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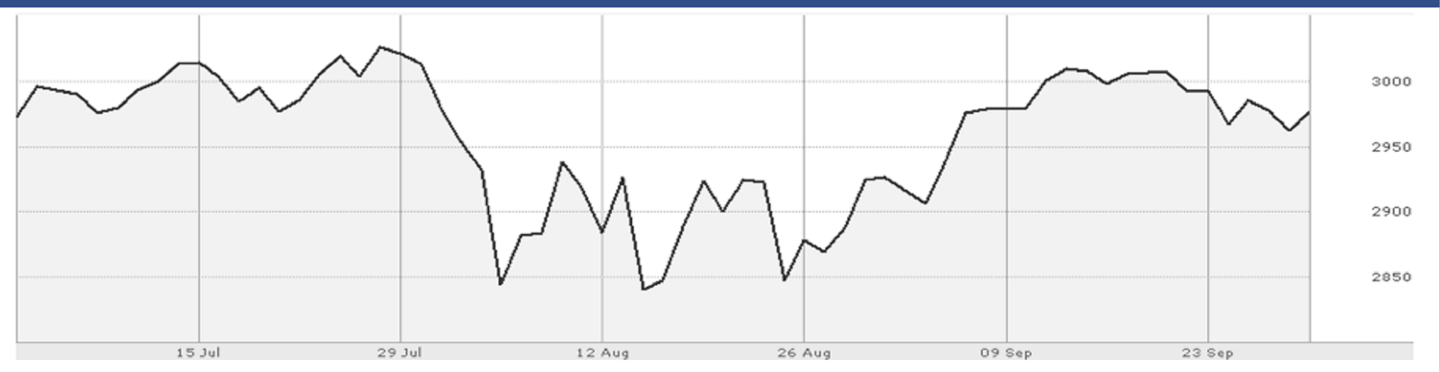
Third Quarter 2019 Recap

The third quarter of 2019 ended with a fizzle for stocks, as the S&P 500 failed to break above its previous highs in July. The NASDAQ finished the quarter flat, while the S&P 500 appreciated by a scant 1.19% (see below), as investors worried about the weight of the trade war and its impact on economies throughout the world. Bonds lead the way with the Bloomberg Barclay's Long-Term Treasury Total Return Index surging 7.92% for the quarter.

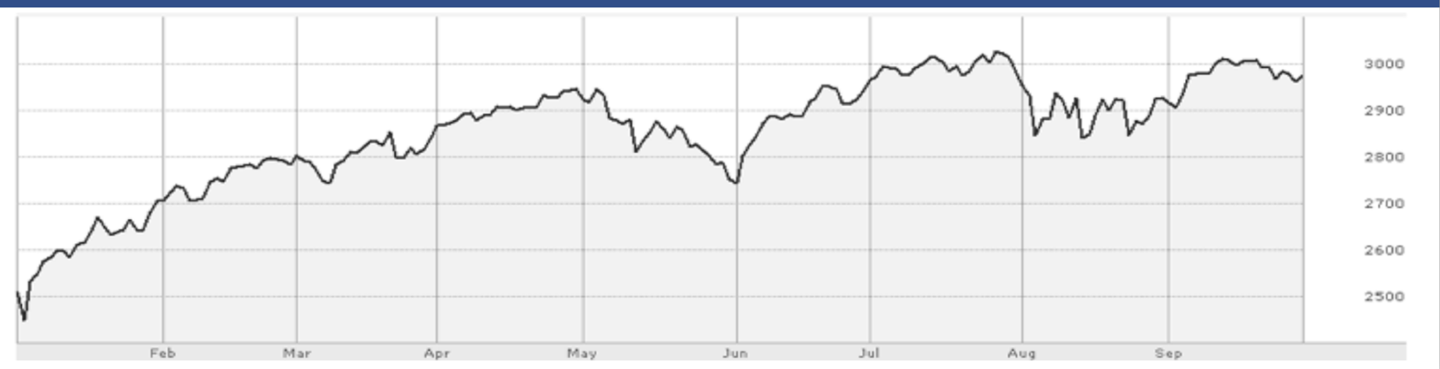
S&P 500 – Third Quarter



Source: TD Ameritrade, Polaris Greystone Financial Group, LLC

The S&P 500 finished the third quarter up 18.74% year-to-date. The markets felt some pressure the last week of the quarter to the impeachment inquiry into President Trump's conversation with Ukrainian President Zelensky (which we will get into greater detail later in this piece).

S&P 500 – Year-to-Date



Source: TD Ameritrade, Polaris Greystone Financial Group, LLC

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Summary:

- Bonds outperformed stocks in the third quarter, but stocks are still the winner for the year so far. The S&P 500 PR has outperformed the Bloomberg Barclays U.S. Aggregate Bond Index by 10.24% for the year.
- The S&P 500 was up 1.19% for the quarter, up 18.74% for the year. This statistic is a little misleading since large-cap growth has outperformed large-cap value by 5.5% year-to-date.
- While the NASDAQ was flat for the third quarter, it is still the big winner for the year, up 20.56% for the year.
- Top-performing sectors during the quarter were Utilities, Real Estate, and Consumer Staples, up 8.40%, 6.88%, and 5.36%, respectively.
- Top-performing sectors for the year are Information Technology, Real Estate, and Utilities, up 29.87%, 26.64%, and 22.29%, respectively.
- Gold was up 4% for the quarter, while the S&P GSCI Commodities Index dropped 5.11%. Even though commodities dropped significantly in the third quarter, they are up 7.82% for the year.
- The Dollar strengthened 3.33% during the quarter.
- Developed international stocks slightly outperformed our domestic stocks, with the MSCI EAFE Index up 1.75%, outperforming the S&P 500's 1.19% climb. For U.S. investors buying the EAFE, the U.S. dollar's strength produced a -1.1% in the EAFE.

The Rest of the Year?

While the markets are certainly fighting political and global economic headwinds, Polaris Greystone believes that the markets will finish the year higher than where we were at the end of the third quarter. Here is why we feel that the markets will be higher in three months.

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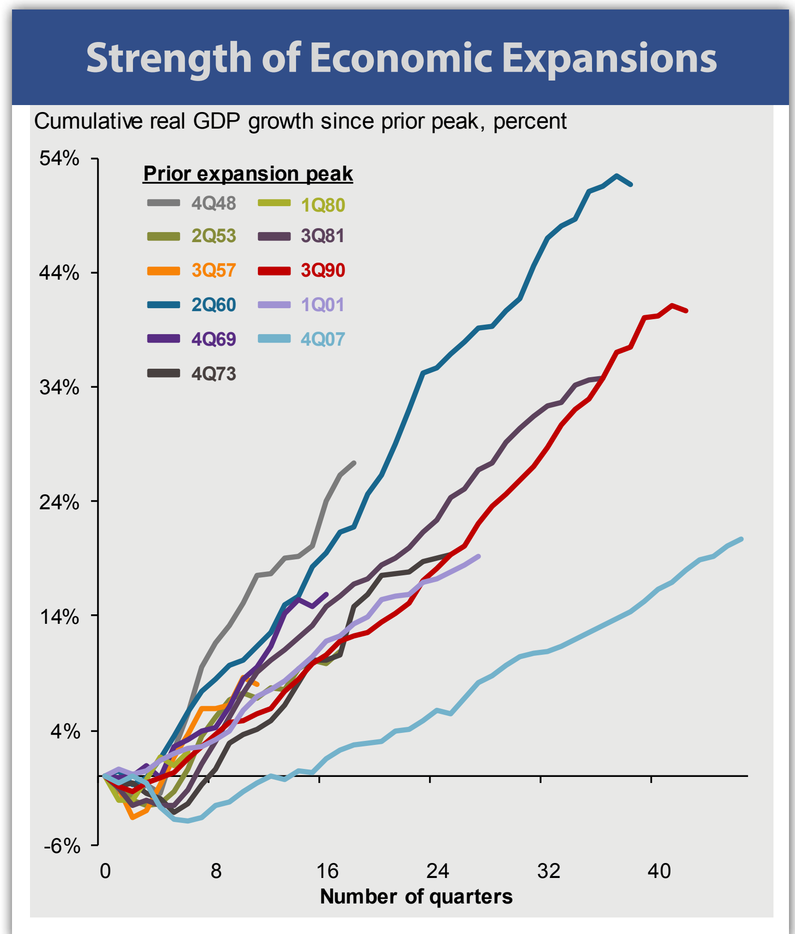
The Economy Looks Fine

According to economic definitions, our economy has grown for 48 quarters (see graph below). This is the longest post-WWII economic expansion, which has many investors worried about when it will end.

As we've discussed in several Polaris Perspective pieces, economic expansion is calculated by measuring it from the previous peak (Q3 2007). Then you must go through your recession and recovery. What isn't being discussed by many is quantitative easing that went on until the end of 2014. We've never had government intervention to this extent during any of our other economic expansions. So how do you measure this one? How do you know when it's going to end when it has only been growing on its own for nearly five years?



Source: Bureau of Economic Analysis, National Bureau of Economic Research & JP Morgan

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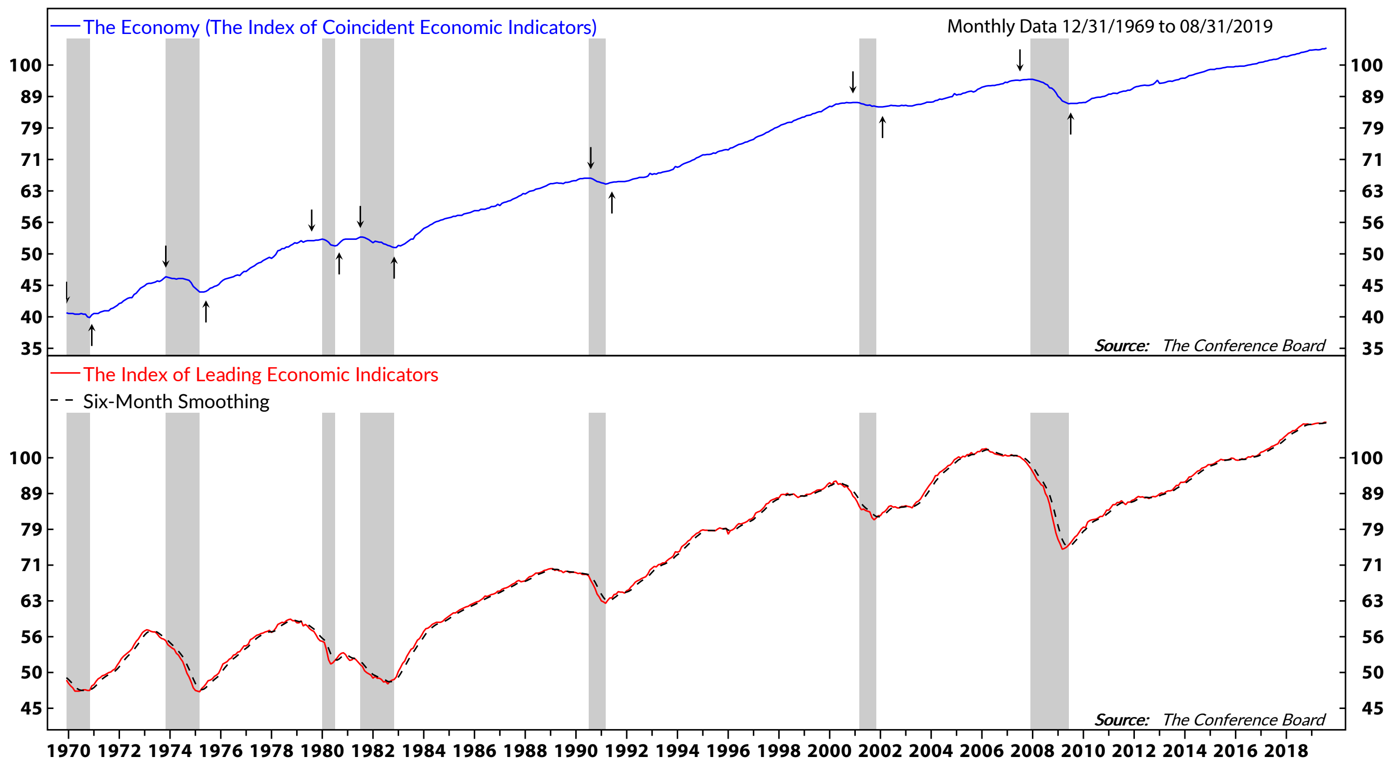
Economic Indicators Look Fine

We look at many economic indicators, but there are two that I really think help illustrate the health of our economy. As you can see from the chart below, the Index of Leading Economic Indicators (LEI) showed that the economy was headed into a recession (arrows in the top chart). While things have slowed, we are not showing a contracting economy.

The Index of Leading Economic Indicators



Expansion signal when smoothing rises by 0.2%.
Contraction signal when smoothing falls by 2.0%

Strategy Performance
Full History: 1959-07-31 to 2019-08-31

Signals	% Gain/ Annum	% Profitable	% Gain/ Trade	Trades/ Annum	% of Time
All	3.0	100.0	13.3	0.2	100.0
Expansion	3.1	100.0	22.2	0.1	85.0
Contraction	2.4	100.0	3.1	0.1	15.0
Buy/Hold	2.3	--	--	--	--

Last Signal: Expansion (2009-07-31 = 86.90)

Strategy Performance
Chart View: 1969-12-31 to 2019-08-31

Signals	% Gain/ Annum	% Profitable	% Gain/ Trade	Trades/ Annum	% of Time
All	2.9	100.0	11.1	0.3	100.0
Expansion	3.0	100.0	19.0	0.1	81.9
Contraction	2.4	100.0	3.1	0.1	18.1
Buy/Hold	2.0	--	--	--	--

Last Signal: Expansion (2009-07-31 = 86.90)

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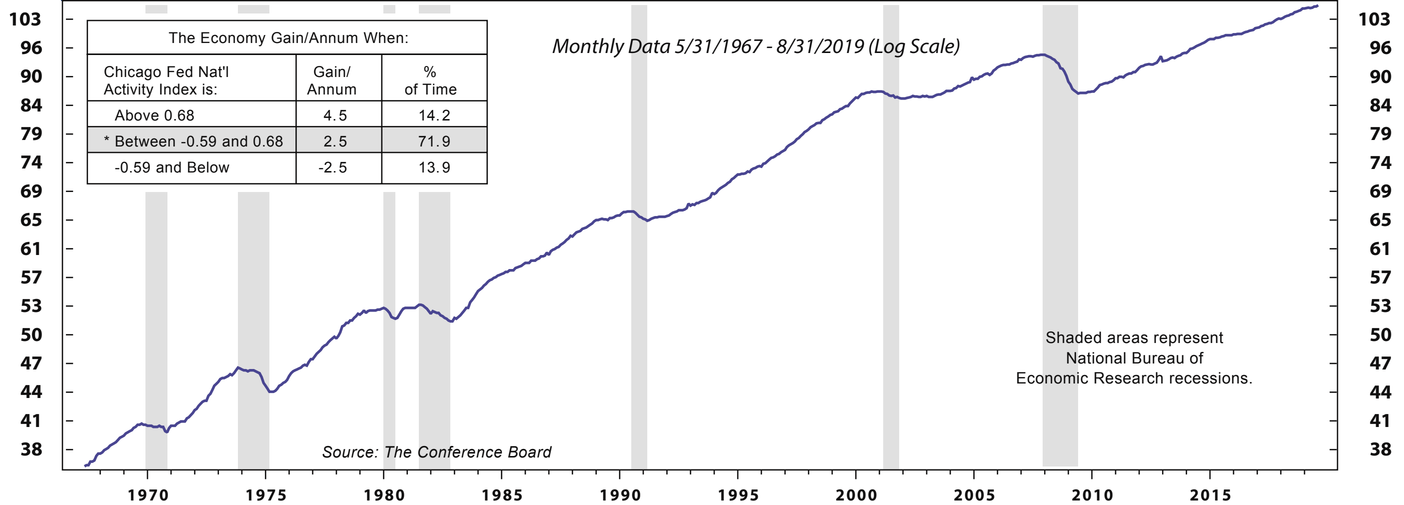
The second is the Chicago Fed National Activity Index (as seen below). The Chicago Fed's proprietary index has accurately indicated when recessions have started for a half-century. As you can see below, when the red line crosses the lower of two dashed green lines, it indicates that we have entered a recession. Again, we did see an economic slowdown and then a rebound. The Chicago Fed is not pointing towards a recession at this time.

The Economy (The Index of Coincident Economic Indicators)



The Economy Gain/Annum When:		
Chicago Fed Nat'l Activity Index is:	Gain/ Annum	% of Time
Above 0.68	4.5	14.2
* Between -0.59 and 0.68	2.5	71.9
-0.59 and Below	-2.5	13.9

Chicago Fed National Activity Index (Three-Month Smoothing)

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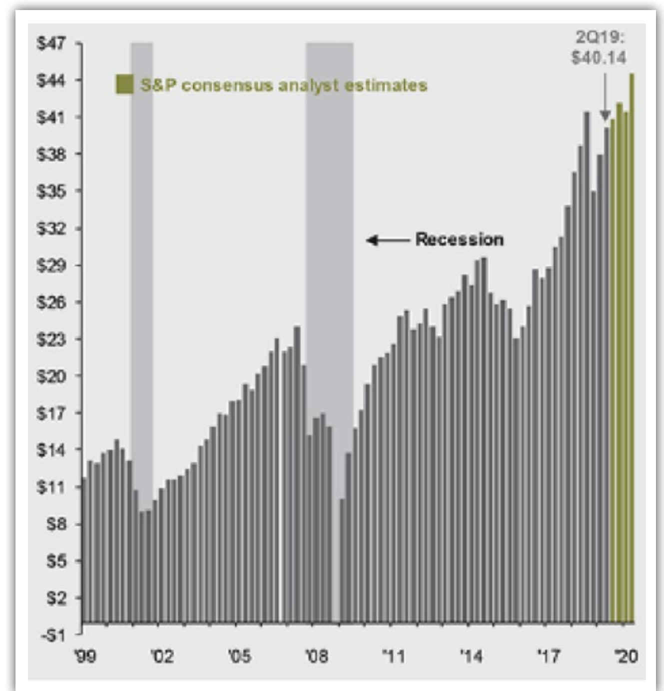
Strong Earnings Are Expected

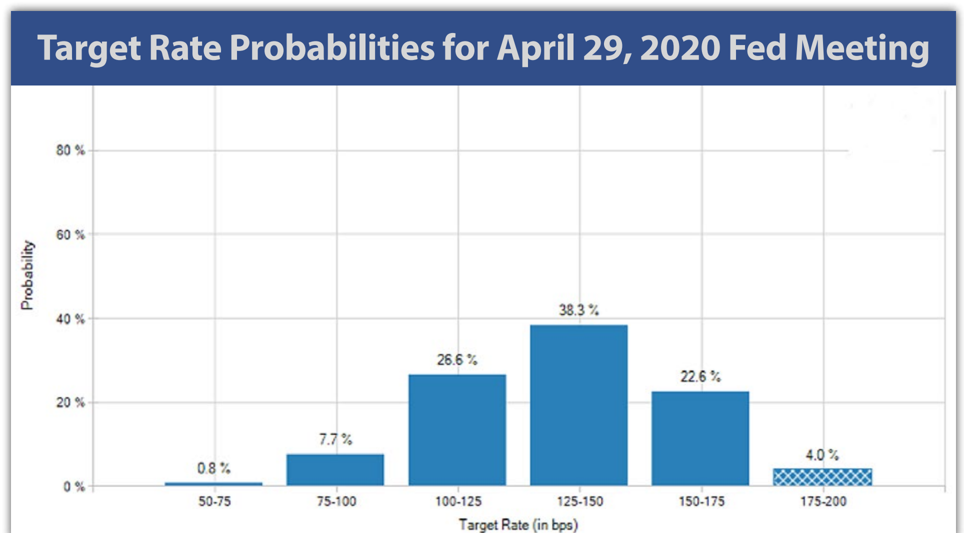
Second Quarter earnings are in the books and were the second strongest earnings in the history of the S&P 500. Q3 2019 is expected to be slightly stronger, with future expectations for record-breaking earnings. While nothing is certain, stronger earnings growth is here and expected to continue for the foreseeable future.



Source: CompuStat, FactSet, and Standard & Poors

An Accommodating Federal Reserve

Last year's pullback in the markets was partially due to investors' fear that the Federal Reserve would continue to raise rates without looking at what was happening around them economically. The rebound in the market began when Fed Chairman Jay Powell publicly stated that the Fed wasn't on cruise control and would consider all economic conditions and how to combat a slowing economy. Since then, the Fed has cut rates twice. According to Fed futures, there is an 83% chance of the Fed cutting rates at their October 30th meeting. And as you can see from the graph to the right, the Fed is expected to be even more accommodating by their April 29th, 2020 meeting.



Source: CME Group

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Concern Points

While we are confident of our opinion that the markets should continue to track higher through the rest of the year, it would be arrogant to not keep an eye on things that could derail these markets. Here are a few things that we will be monitoring.

Impeachment Inquiry

As we've discussed many times, my job is to keep my own political beliefs out of how I manage money. I can't be blue or red. I can't even be purple (a moderate in the middle). I have to be agnostic and clinical about how a political event might impact our investments. Please don't read into anything I write from here. I'm merely stating my clinical (non-political) beliefs.

The obvious hot topic over the past week has been the impeachment inquiry. While I am concerned about the impeachment inquiry, I might be concerned for reasons that are different from yours.

It takes a lot for a President to be impeached and removed from office. To date, no President has been removed from office by impeachment. Richard Nixon resigned before a vote could take place. Andrew Johnson and Bill Clinton faced impeachment proceedings. Both were impeached by the House of Representatives, and in both cases, the Senate was unable to garnish the two-thirds vote needed to remove them from office.

Trump's impeachment inquiry could lead to an impeachment. The Democrats have more than enough numbers in the House of Representatives to get the simple majority necessary to send articles of impeachment to the Senate. Currently, the Senate consists of 53 Republicans, 45 Democrats, and 2 Independents, totaling 100 seats. Let's say that the Democrats could convince the two Independents to vote with them. It would require 20 Republicans, or almost 38% of their ranks to vote with the Democrats to get the necessary 67 votes needed to impeach President Trump. It seems very unlikely.

The impeachment process could be a major distraction and cause other countries to see weakness in our ranks. At the very least, the impeachment inquiry and the probable impeachment process in the Senate could add to uncertainty in the markets.

Trade Wars

The impeachment inquiry might spill over into our trade negotiations with the Chinese. The markets are already susceptible to simple headlines indicating whether things are going well or if there have been setbacks. If the Chinese hint at stalling or stepping away from the negotiating table as a result (directly or indirectly) of the impeachment inquiry, the markets would react negatively.

The Chinese began renegotiating the previously agreed upon terms of the rough draft framework of a trade agreement with them in May when they felt the U.S. was weakening economically. This impeachment inquiry might encourage them to wait until our 2020 election to see if they will still be forced to negotiate with President Trump (if reelected) or perhaps another President that doesn't have the same willingness to have a trade war if President Trump is not reelected. A prolonged delay would be looked at poorly by Wall Street.

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Continued Economic Slowdown

As much as I've said that everything looks fine economically, that can quickly change. Seventy percent of our economy is driven by personal consumption. Any disruption of consumer confidence could quickly influence how our population is spending their money. We will be keeping a close eye on personal consumption and business spending to understand the risk of a recession.

As always, I welcome all questions and comments. Please feel to reach out to me.

Sincerely,

Jeffrey J. Powell
Managing Partner & Chief Investment Officer

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