October 2019

Market and Economic Outlook

Concern Mounts Over Global Growth and Trade as Stocks Continue to Advance

Create Opportunities

"Late cycle" is a popular phrase among market analysts these days. In one sense it is a straight-forward, uncontroversial statement. We are, in fact, in the midst of the longest (but not strongest) economic expansion and bull market in modern history. At some point, the cycle will end. But a subtle implication of "late cycle" can be that the next recession or bear market is already upon us or, at the very least, right around the corner. This is not necessarily so.

Although many risks are glaring at the moment — including signs of a global slowdown in manufacturing, massive corporate and government debt levels, and technical recession indicators like the inverted yield curve — there are also many positives that can sustain the expansion and bull market. These include central bank monetary stimulus, continued jobs growth, and solid corporate profits. In other words, late cycle should not be read as "end of cycle."

Total Returns (%) as of September 30, 2019

Index Name	Capital Market Segment	3rd Quarter 2019	YTD 2019	2018	2017
Bloomberg Barclays U.S. Aggregate Bond	U.S. Broad Market Bonds	2.3	8.5	0.0	3.5
S&P 500	U.S. Large Cap	1.7	20.6	-4.4	21.8
Russell 2000	U.S. Small Cap	-2.4	14.2	-11.0	14.7
MSCI EAFE	Non-U.S. Developed Markets	-1.1	12.8	-13.8	25.0
MSCI EM	Emerging Markets	-4.3	5.9	-14.6	37.3
Hypothetical 60/40 Portfolio*	Diversified Mix of Indexes	0.9	13.3	-5.1	15.3

* 40% Barclays U.S. Aggregate, 32% S&P 500, 7% Russell 2000, 16% EAFE, and 5% EM

An investor cannot invest directly in an index, and the hypothetical portfolio is not intended to reflect any specific portfolio managed by CLA Wealth Advisors. An unmanaged index does not reflect any expenses that may be associated with an actual portfolio.

Source: Morningstar

Real estate and utilities lead large company stocks

U.S. large company stocks eked out a small gain (1.7%) for the third quarter, but are up a robust 20.6% year-to-date (as measured by the S&P 500 index). The best performing sectors for the quarter were real estate and utilities. The stocks in these two sectors pay a relatively high dividend yield — an attractive characteristic in a low interest rate world. The worst-performing sector was energy, as it has been since the Great Recession. Since the crisis lows of March 2009 through September 30, 2019, the energy sector's cumulative total return is 85%; by way of comparison, the top-performing sectors, consumer discretionary and technology, have cumulative returns of 786% and 721%, respectively.

Small company U.S. stocks fell 2.4% in the third quarter. Small caps have languished compared to large caps. By one measure at the end of August, small cap stocks were at a 16-year low relative to large caps (ratio of IWM [iShares Russell 2000 ETF] versus SPY [SPDR S&P 500 ETF]; Bloomberg).

What does late cycle mean?

Economists and analysts generally think of the economy as having four phases or cycles:

- Early cycle
- Mid-cycle
- Late cycle
- Recession

While some on Wall Street are now saying we are in the "late cycle," we do not appear to have crossed into recession.

Foreign stocks lag as strong dollar hinders returns for U.S.-based investors

Foreign stocks showed slight losses for the third quarter. Developed markets (as measured by the MSCI EAFE Index) are up nearly 13% year-to-date and emerging market stocks (MSCI EM Index) about 6%. U.S. stocks continue to outperform foreign issues. One significant contributing factor to this is the continued strength of the U.S. dollar. A couple examples:

Year-to-Date % Return (September 2019)

Selected Country Stock Index (MSCI)	In local currency	In U.S. dollars
France	23	17
Germany	16	11
Brazil	19	11

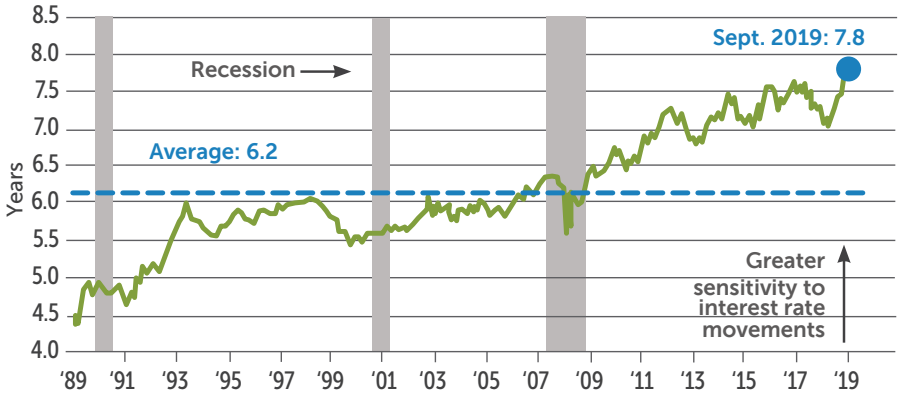
Source: Morningstar

Again, it's important to remember that the dollar also moves in cycles, and the current state of dollar strength will not persist forever. During periods of dollar weakness, the opposite effect will occur and U.S. investors in foreign stocks will have better returns than local currency investors.

U.S. bonds in positive territory for the quarter

The Bloomberg Barclays U.S. Aggregate Bond Index (the Agg) — a measure of the broad, investment-grade bond market — has now returned 8.5% year-to-date, and the trailing 12-month return is now just over 10%. It is worth remembering, as those who read the fine print of investment reports already well know, *past performance does not guarantee future results*. Falling yields have been a boon for bond investors (when yields fall, prices go up). And although we could see rates fall even further, there could be significant volatility. A typical way to measure interest rate risk in bonds is duration. Investment-grade corporate bonds' duration currently reads a high 7.8. Hypothetically, this means that a 1% rise in interest rates would roughly equate to a -7.8% capital loss in those bonds.

Duration of Investment-Grade Corporate Credit Universe



Source: JPMorgan

Divided Fed cuts rates in September

On September 18, the Federal Reserve lowered a key interest rate by 25 basis points (0.25%), as was widely expected. Investors the world over have reacted not only to the rate decision, but have also parsed the vote tally, the language in the Fed's official meeting statement, and what Fed Chair Jerome Powell said at the post-meeting press conference.

This latest vote saw more disagreement than usual among the 10 voting Fed members. Three voted against the rate cut (the most dissenters since 2013), with two of those wanting to see the Fed hold rates steady and a third who wanted to see a larger, 50-basis-points cut. The Fed's statement referred to strong consumer spending, but added that "exports have weakened." At his press conference, Powell stated that the economy "continues to perform well" and the "outlook remains favorable," and noted risks related to trade disputes and weaker global growth. At the time of this writing, investor expectations are for another 25-basis-point cut at the next meeting, October 29-30.

Bull Markets Since 1926

Bull market begin	Cumulative price return	Duration (months)
July 1926	152%	27
March 1935	129%	23
April 1942	158%	49
July 1949	267%	85
October 1960	39%	13
October 1966	48%	25
May 1970	74%	31
March 1978	62%	32
August 1982	229%	60
October 1990	417%	113
October 2002	101%	60
March 2009	340%	126

Sources: Standard & Poors (S&P 500), FactSet, JPMorgan. Data as of September 30, 2019.

As alluded to in previous issues of *Market and Economic Outlook*, Fed policy — and therefore "Fed watching" — is at a fascinating juncture. For the vast majority of the post-Great Recession era, there was very little uncertainty about rate decisions and each move (or lack thereof) was widely expected by the markets. We now find ourselves in an era of the Fed being "data dependent" (in the words of Powell), with the flow of macroeconomic data, and potentially the trajectory of policy rates, being much more uncertain. The discord among voting Fed members is also reflected among market analysts and pundits who debate policy rates. Some scoff at the need for additional monetary stimulus (i.e., lower rates), pointing to the following signs of strength in U.S. markets and the economy:

- The longest economic expansion in history (123 months)
- The longest stretch of monthly jobs growth in history (108 consecutive months)
- The lowest unemployment rate since 1969 (3.5%)
- The longest bull market in stocks in post-war history (126 months)

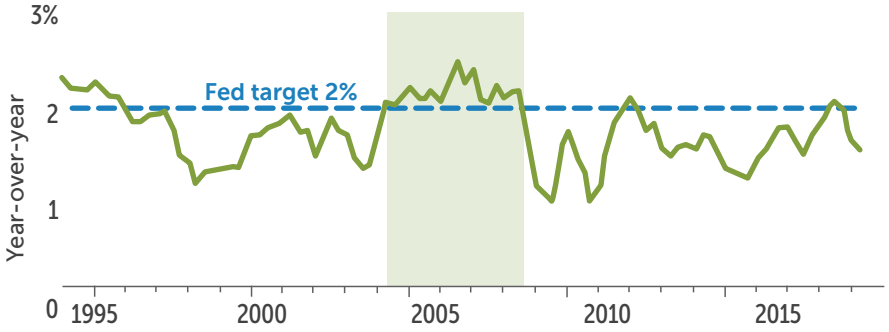
Others, though, advocate for lower rates, and will note:

- Inflation remains well under control and has remained generally below the Fed target of 2%.
- Compared to other developed economies, our rates are high, giving the U.S. room to lower.
- With elevated risk of recession and signs of slowing global growth, erring on the side of more stimulus is appropriate.

It will be fascinating to watch how the Fed attempts to deal with all of these cross-currents.

Inflation Under Control

A core inflation measure has mainly been below the Fed's target rate for the last 25 years.



Source: Federal Reserve. Data shown is personal consumption expenditures excluding food and energy (chain-type price index) percent change from year ago, quarterly, as of 6/30/19.

How impeachment inquiry could affect markets

Last month, lawmakers in the U.S. House of Representatives formally launched an impeachment inquiry related to President Trump's dealings with foreign governments. We recognize there are deep political divisions in our country and do not wish to delve into parsing the issues under investigation, nor make predictions on the outcome. We do, however, think it appropriate to dispassionately examine the impeachment process and look to history to see how prior presidential impeachment inquiries have affected the markets.

In terms of the market's reaction to impeachment, it's notable that the two modern day cases (Richard Nixon in 1973 and Bill Clinton in 1998) occurred during decidedly different economic backdrops. High inflation was a problem in the early 70s, and was exacerbated by the 1973 oil embargo, during which the price of crude oil quadrupled. From its highs in January 1973, the S&P 500 index plunged 47% by October of that year (Morningstar and Bloomberg). Nixon resigned in August 1973.

Clinton's impeachment proceedings occurred during a roaring stock market and rapid economic expansion. The late 1990s was marked by low inflation, steady job growth, and a nearly insatiable investor appetite for internet and telecom stocks. In 1998, the year of Clinton's impeachment, the tech-heavy NASDAQ Composite index surged 40%, while the S&P 500 rose 29%. These robust returns came in spite of the fact that the third quarter of 1998 was extremely volatile to the downside. A financial crisis in Russia and the related collapse of a massive U.S. hedge fund (Long-Term Capital Management), which required a Federal Reserve bailout to avoid a wider market collapse, contributed to concern that the bull market of the 1990s had met its end. However, markets rallied strongly in the fourth quarter of that year.

> Impeachment is clearly a serious matter with major political repercussions, but it is not relevant from a long-term investment strategy perspective.

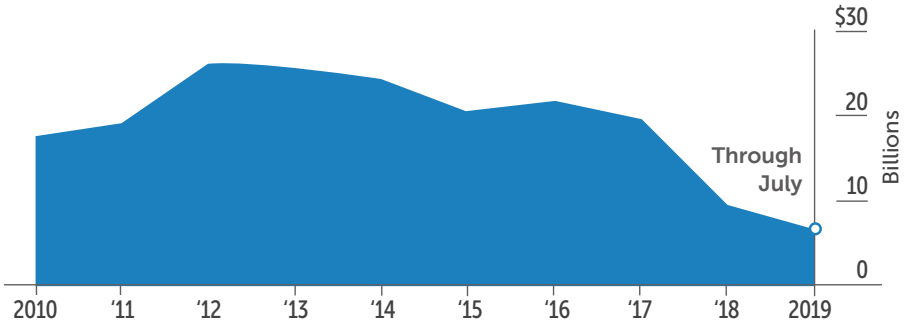
The takeaway from both the Nixon and Clinton sagas is that the stock market and economy are shaped far more by macroeconomic forces (inflation, employment, and other metrics) and exogenous shocks (big surprises, such as an oil crisis or hedge fund collapse) than by impeachment proceedings. Although impeachment is clearly a serious matter with major political repercussions, it is not relevant from a long-term investment strategy perspective.

Agribusiness, trade wars, and the harvest outlook

We have previously written about the risks associated with trade disputes and tariffs leading to an all-out trade war. The technology and manufacturing sectors are the focus of the trade disputes from a U.S. perspective. The commodities markets and agribusiness are areas where we can observe collateral damage as tensions escalate.

One recent example: On September 1, President Trump imposed additional tariffs of $110 billion on Chinese imports, including shoes and apparel. The Chinese government responded with tariffs on U.S. agricultural goods. This may exacerbate an already severe slowdown in China's purchases of U.S. ag products.

Value of U.S. Agricultural Exports to China



Source: U.S. Department of Agriculture

When combined with a general multi-year slump in commodities prices, this represents a significant hit for U.S. farmers. By year-end, the U.S. Department of Agriculture projects net farm income to be down nearly 30% since 2013, while debt levels are increasing.

"Generally speaking, our farmer client base has seen a large reduction in net farm income over the last five or so years," confirms Paul Neiffer, a principal in CLA's agribusiness practice and regular contributor to the firm's agribusiness blog. "The issues with China have not helped the situation, but we must be careful to not blame all of lower farm income on China."

He reminds us that, during the recent five-year period, the American farmer has had record yields and many other regions of the world have also produced all-time high crops. This has resulted in the world supply being greater than demand. He says that over time these imbalances tend to even out, but that it can take several years for this to happen.

"The issues with China have delayed this process by a couple of years," Neiffer predicts.

In the meantime, the president has implemented a strong policy response to the China tariffs in an attempt to ease the pain. Washington will provide farmers $28 billion in direct government aid payments over the 2019 and 2020 calendar years. Although this is a sizable relief package (for context, the $28 billion farm aid package is more than twice that of the $12 billion bailout of automakers in 2009), it won't cover all losses. Iowa State University estimates than the trade war has cost that state's farmers $1.7 billion, while the government package will deliver about $973 million to the state.

"Assistance from USDA has alleviated the China issue to some degree, but has no bearing on the economic trend for farming, which has been down," Neiffer says. "Farming has a super-cycle about every 30 years. The peak for the current cycle was 2012 – 13 and it may take several more years for another peak to happen."

Certainly, the trade war with China is not the only force driving grain and agricultural product prices. For example, U.S. corn exports are at six-year lows, but there's no blaming China for this since they have never been a big buyer. Our major corn customers are Mexico, Japan, and South Korea. Rich harvests in Brazil and Ukraine have dented U.S. exporters. (Bloomberg and USDA)

Corn Shipments Sink

U.S. weekly inspections of corn cargo fall to six-year low.

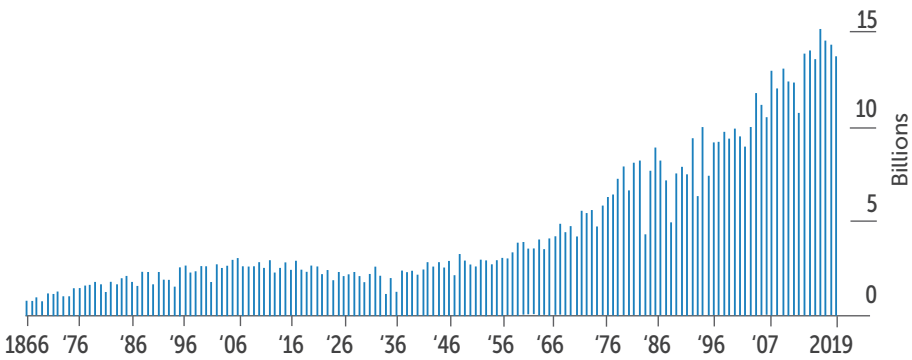
Source: U.S. Department of Agriculture, Bloomberg

Neiffer says soybean farmers have taken a more direct hit from tariffs. The lack of buying by China has caused prices to decrease over the last year or so. But added production by Brazil (the world's largest producer of soybeans) also has added to these downward prices.

"As China reduces tariffs, we may see a rebound in prices," says Neiffer. "But as long as the world supply is more than adequate, no rapid appreciation in prices will occur."

Corn is still the biggest U.S. crop by volume, acres cultivated, and value. The 2019 crop may be down, though, due to a super-rainy Midwest spring and later hot weather, according to Scott Irwin, University of Illinois agricultural economist. The projection for this year's harvest is 13.8 billion bushels, which would be the smallest since 2015.

U.S. Corn Production (Bushels)



Source: U.S. Department of Agriculture

The U.S. farmer is also the world's largest and most efficient corn grower, despite the fact that China has more land planted with corn.

U.S. Corn Farmers Lead the Way

Corn yield and production, 2018 – 2019

	Total production, metric tons (millions)	Yield, metric tons per hectare
U.S.	366.29	11.07
China	257.33	6.11
Brazil	101	5.77
European Union	64.22	7.77
Argentina	51	8.38
Ukraine	38.81	7.84

Source: U.S. Department of Agriculture, Bloomberg

Late cycle seems to equal continued prosperity

Although we are "late cycle" and can observe signs of weakness, there are many positives that may allow the current cycle of prosperity to endure. We continue to follow the flow of market and economic data and opinion, not in a vain attempt to predict the future, but to gain a better understanding of a complex, globally-interconnected financial world.

We wish you all the best for the final three months of the decade.

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