Q3 2019
Investment Perspectives

Dave Keevins
Chief Investment Officer

Andrew Krei, CFA
Head of Investment Research

October 2019

- **GLOBAL GROWTH CONCERNS:** Poor readings across a variety of data points in Q3 stoked fears of a protracted global growth deceleration. Investors pointed to weak industrial and manufacturing readings throughout the world as evidence that the most economically sensitive areas of the economy were flagging.
- **MARKETS SEND MIXED MESSAGES:** An ongoing theme of 2019 continues to be the divergence between falling interest rates—implying lower growth and inflation expectations—and buoyant stock prices—suggesting that the economic outlook is not as dour as fixed income investors perceive. With nearly all major asset classes solidly in the black for the year, pundits have argued that something has to give going forward.
- **FED CUTS RATES:** In response to the backdrop of slowing global growth and inflation missing its 2% target, the Fed lowered its benchmark interest rate by 50 points during Q3. The moves were the culmination of Chair Powell's pivot from the hawkish rhetoric that sent markets spiraling in Q4 2018 to the accommodative stance that has markets celebrating in 2019.

Market Recap

US large cap stocks managed to look through a spate of negative headlines in Q3 to post a third consecutive quarter of positive returns to start 2019. The S&P 500 advanced 1.7% during the period. US small caps and non-US markets were not as upbeat, however. Roughly 18 months into the US/China trade spat that marked the beginning of a series of protectionist trade measures, fears over decelerating global growth weighed on shares of small companies and emerging markets. For the quarter, the Russell 2000 Index declined 2.4% while the MSCI Emerging Markets Index lost 4.2%.

While 2019 has been a decidedly positive period for stocks, a 12-month lookback tells a slightly different story. Viewed through that lens, markets have simply been recovering from the dramatic sell-off in Q4 2018. The S&P 500 has made it out of the hole, posting a 4.3% gain over the past year; however, the Russell 2000 (-8.9%), MSCI EAFE (-0.8%), and MSCI Emerging Markets

continued on page 2

FIXED INCOME

	USD Total Return (%)	
Index	**Q3 2019**	**YTD**
Barclays 1-10 Yr Muni	0.8%	4.7%
Barclays US Agg. Bond	2.3%	8.5%
BofA/ML HY Master II	1.2%	11.51%

EQUITIES

	USD Total Return (%)	
Index	**Q3 2019**	**YTD**
Russell 3000	1.2%	20.1%
S&P 500	1.7%	20.6%
Russell 2000	-2.4%	14.2%
MSCI All Country World	0.0%	16.2%
MSCI EAFE	-1.1%	12.8%
MSCI Emerging Mkts	-4.2%	5.9%

Source: Bloomberg (Data as of 9/30/2019)

(-1.7%) all remain underwater to varying degrees. In fact, on a price basis (i.e., excluding dividends), the Russell 2000 remains roughly 12.5% below its 2018 highs. The MSCI EAFE and MSCI EM are actually in worse drawdowns at 13.6% and 21.4% below last year's highs, respectively.

Interest rates continued to trend lower during Q3, leading to strong price gains for bondholders. The yield on the 10-year Treasury finished the quarter a full percent below its level at the start of 2019, closing at roughly 1.7%. If the Barclays Aggregate Bond Index can maintain its year-to-date return of 8.5%, it would be the best year for the index since 2002 (+10.3%). Credit markets also extended their year-to-date gains as investors continued to search for higher yields. For the year, the BofA/Merrill Lynch High Yield Master Index has returned 11.5%.

CLIMBING THE WALL OF WORRY

There was no shortage of newsworthy activity in Q3 as investors were confronted with a variety of economic and geopolitical issues. The trade war between the US and China remained front and center, but consider this abridged list of other notable uncertainties:

- Brexit
- Hong Kong unrest
- Attack on Saudi oil facilities
- US yield curve inversion
- Trump impeachment inquiry
- High profile IPO flops
- Liquidity squeeze in overnight lending markets

Market commentators will frequently refer to stocks climbing a "wall of worry". As issues are resolved, are deferred until a later date, or simply recede into the background, markets often celebrate. In the meantime, the collective wisdom of market participants works to discount genuine risks to asset prices as opposed to transitory concerns. With US stocks generally faring well against an increasingly unsettled macro backdrop, the maxim has held true again. Maybe the resilience of the market is a sign of abundant capital on the sidelines waiting to "buy the dip", or maybe it is simply an overly complacent market. Regardless, Q3 appeared to be proof that the bar is high to knock the market off of its current trajectory.

A TALE OF TWO MARKETS

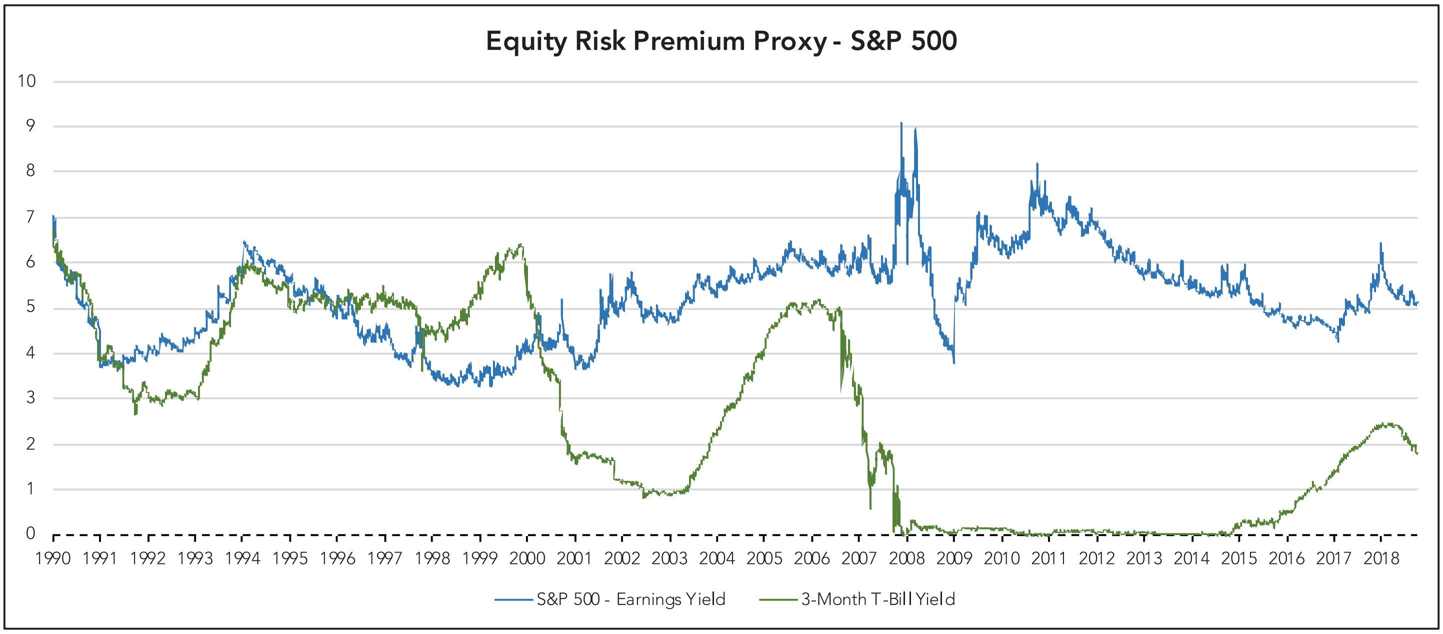
Q3 was a reprise of a familiar theme: the conflicting narratives coming from bond markets and equity markets. Lower rates continue to imply a more pessimistic view of growth and inflation expectations going forward, whereas higher stock prices suggest that the prospects for future growth are more upbeat. Financial markets orthodoxy would say that this dynamic is incompatible over the long-run, but markets have previously shown that they can remain in a "Goldilocks" mode—where conditions are neither too good nor too bad—for an extended period. Low inflation and low growth give the Fed scope to cut interest rates, and all things being equal, lower rates make stocks look increasingly attractive relative to bonds.

One useful way to evaluate this relationship between rates and stocks over time is to look at the so-called "equity risk premium" (ERP). In simple terms, this is the additional return that investors expect to receive for taking the risk of owning stocks rather than risk-free Treasuries. You are probably familiar with the price-to-earnings ratio, or the valuation multiple that investors assign to stocks. If we flip this number on its head, we get the "earnings yield", or the amount of earnings an investor receives relative to the cost of a stock—loosely akin to the yield on a bond. A 20x P/E ratio would be a 5% earnings yield (e.g., a $100 stock that has earnings of $5 per share would have an

continued on page 3

earnings yield of $5 ÷ $100 = 5%). When stock valuations go up, the earnings yield goes down; investors get paid less in earnings per dollar invested. Conversely, when valuations go down, the earnings yield goes up.

We can use the earnings yield as the basis for an apples-to-apples comparison of shareholder returns relative to a 3-month Treasury—a risk-free asset. On the chart below, we plot the S&P 500 earnings yield in blue and the 3-month Treasury yield in green since 1990. The gap between the blue line and the green line represents a rough proxy for the return premium that stock investors expect to receive relative to safe assets. All things being equal, when the gap is wide, stocks are offering an attractive return premium over bonds. When the gap is narrow or negative, risk-free bonds should look increasingly attractive compared to stocks. This is a core component of the argument that lower interest rates make stocks appear more compelling on a relative basis.



Source: Bloomberg (Data as of 9/30/2019)

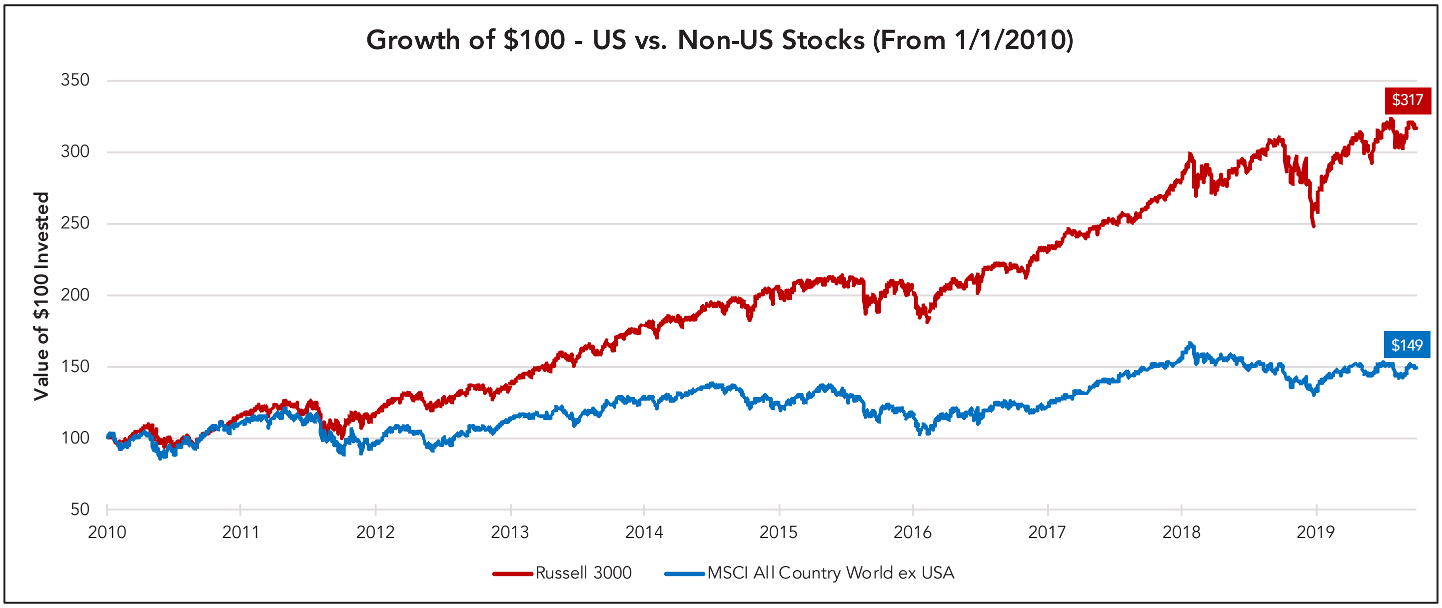
You can see that this relationship shifts over time as bond yields rise and fall and stocks become more or less expensive. In fact, the relationship was upside down for periods around the dot com bubble as investors bid stocks to lofty valuations and short term rates were relatively high. Over time though, the average gap between the two measures is roughly 2.6%. As of quarter-end, the gap was 3.3%, or a level that implies that stocks currently offer an attractive premium versus bonds in a historical context.

US MARKETS LEAD AGAIN

The theme of US stocks broadly outperforming non-US stocks persisted once again in Q3. In fact, as we near the end of the decade, it is interesting to observe the magnitude of the US outperformance during this 10-year period marked by slow, but uninterrupted, growth. On the chart on the following page, you can see that $100 invested in the US stock market—as measured by the Russell 3000 Index—grew to $317 at the end of Q3 2019. $100 invested in the MSCI All Country World ex. USA Index only grew to $149 over the same period.

There have been a few widely-cited reasons for the performance dispersion, but chief amongst them are higher growth rates and higher profitability in the US. Specifically, one can point to the difficulties that the non-US financial sector has had relative to the fast growing and highly profitable US tech sector. Financials are the largest weight in the non-US index (21%), whereas tech is the biggest sector within the US index (23%). Since 2010, the Russell 3000 Technology sub-index has appreciated at an annualized rate of 15.4% versus the paltry 3.7% annualized growth for the MSCI AWCI ex. USA Financials sub-index. More broadly, with global trade growth this

continued on page 4



Source: Bloomberg (Data as of 9/30/2019)

decade averaging roughly half the rate of the prior 20 years (per IMF data), the more domestically-oriented US economy has had a leg up on economies levered to export growth.

With ultra-low interest rates around the developed world continuing to hamstring the profitability of banks (the European Central Bank and Bank of Japan have given no indications that they will reverse course on their extremely accommodative monetary policies any time soon), the catalyst for a non-US "catch-up" phase will likely need to come from a synchronized global growth cycle. At the same time, however, protectionist measures are becoming increasingly common in the global marketplace, seemingly reducing the odds of an export growth-fueled recovery. Perhaps the best argument for a performance convergence is the US entering a "catch-down" phase driven by lower valuation multiples and/or increased regulatory scrutiny leading to lower profitability.

LARGE CAP LEADERSHIP

While the dispersion between large cap and small cap stocks has not been nearly as dramatic as the spread between US and non-US stocks in recent years, this year has seen a wide gap develop. The chart on the following page plots the relative performance of the S&P 500 versus the Russell 2000 through the first three quarters of every year since 1989. Positive numbers indicate that large cap stocks were outperforming small caps, and vice versa for negative numbers.

The +6.4% relative outperformance for large caps thus far in 2019 is not extraordinary, but it is the sixth largest gap over the past 30 years. Perhaps more interesting is what we can glean from similar periods of material (>6%) large cap outperformance: Investors often favor large caps over small caps around periods of economic weakness or market stress. Large caps generally have better access to capital markets, their businesses and customer bases are often more diversified, and they frequently pay a dividend—all attractive attributes in a downturn.

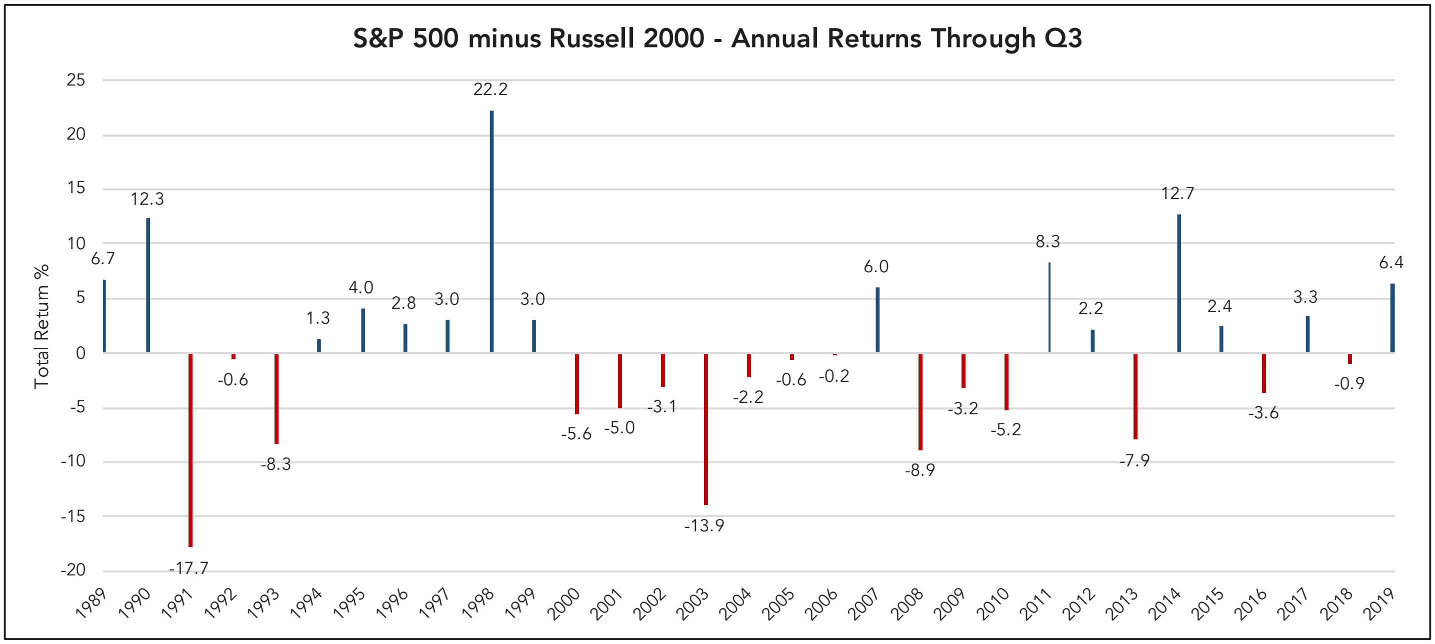
As it relates to past periods of large cap outperformance, consider the following:

- 2014 – Markets were growing increasingly concerned about a global growth slowdown that took hold in 2015.
- 2011 – Markets were worried about a double-dip recession in the US and economic weakness abroad.

continued on page 5

- 2007 – Markets were discounting the end of the cycle and the popping of the real estate bubble.
- 1998 – The Asian financial crisis stoked global contagion fears.
- 1989-1990 – Markets began discounting the recession that began in late 1990 and lasted into 1991.

As with most market events, these narratives become clear with the benefit of hindsight but were difficult to discern in the moment. Even if you had spotted the trend in real-time, trying to precisely time a market sell-off and recovery would have been a fool's errand. Our earlier comments about the market's ability to climb a wall of worry are apropos. But, taken in a broader context, this measure appears to be a helpful barometer of perceived—if not actual—risks in the near-term.



Source: Bloomberg (Data as of 9/30/2019)

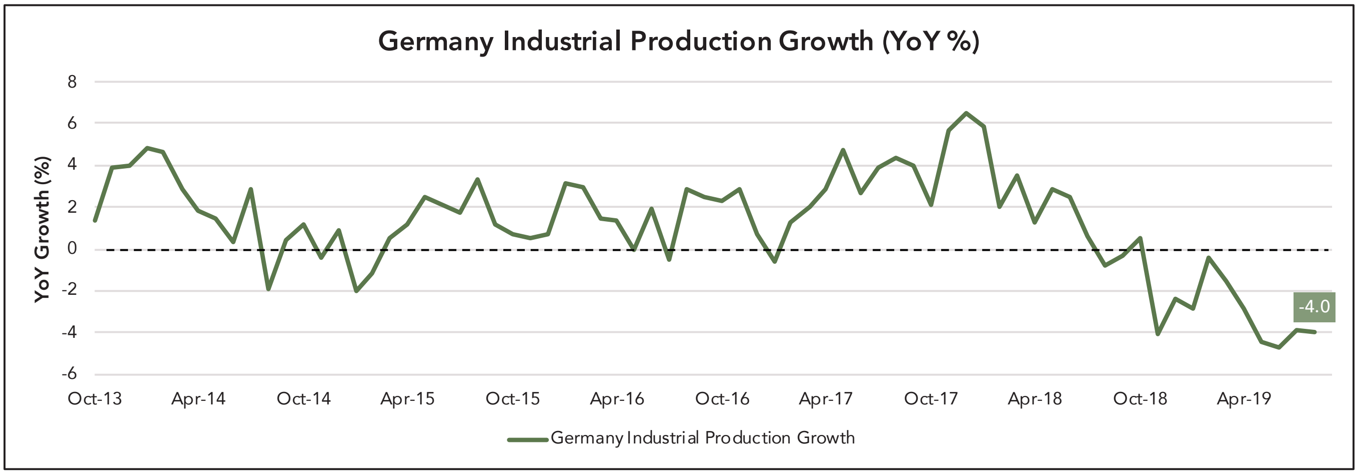
In terms of the present situation, it is true that global growth prospects have increasingly been called into question; however, perhaps the trade war and its idiosyncrasies are the more salient factors driving investors into large caps versus small caps this year. Investors could be expressing a temporary preference for larger companies that may have greater pricing power as well as redundancies built into their supply chains that allow them to more easily mitigate the impact of tariffs. Whatever the explanation, investors should take note of the performance dispersion and its historical analogues; while this time may, in fact, be different, the data suggests that a more cautious posture would be warranted.

Snapshots of a Global Growth Slowdown

With financial media understandably fixated on the US/China trade spat, there have been an increasing number of stories exploring the global growth slowdown in terms of tariffs and their derivative effects. However, a deeper dive into the data shows that the growth deceleration had started before the trade dispute began, and certainly before the impacts would have been observed in the numbers.

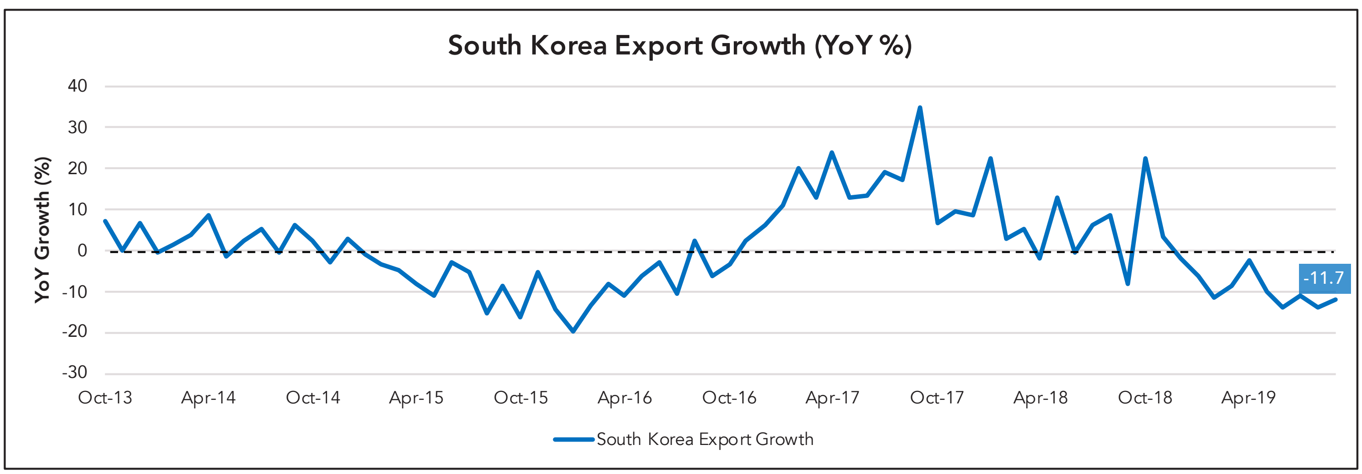
Abstract discussions about a global growth slowdown can fail to capture some of this nuance, so we wanted to highlight a few data points from around the world that provide some additional insight into the warning signs being flashed by global trade and manufacturing data.

1) **Germany industrial production.** Germany has long been a manufacturing powerhouse in Europe, and roughly 47% of its GDP is derived from exports, per World Bank data. The deceleration of Germany's industrial production has been stark since late 2017, with the most recent reading into the health of its manufacturing sector indicating a 4.0% contraction since the same period last year. The deteriorating cyclical data is emblematic of the sluggish growth across Europe and a big part of the reason that the European Central Bank continues to pursue stimulative measures.



Source: Bloomberg (Data as of 9/30/2019)

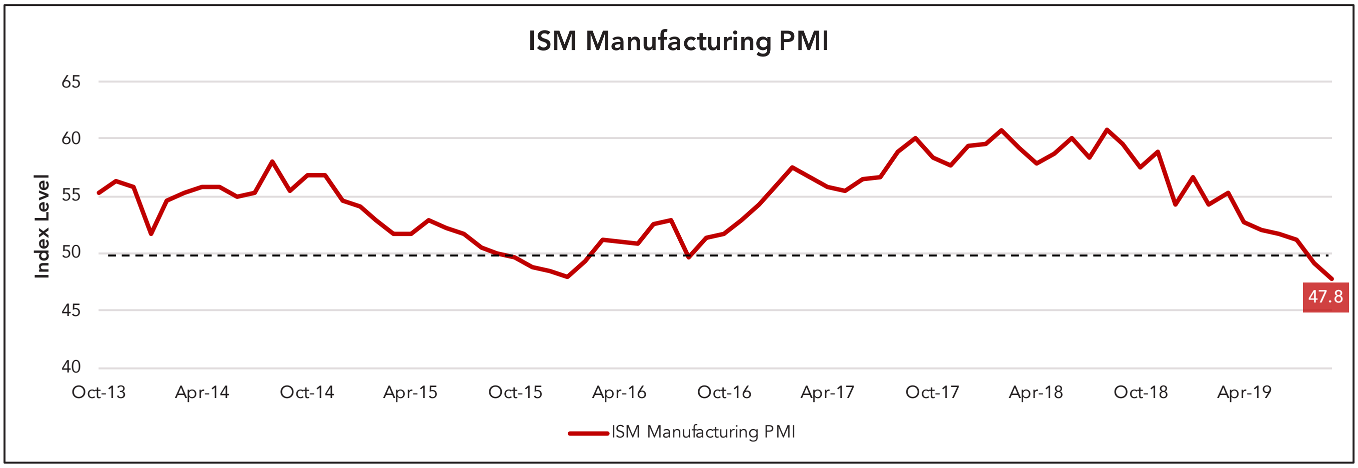
2) **South Korea export growth**. Similar to Germany, South Korea's economy is heavily reliant on external markets, with exports accounting for upwards of 50% of the country's GDP in recent years, per World Bank data. Given its exposure to international trade, economists frequently look at South Korea as a proxy for the health of the global economy. The chart below shows the recent trend for South Korean export growth—most recently indicating a contraction of 11.7% on a year-over-year basis. Notably, the trend actually started in late 2017, well before the US/China dispute began in earnest.



Source: Bloomberg (Data as of 9/30/2019)

3) **United States ISM Manufacturing PMI.** The Institute for Supply Management's Manufacturing Purchasing Managers' Index (ISM PMI) is often cited as a key gauge for the relative health of the US manufacturing sector. The survey data tracks whether conditions are improving or deteriorating across a variety of business fundamentals. Readings above 50 indicate improvement and below 50 indicate deterioration. Although the US data has been among the last to show signs of weakness, the recent reading of 47.8—the worst since the beginning of 2016—suggests that US manufacturers are coming

continued on page 7



Source: Bloomberg (Data as of 9/30/2019)

under increasing pressure. Perhaps more importantly, as we discussed in last quarter's newsletter, the PMI data has historically been a strong leading indicator for the trajectory of S&P 500 earnings growth. The data would imply that earnings weakness lies ahead.●

Chart of the Quarter

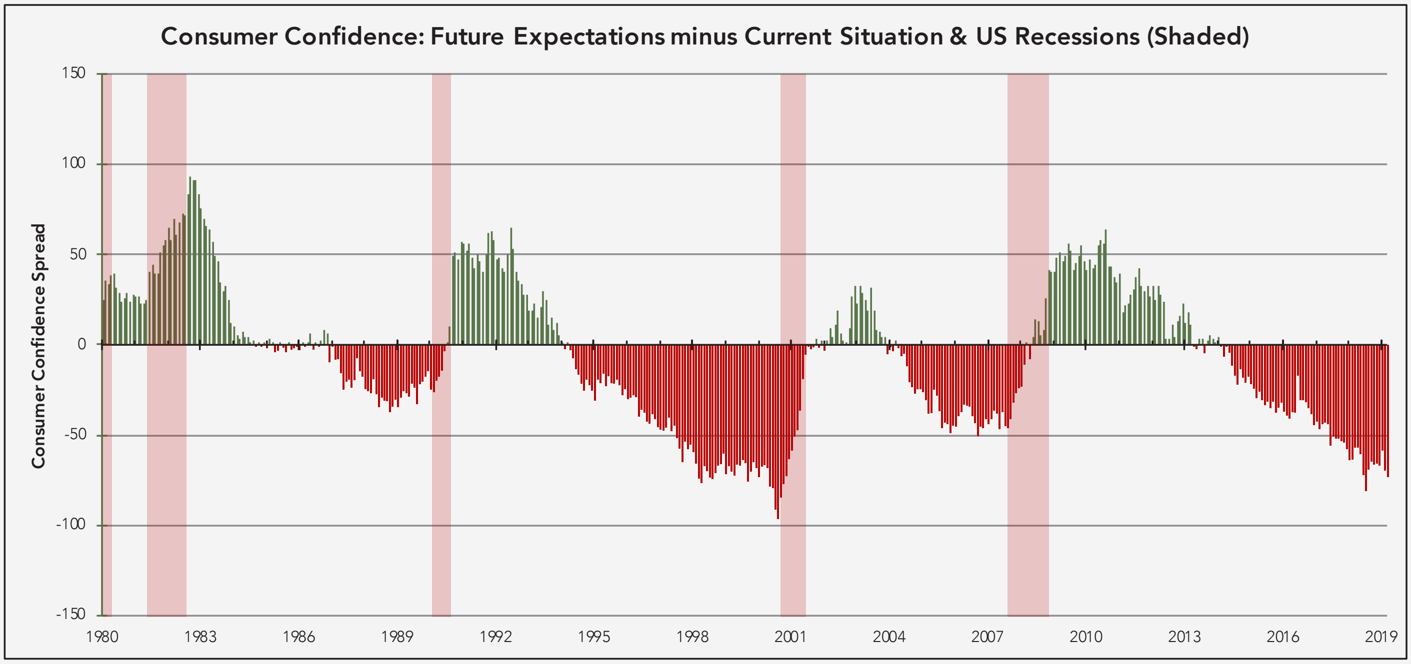
Despite the negative headlines about the state of the global manufacturing sector and weakness within industrial data, there has been a consistent refrain that consumer strength will continue to support the economy—particularly in the US. It is easy to sympathize with a sanguine view of the consumer; consider that US unemployment is at its lowest levels in over 50 years, that average hourly earnings growth reached its highest level since 2009, and that household balance sheets as well as savings rates are much healthier than they were in the lead-up to the global financial crisis.

The Q3 2019 "Chart of the Quarter" explores the other side of this narrative. Namely, what if the "hard data" belies a deteriorating consumer psyche and growing concerns about the economic outlook? Perhaps more specifically, what if employment and wage data are lagging indicators that are less useful in predicting the future path of the economy and markets?

Using data from the Conference Board's measures of consumer confidence going back to 1980, the graph on the following page plots the difference between the measure of future expectations (i.e., what is your level of confidence about the economic outlook in roughly one year?) and the measure of confidence in the present economic environment. The green bars (above zero) are periods where consumers were more positive about the future than the present, and the red bars (below zero) indicate that consumers are more pessimistic about the next 12 months than the current situation.

A clear, cyclical pattern begins to emerge—particularly when the data is contextualized via the shaded red areas that represent US recessions: Consumers had increasingly negative views about the outlook for the future relative to their current economic circumstances in advance of the last three recessions. The thinking is that households eventually reach a tipping point, perhaps triggered by an exogenous event like the dot com bust or the housing crisis, and begin to retrench in anticipation of leaner days ahead. Given that the consumer accounts for roughly 70% of GDP in the US, modest changes to spending patterns can have a meaningful effect on the economy, potentially exacerbating a contraction.

continued on page 8



Source: Bloomberg (Data as of 9/30/2019)

To be clear, this data offers little help from a market timing perspective; the magnitude and duration of the trends have not been consistent from cycle to cycle. Moreover, one could point to the high absolute levels of consumer confidence as a positive indicator in the near-term. We would simply offer a more cautionary view relative to the consensus narrative and suggest that investors stay alert to catalysts that could trigger a consumer retrenchment.●

CONTACT US

Dave Keevins
Chief Investment Officer
Managing Director

Andrew Krei, CFA
Head of Investment Research
Client Advisor

Alan Cheskey
Senior Client Advisor

Blake Durham
Client Advisor

Gary Gawryleski
Client Advisor

Gregg George
Managing Director

Chris Jauch
Client Advisor

Nick Kochanski
Managing Director

David Ness
Institutional Portfolio Manager

Robert Peterson
Senior Wealth Advisor

Mitchell Prosk
Senior Client Advisor

James Wood
Senior Client Advisor

Tony Wright
Senior Client Advisor

Crescent Grove Advisors, LLC
100 Field Drive, Suite 215, Lake Forest, IL 60045 • 847.752.0292
313 N. Plankinton Avenue, Suite 216, Milwaukee, WI 53203 • 414.386.5340
3284 Northside Parkway NW, Suite 495, Atlanta, GA 30327 • 678.585.6625
crescentgroveadvisors.com