Towerpoint Wealth
Monthly Market Lookback

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Will You Still Love Me Tomorrow?

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"An Investment in Knowledge Pays the Best Interest"
(Ben Franklin)

Will You Still Love Me Tomorrow?

Tonight you're mine, completely
You give your love so sweetly
Tonight the light of love is in your eyes
But will you still love me tomorrow?

Is this a lasting treasure
Or just a moment's pleasure
Can I believe the magic in your sighs
Will you still love me tomorrow?…

I'd like to know that your love
Is a love I can be sure of
So tell me now and I won't ask again
Will you still love me tomorrow?

(From "Will You Still Love Me Tomorrow?" by Carole King and Gerry Goffin, 1971)

The phrase "October Surprise" usually refers to a sudden, politically-motivated "reveal" about the opposition candidate just prior to an election. The hope is to announce negative news about the opposition candidate just when voters are finally focusing on who and what they want to vote for (or against).

This year, there very well may be a political "October Surprise", though as we write this we are running out of days in which one may occur (perhaps the recent spate of "pipe bomb" deliveries to prominent Democrats qualifies, though the actual *sender* of those bombs remains highly questionable).

But, for many investors, this October certainly has been a negative surprise, as most major markets have sharply corrected over the course of the month, with the S&P 500 index, for example, giving back in roughly three weeks roughly half of its YTD gain through the end of September. And Small Cap stocks have fared even worse. As of the end of September, the Russell 2000 (a commonly used index for Small Cap stocks) was up more than 11%. As we write this, that index now has slipped into negative territory.

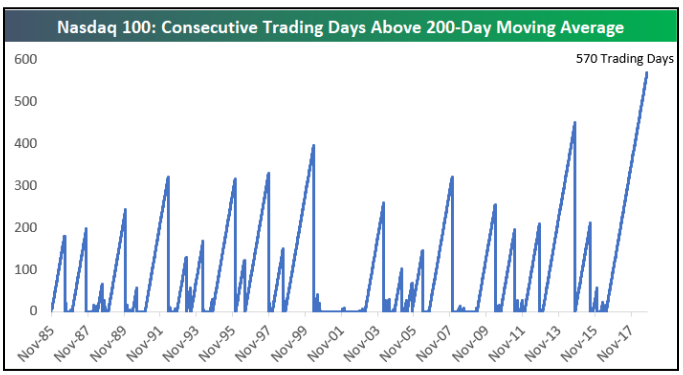
But how big of an "October Surprise" is all of this, really? Many of the equity market's worst disruptions occurred in October – The Panic of 1907, the Great Depression market crash of 1929, "Black Monday" in 1987 and, of course, the Great Financial Collapse of 2008, though the final (but by no means only) catalyst for this event – the collapse of Lehman Brothers – occurred in mid/late September. Not all bad market events occur in October, of course, and in many cases these crashes were the final outcome of a series of events that took place over many prior months or even years. But October gets a "bad rap" for sure, and with some justification.

To be clear, we are not suggesting that the market corrections of this past month remotely resemble those historic seismic disruptions (although it may *feel* like them to complacent investors who have enjoyed years of central bank-manipulated positive capital markets action). In fact, we've been suggesting for months that just such a correction was due – we do not have a crystal ball and never "time stamped" when this correction might occur, but we believed it would at some point. To quote from our July Monthly Market Commentary:

> *Look for volatility to increase as the (trade) rhetoric heats up and we work our way through the typically slow summer trading months. As has been the case for the past several years,* ***September and October look to be much more "interesting"****, and it is not too early to start thinking about how to allocate your portfolios accordingly. (emphasis added)*

Let's review some of the factors that contributed to this most recent edition of an "October Surprise":

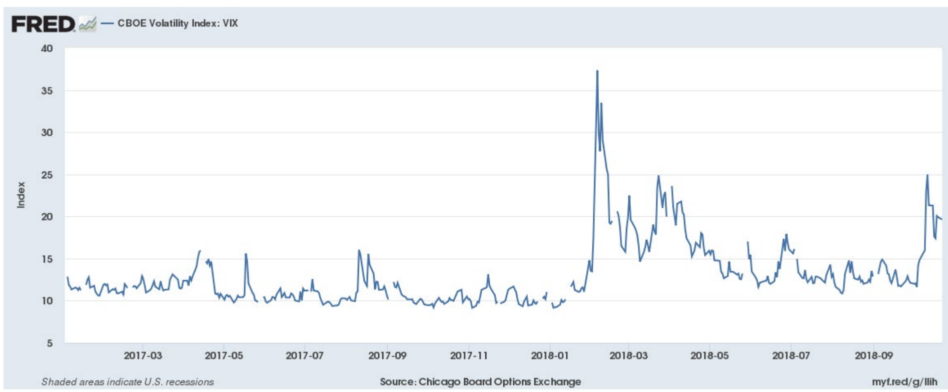
1. The markets (especially the Tech sector), were remarkably complacent for months. See, for example, the following chart from *Bespoke Premium* that illustrates just how consistent the Tech rally had been in comparison to historical performance. If you believe (as we do) in even a modicum degree of market mean reversion, the recent pullback is no surprise, and perhaps even long overdue.



2. Market valuations are inversely correlated to interest rates and volatility. Put differently, valuations tend to go up when interest rates and volatility are low, as they have been for much of the past 7-8 years. But they also tend to decrease when interest rates rise and/or when volatility increases.

   Interest rates have risen steadily over the course of 2018 (albeit fairly slowly), and even with the recent rally the 10-year Treasury rate now trades consistently above 3.00%:

Likewise, volatility (as measured by the VIX) has also increased recently, after trading at historically low levels for most of the past two years (with the exception of the *last* market correction we experienced in late January of 2018):



3. Perhaps most importantly, the stock market is a *discounting* mechanism – it focuses less on current market conditions (which are already priced in) and more on future expected conditions. The US economy is humming right now, and corporate earnings are fairly strong. But, as we increasingly get through the Q3 reporting season in the US, we see a troubling trend – the *earnings* “beat rate” remains strong, above 70%. But the *revenue* “beat rate” has fallen off dramatically (currently below 60%). In other words, companies are engaging in financial engineering to drive earnings growth, but top line revenue growth is decelerating, and the markets are reacting accordingly.

4. Furthermore, while the current US economy is doing well, there are distinct signs that the effects of tax reform and fiscal stimulus legislation of late last year and early this year are beginning to wear off. We are not suggesting imminent recession, simply a deceleration of growth and, again, investors are reacting accordingly.

5. The outcome of the upcoming mid-term elections in the US, combined with ongoing trade uncertainties, continue to contribute to a fair level of market uncertainty.

We have been suggesting for several months that market valuations are expensive and that market complacency was high. In this "perfect storm" of rising rates, increased volatility, expected deceleration of economic growth and corporate earnings, and exogenous issues such as the elections, trade negotiations, and Middle East tensions, no one should be surprised that the market (finally) reacted.

With that as a backdrop, looking out over the economic and investment landscapes, here is what we see.

The Current Economic Landscape

The global economy continues to grow, though with distinct signs of deceleration, especially outside the US:

- The consensus estimate for Q3 GDP growth in the US is now a solid 3.4%. That growth is then expected to decelerate to 2.9% in Q4, bringing overall 2018 GDP expectations to 3.1%; (source: *The Wall Street Journal*);
- This GDP forecast remains sensitive to ongoing trade negotiations, political tensions in the Middle East following the assassination of journalist Jamal Khashoggi, and the outcome of the upcoming mid-term elections here in the US;
- On the election front, the polling averages from *Real Clear Politics* suggest (a) the Republicans will retain control of the Senate (and perhaps even pick up a seat or two) and (b) the Democrats will regain control of the House, though earlier suggestions of a "blue wave" election have subsided and even Democrats acknowledge that this is likely to be a very close election;
- Both US manufacturing and services remained strong in September, with the PMI (manufacturing index) coming in at 59.8, down slightly from 61.3 in August, while the NMI (non-manufacturing index) jumped to 61.6 in September, up from 58.5 in August; any reading above 50 is considered expansionary. The PMI has now been in expansionary territory for 113 consecutive months, while the NMI notched its 104th consecutive expansionary month (source: *Institute for Supply Management*);
- One possible future trouble spot for the US economy is a marked slow-down in the housing sector, as permits, housing starts (especially in the multi-family sector), and affordability have all trended downward for several months (source: *Bespoke Premium*);
- Inflation (as measured by CPI) fell to 2.3% year-over year in September, down from 2.7% in August, continuing a 3-month trend. Oil prices (as measured by WTI) have fallen steadily since late September, falling from roughly $76 per barrel to roughly $67 per barrel over the course of October. Wages finally are starting to increase (up 4.79% year-over-year in August – the most recent reading), but a slowing global economy outside the US, especially in China, is keeping commodity prices under control (even falling). The Personal Consumption Expenditure (PCE) index – which is the Fed's preferred measure of overall inflation, increased 2.2% in August (the most recent reading), down slightly from 2.3% – generally in line with the Fed target rate (source: *TradingEconomics*).
- We continue to believe that inflation will increase slowly over the rest of this year, but will remain somewhat dampened by (1) continued slow (but positive) wage growth; (2) a generally strong dollar; and (3) a decelerating global economy (ex-US), which will dampen demand. As such, we continue to believe that inflation does not *yet* constitute a primary risk to economic growth;

- As expected, the Fed raised interest rates in late September, and there is a strong consensus that it will do so again at its December meeting. President Trump does *not* agree with current Fed policy, and has made it clear that he wants the dollar weaker and interest rates kept low (he is unlikely to achieve either objective). Should the economy slow down or the current market downturn continue, it is a safe bet that Trump will hold the Fed responsible;
- The yield curve has risen steadily over the past several months but remains very flat, as the Fed raises rates on the short end but the long end remains “tamped down” by high demand and a lack of inflation fears. As of late October, there remains less than 30 basis points difference between the yield on the 2-year and 10-year Treasury.
- We saw a brief rally in the longer end of the curve due to the market disruption in early/mid October, but the 10-year rate remains above the psychological barrier of 3%, and we repeat that we do not anticipate (or fear) an inverted yield curve – should one occur, we believe it will be because of investment flows and Fed actions, not a harbinger of an imminent recession;
- The US dollar generally remains strong. It weakened slightly against the euro through October, but continued to strengthen against both the Japanese yen and (especially) the Chinese yuan;
- The Q3 earnings season is underway, and we are seeing a mixed bag of results. Of the roughly 70 S&P 500 companies that had reported through the third week of October, we saw a 20% increase in earnings on 7.8% higher revenues. More troubling, however, is that while the *earnings* “beat rate” remains strong, above 70%, the *revenue* “beat rate” has fallen off dramatically (currently below 60%). This simply means that companies are using financial engineering (stock buybacks, etc.) to generate earnings growth versus organic top-line growth. Further, the number of companies issuing reductions in future earnings guidance is increasing. So, while the numbers certainly remain *positive*, growth is still expected to decelerate as we head into 2019, with earnings growth of 9.7% and revenue of 5.1% (sources: *Zachs Earnings Report* and *Bespoke Premium*);
- Manufacturing across the Eurozone remains expansionary, though the Markit Manufacturing index fell to 52.1 in October, versus 53.2 in September, a continuation of a general YTD decline. Likewise, the Services index fell slightly to 53.3 in October from 54.7 in September – the slowest services expansion rate since October 2016 (source: *TradingEconomics*);
- Eurozone unemployment edged down to 8.1% in August (the most recent reading), from 8.2% in July, and it remains at its lowest level since December of 2008. Annualized inflation edged up to 2.1% in September, up from 2.0% in August (source: *TradingEconomics*);
- Japan’s GDP rose 3% (annualized) in Q2, after a decline in Q1. The expansion was driven by strong consumer and business spending and was the strongest reported growth rate since Q1 of 2016. The consensus estimate for 2018 GDP growth is 1.7% (source: *TradingEconomics*);
- China’s (official) GDP growth in Q3 was 6.5% (annualized), down from previous quarters, and it is expected to post an (official) growth rate of 6.6% for all of 2018. There are other (non-official) signs, however, that the Chinese economy is slowing faster than the official numbers indicate. For example, the Chinese Caixin Manufacturing Index fell to a 16-month low of 50.0 in September, the Chinese stock market is down more than 20% YTD, and the yuan continues to weaken significantly against the dollar (source: *TradingEconomics*).

The Towerpoint Wealth Economic & Market Outlook:

- ***The global economy continues to expand, though there remains a distinct "desynchronization" of growth. The US economy shows continued growth, with perhaps some yellow lights beginning to flash (e.g., housing), and there is an expectation of a decelerating economy through 2019 as the effects of fiscal stimulus and regulatory and tax reform begin to tail off. At the same time, the rest of the world appears to be decidedly decelerating – still expansionary, but slowing down (especially in China);***
- ***US Inflation is trending higher, but we maintain our belief that it (as of yet) does not represent a problem for continued economic expansion. Wages in the US are increasing slowly, oil prices have actually fallen over the past 5-6 weeks (despite tension in Saudi Arabia over the assassination of journalist Jamal Kashoggi), and overall commodity prices remain repressed by slowing demand and the generally strong dollar. Outside the US, inflation simply is not a problem, despite the rise in oil prices;***
- ***In the US, tax and regulatory reform and fiscal stimulus continue to win the ongoing economic tug-of-war against monetary tightening, and continue to pull future consumption forward as consumers and small business owners lean fully into the ongoing recovery. That said, the Fed has a laid out a fairly aggressive tightening program over the next 12-15 months and there perhaps is a risk it will "overshoot" in its tightening and choke off the expansion. As the cliché goes, "Economic expansions rarely die of old age – they generally are killed by the Fed";***
- ***At some point, the markets will need to be concerned again about massively increasing deficits and debt, but right now neither party (nor, especially, President Trump) show the slightest interest in addressing this rapidly growing problem;***
- ***Solid US GDP growth, as well as respectable earnings and revenue growth, make for a generally positive market environment, and we maintain our view that US stocks will end the year higher than where they began.***
- ***As we discussed above, however, the markets seemingly have begun to react to decelerating earnings growth, decelerating economic growth, and generally rising interest rates. Through October, we've seen these factors, plus uncertainty over trade policy and the mid-term elections, all combine to push valuations down and volatility up;***
- ***Ongoing trade tensions and (perhaps) an overly aggressive Fed seem to be the largest potential threats to the current generally positive economic regime;***
- ***EM and EAFE (Developed International) markets continue to be hurt by a generally strong US dollar, trade tensions, and a corresponding "risk off" mentality driving investment outflows. We still like EM and EAFE as longer-term positions, from both a valuation and economic growth perspective, but investors should expect continued volatility and probably negative performances for the year (in US terms);***
- ***Interestingly enough (perhaps because of lower starting point valuations), non-US markets generally have held up better than US markets (especially Small Caps, which have taken it on the chin) during the market gyrations of October;***

- ***At current interest rates and credit spreads, the public credit markets continue to look very expensive to us, and our return expectations are muted accordingly. We are nearing the end of the current credit cycle and risks are increasing;***
- ***In particular, the leveraged loan market (i.e., floating rate bank loans) has seen a decided deterioration in both the credit quality of borrowers and in the covenant structures of the loans – both distinct warning signals.***
- ***Likewise, the traditional Investment Grade bond market has seen a downturn in the average credit rating of borrowers. This could have dramatic implications if/when the next recession hits and corporate revenues decline;***
- ***Many investors increasingly are turning to shorter-duration bond strategies and even cash solutions, which finally have a positive real yield again due to the Fed rate hikes. The curve is so flat that investors simply are not being sufficiently compensated to take on term or duration risk;***
- ***We have muted our expectations for real assets and the overall commodity complex, due to lower than expected global inflation, slowing demand, and the strong US dollar;***
- ***While we generally are constructive on the global economy and overall market performance, the public markets are not cheap, and the market volatility we have long expected has materialized (in spades). We still believe that the market can move higher over the rest of the year, though with increased volatility. We also believe, however, that clients need to have their expectations managed as to what a globally diversified portfolio can deliver over a full market cycle.***

"*We have met the enemy and he is us*" is the famous quote from the iconic comic strip character Pogo. Investors need to remember that market volatility is *normal*, geopolitical uncertainty is *normal*, and evolving economic cycles are *normal*. We collectively have enjoyed 8+ years of central-bank induced complacency, but those days are over. As the Brits used to say in WWII, "*Stay calm and carry on*". Investors should, of course, be paying attention, but they also need to remain calm, stay disciplined, and keep their investment horizons aligned with their long-term financial goals and objectives.