Stembrook Market Review — Third Quarter 2019

After a very strong first half of the year, global equities paused for a breath in the third quarter of 2019. Escalating trade tensions, rising geopolitical tensions, slowing earnings growth and a decelerating global economy have calmed investors' risk appetites, for the time being. Despite some areas of brightness over the last 3 months, global stocks fell by -0.8% during the quarter, but are still up 16.7% for the year.[1] Global bonds continue to deliver returns in excess of their yields, as interest rates fall. Global bonds returned over 2.8% in the quarter and are currently up over 8.5% for the year.[2]

Global central banks continue to keep interest rates low and in some cases negative, as witnessed in Japan and Europe. The U.S. Federal Open Market Committee (FOMC) announced at their July meeting that they would begin lowering rates from the recent peak of 2.5%. The committee has since cut rates to 2% at their September meeting citing weakness in exports and business fixed investment. As highlighted in last quarter's note, we are currently in the longest, but not the strongest, economic expansion in U.S. history. Economic expansions do not die of old age, but the data is starting to suggest a slowdown both in the U.S. and globally. The Purchasing Managers Manufacturing Index (PMI) is signaling contraction for developed markets, while emerging markets continue to show expansion.[3] This does not mean that a recession is imminent, but indicates that managers have less optimism and global economies are not growing at the rates that they previously were.

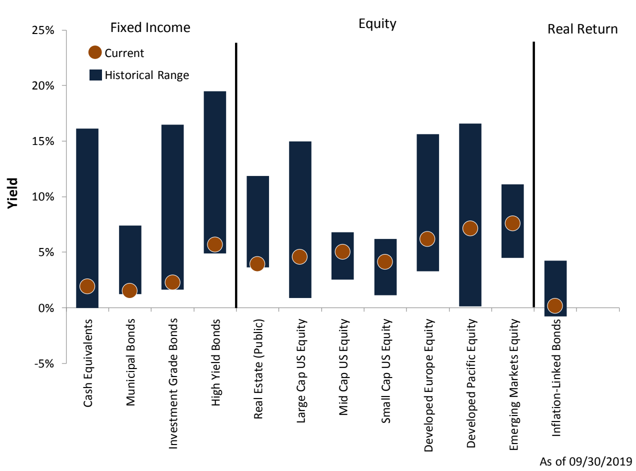
Our proprietary models forecast long-term, pre-tax returns ranging from 1% to 3% for fixed income-like asset classes and 4% to 11% for equity-like asset classes (see table to the right). Bonds have become less attractive as yields have fallen. We maintain target weight allocations for equities and fixed income, but are cautious as we move further into this bull market. Our more detailed observations and current portfolio positioning are outlined in the following comments.

Expected Market Returns and Risks
7-10 Year Horizon

		Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility[1]
	Inflation	1.5%	1.5%	3.1%
Fixed Income	Cash Equivalents	0.4%	0.2%	3.5%
Fixed Income	Municipal Bonds	1.4%	1.4%	4.4%
Fixed Income	Inflation-Linked Bonds	1.5%	0.8%	5.6%
Fixed Income	Investment Grade Bonds	2.0%	1.1%	6.7%
Fixed Income	High Yield Bonds	2.5%	1.1%	13.2%
Equity	Real Estate (Public)	4.0%	2.1%	17.5%
Equity	Broad Market US Equity	8.8%	6.9%	16.9%
Equity	Developed Non-US Equity	9.1%	7.0%	21.4%
Equity	Emerging Markets Equity	11.0%	7.3%	29.6%

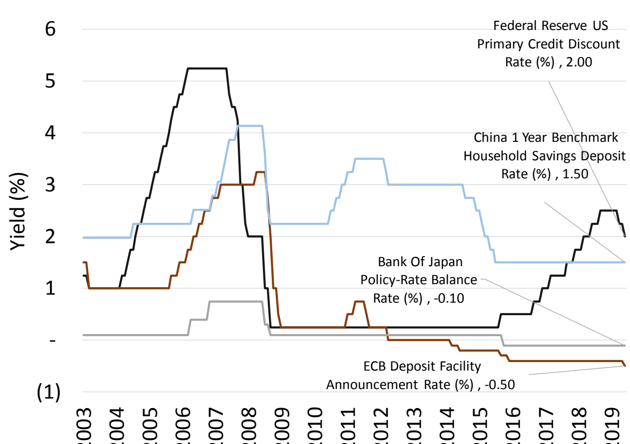
A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.

Yields Across Asset Classes



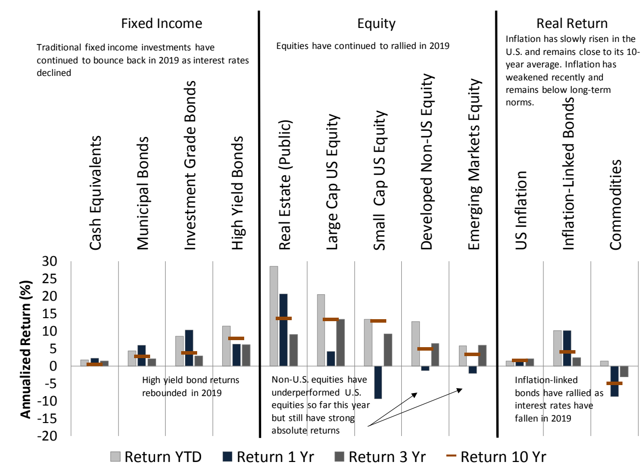
Yields are an indicator of future returns. Orange dots show current yields, blue bars show historical ranges. Yields are generally low versus their historical range.

Global Central Bank Policy



The U.S. has reversed its course on raising interest rates. Global Central Banks continue to keep interest rates low, and in some cases, negative.

Historical Market Returns



Historical market returns as of September 30th, 2019. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

Global Asset Class Returns

Asset Class Name	Last 10 Years	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Small Cap US Equity	Small Cap 11.2%	EM Eq 79.0%	Real Estate 28.6%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%	Small Cap 26.5%	EM Eq 37.3%	CPI 2.0%
Large Cap US Equity	S&P 500 10.8%	HY Bnd 56.3%	Small Cap 26.3%	Real Estate 9.2%	Real Estate 17.6%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	HY Bnd 17.5%	Intl Eq 25.0%	Inv Grd Bnd 0.0%
Real Estate (Public)	Real Estate 10.5%	Intl Eq 31.8%	EM Eq 19.2%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%	S&P 500 12.0%	S&P 500 21.8%	Infl-Indx Bnd -1.8%
High Yield Bonds	HY Bnd 9.0%	Real Estate 28.6%	Commod 16.8%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%	Commod 11.4%	Small Cap 13.2%	HY Bnd -2.1%
Emerging Markets Equity	EM Eq 6.7%	S&P 500 26.5%	HY Bnd 15.2%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%	EM Eq 11.3%	Real Estate 8.7%	Real Estate -4.0%
Developed Non-US Equity	Intl Eq 5.4%	Small Cap 25.6%	S&P 500 15.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%	Real Estate 8.6%	HY Bnd 7.5%	S&P 500 -4.4%
Investment Grade Bonds	Inv Grd Bnd 2.9%	Commod 18.9%	Intl Eq 7.8%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%	Infl-Indx Bnd 3.6%	Inv Grd Bnd 3.5%	Small Cap -8.5%
Inflation-Linked Bonds	Infl-Indx Bnd 2.9%	Infl-Indx Bnd 10.1%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%	Infl-Indx Bnd 3.0%	Commod -13.0%
Inflation	CPI 1.6%	Inv Grd Bnd 5.9%	Inv Grd Bnd 6.5%	Commod -13.3%	CPI 2.0%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%	CPI 1.8%	CPI 2.1%	Intl Eq -13.3%
Commodities	Commod -3.4%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

Economic Backdrop

- **The global economy has continued to slow in recent months.**
- Despite slowing, global economies continue to grow. The group of G-20 countries grew at a 2.2%[4] annualized pace in the third quarter. Inflation for the group increased at a 2.2% annualized rate.[5]
- Trade tensions have weighed on countries, such as Germany, that are heavily dependent on exports. The German economy has slowed to a real annualized growth rate of 0.4%[4] and the Manufacturing PMI has fallen to 41.7.[3]
- Emerging Markets' GDP growth continues to march on at a subdued pace. Real annualized growth is expected to continue at 4.1%, in the third quarter.[4] This is almost twice the pace of developed markets, but slower when compared to prior periods.
- The labor market in the U.S. remains very strong. At 3.5% at the end of September, the unemployment rate is now at its lowest level since May of 1969.[6] It is worth noting that the unemployment rate tends to be a lagging indicator of future economic growth. In other words, unemployment tends to go up *after* a recession has started.

Equities

- **Global equity markets declined slightly as a reaction to slowing earnings growth and trade tensions between the U.S. and China.**
- Trade tensions hindered emerging market equities in the third quarter. The index fell by just over -5% during the period.[7] Developed non-U.S. equity markets were also down -1.8% in the quarter.[8]
- Broad market equities in the U.S. were largely unchanged as a group, up 0.6% in the third quarter. [9]
- Within the U.S., returns varied quite a bit. As interest rates declined, interest rate sensitive investments such as REITs rallied, up nearly 6.2% in the quarter. [10] Value stocks outperformed growth by over 2% in the quarter, but still trail by just over 1% year-to-date. [11]

Fixed Income

- **The rally in fixed income securities continued in the second quarter, driven by lower interest rates in the U.S.**
- Investment grade bonds in the U.S. were up over 2.1% and are now up by 10.3% for the year.[12]
- Longer dated inflation-linked bonds continued to deliver returns well in excess of yields, up over 1.9% in the quarter, and have returned over 10.1% year-to-date. [13]

Current Positioning

- We maintain our **overweight to developed non-U.S. and emerging market equities**, where valuations and long-term growth potential remain attractive.
- We also maintain our **underweight to large cap U.S. equities.** After years of holding an overweight position in an outperforming market, valuations rose to above average levels and our models indicate that a reduced allocation to U.S. equities is prudent.
- We favor **lower priced, value-oriented equities, both in the U.S. and abroad,** which tend to outperform the broad market over time, with less volatility.
- We remain **overweight municipal bonds** for taxable investors.
- Given our significant concerns regarding a longer-term, secular rise in interest rates and the resulting negative impact on bond prices, we continue to **hold shorter maturity bonds**, while steering away from **U.S. Treasuries.**

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses time-tested return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in our continuing effort to craft and implement your customized investment solution.

As we approach the end of the year, please keep tax planning and gifting strategies in mind. If you would like to discuss your specific tax situation or plans for year-end gifting, please let us know and we can schedule a time to speak.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

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Thomas Kosinski

Endnotes and Sources:

Text:

(1) Bloomberg: MSCI ACWI Total Return. 6/30/19-9/30/19, 12/31/18-9/30/19.
(2) Bloomberg: Bloomberg Barclays Global Aggregate Bond Index Total Return. 6/30/19-9/30/19, 12/31/18-9/30/19.
(3) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing and Service. As of 9/30/19.
(4) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated into USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 9/30/19.
(5) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 9/30/19.
(6) BLS: The United States Unemployment Rate. As of 9/30/19.
(7) Bloomberg: MSCI Emerging Markets Total Return. 6/30/19-9/30/19.
(8) Bloomberg: MSCI EAFE Total Return. 6/30/19-9/30/19.
(9) Bloomberg: S&P 1500 Total Return. 6/30/19-9/30/19.
(10) Bloomberg: FTSE NAREIT All Equity REITS Total Return. 6/30/19-9/30/19.
(11) Bloomberg: S&P 1500 Value Total Return, S&P 1500 Growth Total Return. 6/30/19-9/30/19, 12/31/18-9/30/19.
(12) Bloomberg: Bloomberg Barclays U.S. Aggregate Index Total Return. 6/30/19-9/30/19, 12/31/18-9/30/19.
(13) Bloomberg: S&P 10 Year U.S. TIPS Total Return. 6/30/19-9/30/19, 12/31/18-9/30/19.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 9/30/19.
Source: Stembrook Research.
(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 9/30/19.
Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

Global Central Bank Policy: As of 9/30/19.
Source: Bloomberg, Stembrook Research.

Historical Market Returns: As 9/30/19.
Source: Bloomberg, Stembrook Research.
Indices: Bloomberg Barclays U.S Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S. Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Consumer Price Index – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns: As of 12/31/18.
Source: Thomson Reuters, Bloomberg, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Bloomberg Barclays U.S. Treasury Bills: 1-3 Month Index, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index, Bloomberg Barclays U.S. Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Bloomberg Barclays U.S. Corporate High Yield Index, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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Additional information is available upon request.