PROCEED WITH CAUTION

We titled our Spring Newsletter: **"The Check Engine Light is on,"** which was triggered by the inversion of the yield curve. That is an age-old indicator of stress in the financial system, which has often preceded an economic recession. In the past 50 years, every recession has been preceded by an inverted yield curve. Importantly, not every yield curve inversion has led to a recession.

The Federal Reserve Bank responded to the inversion by lowering interest rates to steepen the curve, but it has not resolved the issue. Under the hood, there are many issues that need further attention. The issues are global in nature. They are completely related to the earnings and economic cycle. Heading into the Fall, six months later, we now see flashing lights on our dashboard indicating more caution required ahead. **The Global Economy is slowing. Corporate Earnings are slowing. Stocks are on the expensive side. And Washington is now a major overhang and could further stall growth. We are proceeding with caution.**

AMERICA'S RECORD RUN

This economic expansion is now the longest in recorded American history. In its 11th year, this economic cycle has outdistanced the Dotcom Bull run in the 1990s. They don't last forever. This cycle is maturing.

BULLS AND BEARS

It has been a strong move for stocks in 2019, with the best 9-month start in two decades. But that statistic ignores the violent sell-off from a year ago, which saw a crashing end to 2018. Though the S&P 500 is not far from the all-time highs reached in July, it hasn't moved much from the highs first hit in January of 2018. In fact, the S&P was smack dab back at that level 20 months later in August.

The Stock Market has basically gone sideways with sharp forward peaks and valleys. There has been serious volatile price action the last two years with very little progress. This is actually fairly normal for a late cycle. This has been a cyclical Bear Market within the long-term, secular Bull. **The keys for investors in this type of environment are defense and fighting through the challenges.** It's survival mode until the issues are resolved and the cycle runs its natural course.

Growth is slowing. It accelerated in 2018. Earnings grew over 20%. The US Economy grew 3%. Both growth rates were well above trend. Corporate America was a prime beneficiary of the tax cuts in 2017. Profit margins reached all-time highs. From a financial standpoint, for the Stock Market, 2018 was pretty much as good as it gets. Despite the slowdown, the US is still proving to be much stronger and more stable than the rest of the world. **But the cycle is far stronger than any other Market force.**

The Bond Market has also been volatile. Treasury yields have moved wildly and rapidly. The 10-Year Treasury yield was near 3% to start the year and fell to 1.4% over the Summer, followed by a bounce back towards 2% in September, only to enter October at 1.6%. This is a lot of volatility for a normally slow and steady market metric. It isn't normal. The Bond Market is important to watch. It keeps telling a story of caution. Historically, the Bond Market is the smart money. The Bond Market can intimidate anyone. James Carville rightly acknowledged that.

WAR ON TRADE

There are some similarities to last year where strong gains for the first nine months of the year were wiped out by a 20% decline through the holidays. The Trade War was a big issue then. The Trade War is a big deal now. We just don't see a material deal on trade occurring. Nobody wins in a trade war. **Even though both leaders need a win, China has been hurt by this war on trade far more than the United States.** Its economy might not achieve the 6% growth rate it outlined in January. The rest of the world is feeling the pinch. Estimates for global economic growth have already been cut twice this year. Europe is a big trade partner with both China and the US. Germany and Great Britain are facing recession. Both nations are likely already in it. Brexit is not helping.

But China is playing the long game and will not concede on intellectual property or government subsidies. It has been said that China believes the US is trying to colonize its economy, and that will not be allowed. A deal which has China buying more American agriculture and energy seems to be in the cards. Both leaders could claim victory. **But neither nation is willing to concede its dominant position in this Digital Revolution.** The stakes are just too high, economically, politically and militarily. **A Cold War on Trade seems long-lasting.**

CONSUMER RESILIENCE

American consumers have benefited from trade with China. We have basically imported deflation for two decades, in the form of products like clothes, furniture and toys. China is no longer low-cost labor. It has been maneuvering to keep Chinese made goods competitive. Currency manipulation is one of the alleged tactics. Though shrinking in significance, exports still matter to the Chinese economy. **The US economy is driven by the Consumer. It represents 70% of Gross Domestic Product. Because of this, the US is largely insulated from the global slowdown. But it is not immune.** The Stock Market, conversely, is very exposed to the global economy. And the American Consumer feels wealthier and spends more when the Stock Market is rising. The reverse is true too. The cycle slowdown could put a dent in consumer spending. We think it will.

AMERICAN ASSETS

Demand for US assets is strong. It is likely to stay strong. **US Dollars, US Stocks, US Bonds and US Real Estate have performed much better than international assets.** The rest of the world is in worse shape. It's not that the US is in great shape. It's just in a much better place than overseas. That is a conundrum for the Fed Chair who has the President breathing

down his neck for aggressive cuts and quantitative easing. Policy is not on a pre-set course. The US Economy does not need the medicine right now, but the Market is hooked on it.

The Stock Market is addicted to monetary medicine. The Stock Market threw a tantrum last December when the Federal Reserve raised interest rates. The Fed flinched and the Stock Market got its way. It's still unbelievable to us that the Federal Reserve is cutting interest rates with the Unemployment rate at a five-decade low, the US Stock Market at all-time highs and a US Economy that continues to chug along. Growth is undeniably slowing around the globe, but the rest of the world is not part of the Fed's guiding dual mandate. It has quickly become the third.

IPO'S AND SKY-HIGH PRICES – WE PREFER VALUE

American assets seem overbought and on the expensive side. Asset prices have risen far more than income around the country. Americans are being priced out of many regions to buy homes. Growth stocks, led by Tech, have been the dominant themes for investors this decade. There are some similarities to the Dotcom days two decades ago. Inflated valuations and a hot IPO Market full of unprofitable companies looking to capitalize on the enthusiasm took over 2019. It didn't last long.

Many of the so-called Unicorn companies had disappointing debuts and one real estate company masking as a Tech start-up couldn't even make it to market. That's actually a really good thing, but more evidence for caution ahead.

Not all stocks have participated in this record run. While Growth stocks went skyward, traditional Value stocks got left behind. There are a vast number of inexpensive, established companies that might not be growing to the stars, but they have disciplined management teams and pay attractive dividends. The spread between Growth and Value has never been this wide. There is a historical gap between the haves and have nots. We see a reversion to the mean ahead. We have been migrating back to Value stocks and expect that to continue towards year-end while the high-flyers come back to earth.

DON'T FORGET ABOUT DEBT

Historically, periods of prosperity would see debt paid down, deficit spending cut, and even surpluses established. That happened in the 1990s. Not so this time with record government spending and no signs of slowing. The US economy is $22 Trillion. The problem is, its debt is $22 Trillion too. In fact, it actually owes more than it produces now with Debt to GDP at 104%. It was 63% a decade ago.

Modern Monetary Theory is less concerned with debt because sovereign nations have the ability to manipulate their currency and print money. Europe and Japan are running a dangerous experiment with negative interest rates. It's not working. Their economies are not responding to the stimulus. That goes for China too. Something that really concerns us is, what happens when things really turn down and stress returns? Will these central banks have the tools to fight off another crisis, or did they already tap their toolboxes?

Impeachment is not an economic issue. But it could very well help accelerate the economic slowdown. It is looking very unlikely that Congress agrees on anything going forward. Regardless, the primary driver of stock prices is earnings. The primary drivers of the Stock Market are earnings cycles and economic cycles. They almost always overpower politics. The cycle dictated Market activity during the previous impeachment periods in our nation's history. There is no reason for us to think that this time plays out any different.

BOTTOM LINE – THE CYCLE IS SLOWING

Natural cycles are critical. They're healthy. Corrections are part of Market cycles. Recessions are part of economic cycles. They're necessary to address and recalibrate the excesses and inefficiencies. We have been extremely bullish throughout the vast majority of this 11-year Bull cycle. We just aren't right now.

Central banks were instrumental in saving the financial system during the Financial Crisis. They did whatever it took. But there are some unintended consequences of central bank activity. The longer that economic cycles are extended through government intervention, the more dangerous and violent the next sell-off could be. Spending has limits. Too much debt and unbalanced budgets are not sustainable. They lead to trouble. It's just a matter of when. **The Stock Market likes to party to the very end.** We prefer to step away before trouble sets in. We are okay with being early. It might feel like we missed out at first, but eventually, it pays to be disciplined. We plan to stay defensively positioned, seeking safety in value areas while anticipating better buying opportunities for growth. That would seemingly be at lower levels where we would get more Bullish for a new and healthier cycle.