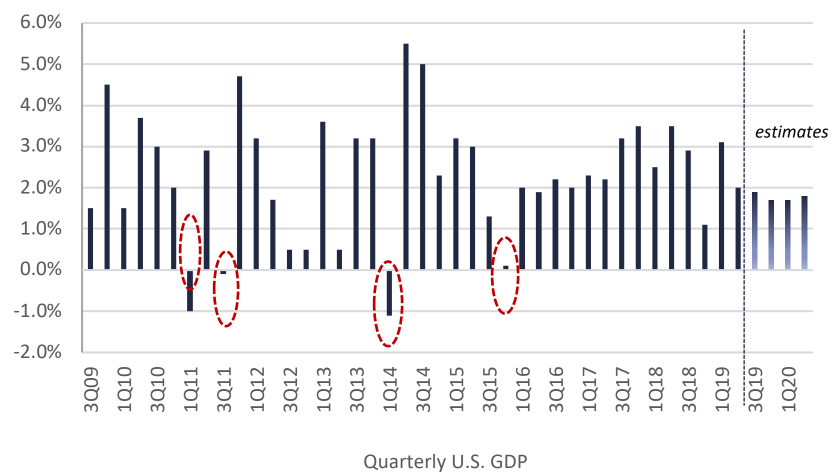


Chart 2: A Historically Long and Resilient Economic Expansion

Footnotes: Estimates for 2019 and 2020 growth are as of October 2, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Past performance is not indicative of future returns

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- **Globally coordinated easy monetary policy:** The Federal Reserve is on pace to cut interest rates further in 4Q19. When looking at the past six recessions since 1973, the economy has never entered a recession with a real Fed funds rate (which factors in the inflation rate) that is as accommodative as it is now **(chart 3).** In addition, the accommodative monetary policy has been a globally coordinated process with all but two of the G20 central banks expected to be easing monetary policy over the next 12 months.

- **Consumer resilient:** A lower interest rate environment, modestly rising wages, healthy balance sheets and solid labor market should support consumer spending. Given that consumer spending makes up ~70% of GDP, it is hard to see a contraction in growth if spending continues at or near its current pace. Consumer confidence is a good leading indicator to gauge the health of future spending. The negative headlines around politics and trade may be challenging consumer confidence **(chart 4)** but even if confidence were to dip lower from its cyclically high levels, history still suggests robust personal consumption growth.

- **Housing offer a small boost:** Housing and the actual construction make up a small portion of GDP. However, we cannot ignore the far-reaching tentacles that home ownership/purchasing can have on GDP as it coincides with the need for items in the service sector (e.g. utilities, insurance), goods (e.g. furniture, electronics) and materials (e.g. building materials). Over the past year, the 30-year mortgage rate has declined by over 100 bps and this has slowly started to filter into housing data and refinancing activity. Housing starts and new home sales are rising **(chart 5)** and the mortgage refinancing index has jumped to a three-year high. For those homeowners able to refinance, this is a direct addition to their monthly spending power.

Chart 3: Fed Is Extraordinarily Accommodative

Footnotes: Data as of September 2019 and estimates for rate cuts and inflation through 2019 as of October 1, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

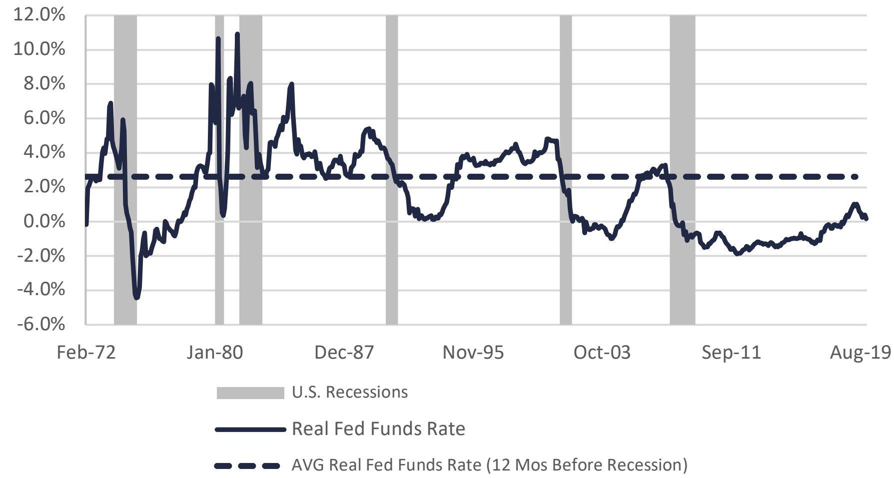


Chart 4: Consumer Confidence Peaking but at Robust Level

Footnotes: Data as of September 2019.
Source: Bloomberg FInance LP, Verdence Capital Advisors.

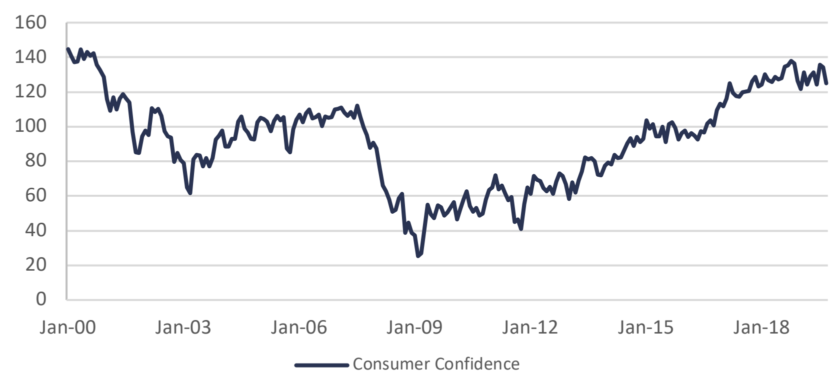
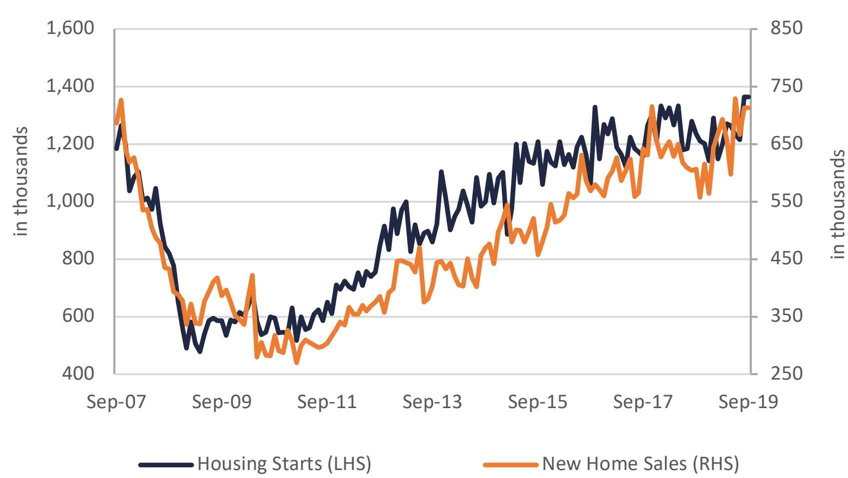


Chart 5: Housing Receives a Boost From Lower Rates

Footnotes: Data as of September 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Fixed Income – A Dramatic Shift to Panic Mode

Typically, when we mention volatility, an investor's mind quickly thinks about the equity market. In 3Q19, investors saw what volatility in the fixed income market feels like. In August, long term bond yields (i.e. 10YR U.S. Treasury) declined by 50 bps (0.50%), the biggest one month drop in more than four years. The 30-year Treasury bond saw its best quarterly return in roughly five years and is on pace for its best annual return since 2011. This is a sharp reversal to the bond sell off we were experiencing just one year ago (in 4Q18) **(chart 6).**

There are many factors that have shifted bond yields lower. The unprecedented amount of negative yielding debt globally is causing a scramble to markets that offer yield (e.g. U.S. Treasury bonds) **(chart 7).** Technical disruptions in short term funding markets and a brief inversion of the yield curve fueled liquidity and recession fears. Inflation is persistently low around the world and keeping interest rates low. Geopolitical tensions continue to test market sentiment, and most importantly global growth is slowing. Naturally when growth slows interest rates decline. However, there is a difference between bonds pricing in a growth slowdown and mispricing the underlying fundamentals.

There is no fundamental model, even considering the slowdown in growth that validates long term bond yields where they are currently priced (even with the recent move higher). However, it is very difficult to predict how long any investment can stay over or even undervalued. All we can do is look within our fixed income positioning to make sure we are positioned for when yields do normalize and begin pricing off fundamentals and not emotion. We do not recommend selling your fixed income exposure as it serves as a viable portfolio diversifier and can hedge against a further drop in economic activity, however we recommend the following positioning:

Chart 6: What a Difference a Year Makes
Footnotes: Data as of October 2, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors

Chart 7: Negative Yield Debt Creating a Search for Yield
Footnotes: Data is weekly and as of September 27, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

- **Duration management:** Even if growth worsens, the bulk of the decline in core fixed income yields is likely behind us and investors should not get accustomed to the returns seen this year. Keep in mind, the lower yields drop, the higher your interest rate risk rises. With long term yields being held artificially low for reasons beyond our control and not underlying fundamentals, we would not recommend purchasing long term bonds. We would prefer bonds maturing in the short to very intermediate range to mitigate at least some of the interest rate risk as rates normalize.

- **Do not sacrifice quality for yield:** We recommend staying with investment grade high quality bonds in these highly uncertain economic times. Credit quality is beginning to show weakness as high yield credit downgrades have been outpacing upgrades for the past four consecutive quarters, the longest streak since 2014-2015. However, the extra yield you earn for holding high yield is about 100 bps (or 1.0%) lower than the last time that downgrades outpaced upgrades for this length of time. Therefore, the risk/reward is not there for investors to reach for yield **(chart 8).**

- **Emerging market bonds attractive:** Instead of reaching for yield in the U.S. high yield market we would focus on emerging market debt which offers attractive yields and reasonable valuations. We have seen many emerging market central banks cut interest rates to support growth which should benefit their sovereign bonds.

Global Equities – Discipline in a Dynamic Environment

There was a clear bifurcation in the global equity market in 3Q19. While U.S. equities (i.e. S&P 500) registered a 6% pullback, the Index went on to climb within 1% of its record high before the end of the quarter. From a global perspective, international equity markets took the brunt of the global growth uncertainty in 3Q19 with the emerging markets nearing correction territory (10% decline) and developed international markets underperforming U.S. equities for the seventh quarter out of the past eight **(chart 9).**

Chart 8: No Reward For Reaching For Yield

Footnotes: Data is monthly and as of September 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

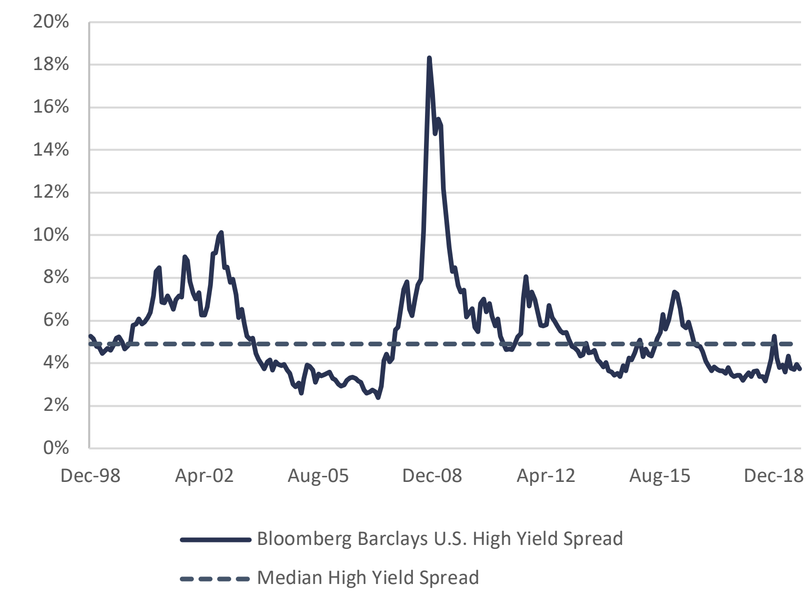
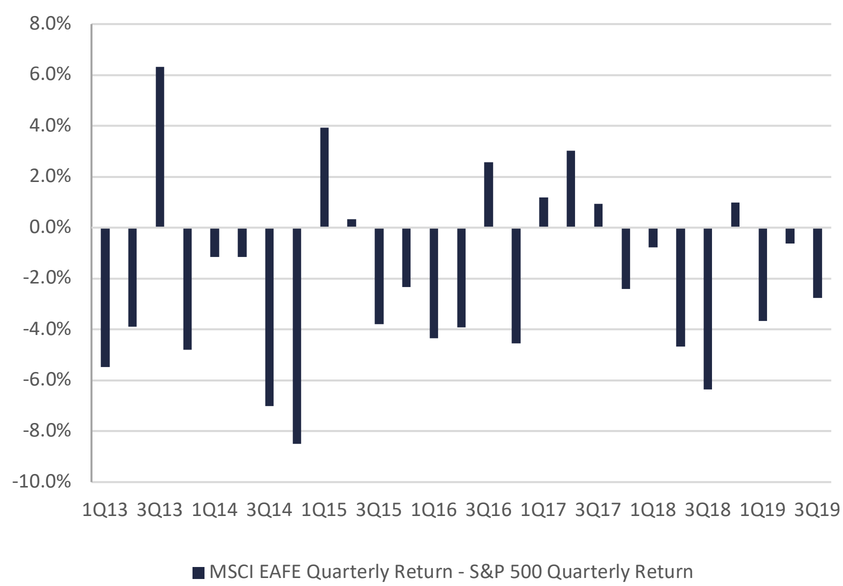


Chart 9: Developed International Persistently Underperforms U.S. Equities

Footnotes: Data is as of 3Q19.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



Even with the rising uncertainty there are areas of the global equity market that are expensive and we remain selective in our global equity exposure. In these highly dynamic times, it is important to focus on the long-term outlook and look for areas that have been unfairly beaten down due to the uncertainty over trade and global growth.

- **International over U.S. equities:** The fact that the U.S. has been more resilient to the global growth slowdown is also being reflected in the ongoing outperformance of U.S. vs. international equities. Since the start of the bull market, U.S. equities have outperformed international equities by ~10% annually. In fact, international equities are now the cheapest on a relative basis to U.S. equities than they ever have been **(chart 10).** To put that in perspective, international equities were not even this cheap vs. the U.S. when we were navigating through the possible breakup of the entire European union (2010-2012).

- **EM attractive despite global woes:** The emerging markets have lagged the other global regions this year. While emerging markets are sensitive to the decline in global trade, they also stand to benefit the most if there is any sign of a positive outcome in the U.S./China trade dispute. However, the under-performance suggests that they may be reflecting the worst-case scenario on trade, especially in Asia. Asia is not just China and many smaller emerging Asian economies stand to benefit from U.S. companies diversifying out of China. For example, U.S. total trade with Vietnam has increased 29% while Taiwan's trade has increased by 15% **(chart 11).**

- **Small and midcap over large cap.** Within the U.S., large cap growth stocks look expensive relative to small and midcap stocks. On a rolling three-year basis, large cap is outperforming small cap by the most since the dotcom bubble **(chart 12).** As a result, small cap stocks look cheap not only relative to large cap stocks but relative to their own historical average. In addition, the underperformance of small cap stocks this year compared to large caps is a mispricing. Large cap stocks are the most impacted by disruptions in global trade as they generate more of their revenues overseas than small cap stocks. In addition, small cap stocks tend to have more debt so the recent decline in interest rates should help those companies.

Chart 10: A Historical Contrarian Trade

Footnotes: Data is monthly and as of September 30, 2009.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

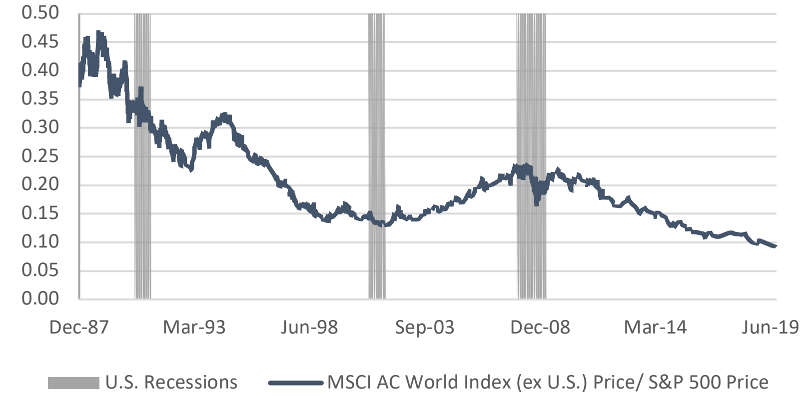


Chart 11: Trade Tensions Aiding Other EM Regions

Footnotes: Data as of July 2019.
Source: Bloomberg Finance LP, Strategas Research Partners, U.S. Census, Verdence Capital Advisors.

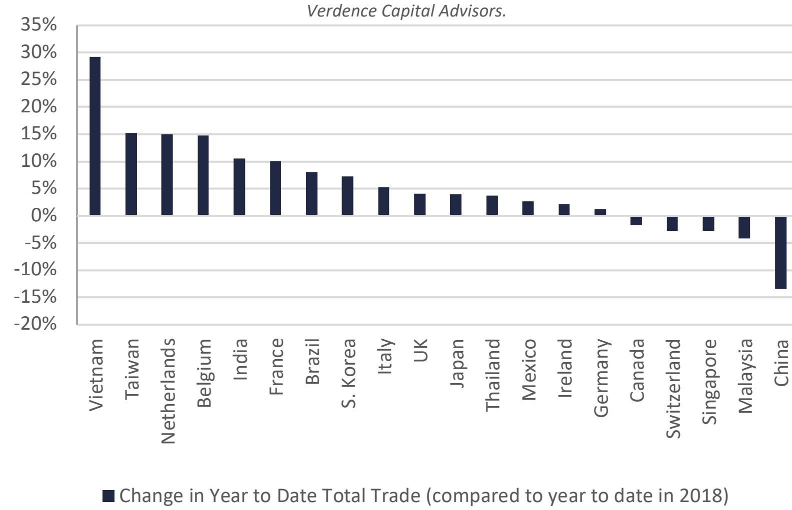


Chart 12: Large Cap Beating Small Cap the Most Since Dotcom Bubble

Footnotes: Data is monthly and is rolling three year return as of September 30, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Alternatives: Diversify in Volatile Markets

Given the heightened economic uncertainty, equity volatility normalizing after a period of historically low volatility, expensive valuations in pockets of the public equity market and absurd premiums on traditional fixed income, we recommend a healthy allocation to alternative investments. Hedge funds in the credit alternative space are an attractive way to find opportunity in an overvalued fixed income world. Real assets, especially real estate should benefit from low interest rates and can even prosper in a slow, albeit positive growth environment. However, we would focus on private real estate as opposed to public real estate investment trusts that may be correlated to heightened volatility in public equities. In addition, other income producing private equity investments (e.g. private credit) offer diversification and potential for attractive income.

The Bottom Line:

It is evident that the U.S. economy is slowing, and the expansion is facing its toughest test in this historically long cycle. The most uncertain and primary driver of the economic slowdown is the ongoing trade tensions between the U.S. and China. This has driven manufacturing into contraction territory, weighed on business confidence and capex spending and we have seen softer employment data in those areas most affected (e.g. manufacturing). What is important is that easing tensions or even an agreement could cause a reversal in this weakness and shift risk sentiment quickly (we have started to see this at the start of 4Q). In this highly dynamic, nontraditional and politically uncertain environment we must be prepared for many different outcomes and be vigilant and flexible when considering the economic outlook and its impact on asset allocation. As always, we will not chase momentum driven investments (e.g. long-term bonds, large cap growth stocks). Instead we will focus on our long-term outlook, take advantage of risk mispricing in the markets and consider our clients long term investment objectives.

If you have any questions or feedback, please feel free to reach out to your financial advisor.

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