The Longer View

Comments & Outlooks from Longer Financial

October 1, 2019

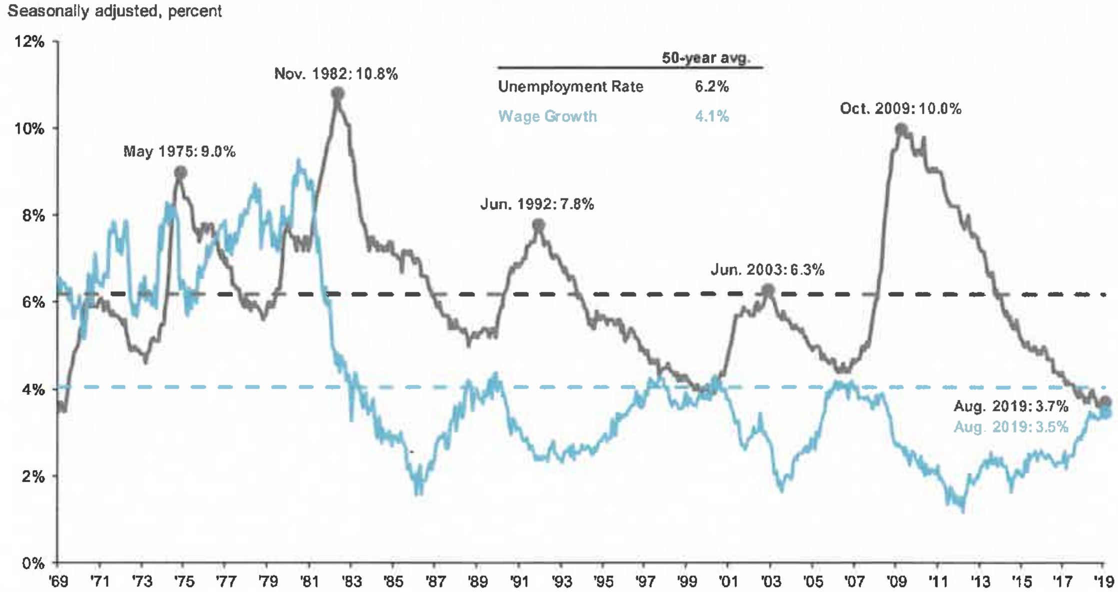
Modest Third-Quarter Returns for Stocks and Bonds

Despite another bout of volatility in August, stocks closed slightly higher for the third quarter, ending September near their 2019 highs. On a year-to-date basis, the S&P 500 and Dow Jones Industrial Average had returned 20.55% and 17.51%, respectively, while the Morningstar Dividend Yield Focus Index gained 14.62%. Bonds have continued their impressive march forward as interest rates remain under pressure. At the end of September, the 10-year Treasury yield settled at 1.68%, after briefly slipping below 1.50% earlier in the quarter. This precipitous drop, from prior levels of 2.65% on January 1 and nearly 3.25% last fall, produced a total return on the Barclays' US Aggregate Bond index of 8.52% through quarter-end. This year's bond returns include both the income earned on the bonds and price appreciation resulting from the decline in interest rates. Stock and bond prices have historically maintained an inverse relationship, but this year's unique simultaneous increases have boosted returns for both conservative and aggressive investors alike. We are proceeding with caution, however, as stocks have stumbled out of the gate in October on renewed recessionary fears.

Mixed Economic Signals, Trade Concerns Persist

Although stocks approached and in some cases hit all-time highs in the third quarter, signs of weakness have emerged in recent weeks. Even after two interest rate cuts from the Federal Reserve, the yield curve remains inverted, with short-term interest rates higher than long-term rates. After a brief spike due to the attacks in Saudi Arabia, oil prices have also dipped, bringing many energy stocks into negative territory for the year. Transportation stocks have largely rolled over as management lowered forward guidance in recent earnings updates. The ISM Manufacturing Survey Index released on October 1st demonstrated clear signs of slowing in the manufacturing sector, as it hit the lowest level we have seen since 2009 at 47.80%. Any number below 50% is considered a contraction. Much of this has been attributed to the ongoing trade war with China, as business spending has dried up amid the cloud of tariffs. However, the U.S. consumer remains a bright spot, supported by a robust labor market and a pick-up in wage growth, illustrated in the chart below.

Civilian unemployment rate and year-over-year wage growth for private production and non-supervisory workers
Seasonally adjusted, percent



Source: BLS, FactSet, J.P. Morgan Asset Management. *Guide to the Markets – U.S.* Data are as of September 30, 2019.

Though markets have had only mild reactions to the impeachment proceedings (due to the low probability of a Senate conviction), they are laser-focused on President Trump, as he is set to resume trade talks with China later this month. We remain skeptical of a major deal coming to fruition in the near term, but expect to see some signs of progress to address both economic and political concerns that must be weighing on the President.

Navigating Fourth-Quarter Uncertainty

As we enter the fourth quarter, we are faced with stock prices near their all-time highs and bond interest rates at historically low levels. Due to these current valuations, many financial institutions have lowered their forward-looking return assumptions for both equities and fixed income over the next three to five years. At this stage in the cycle, we feel that a disciplined approach in stock selection with a focus on earnings quality is critical. As noted in our quarterly client letter, we have also harvested some portfolio gains in the past few weeks in order to have cash available in any material pull-back. We will continue to use caution when establishing new positions in our efforts to limit downside exposure, as we bear in mind the individual risk tolerance for each client we have the privilege to serve.

Thank you for your continued trust. As always, please don't hesitate to reach out with any questions that you may have, or if you would like to schedule a review.

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