Fourth Quarter 2019 Investment Outlook

It's A Wild, Whacky Investment World ("WWIW")

Siemens just borrowed $1.6 billion without offering a penny in interest. It's another sign that investors are betting that rates are going to fall even further as storm clouds gather over the global economy. Siemens borrowed €1.5 billion euros over two and five years. Those bonds offered a zero coupon (interest rate) and were priced with negative yields.

– CNN news report

"The negative interest rate policy of the ECB is ruining the financial system and is a socio-political poison. The financial system is absurd if we have to explain to the children that money has a negative value – and thus debt is good, because we may not have to repay everything."

– Frank Kohler – CEO, Sparda-Bank Berlin

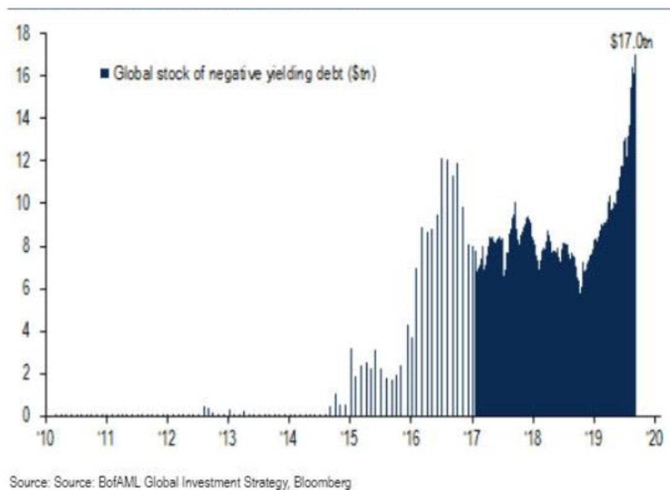
"Negative rate policies distort the economic and financial markets systems. The unintended consequences from these policies will be significant and harmful."

– Bob Rodriguez – Former Managing Partner - FPA

Bonds, normally a staid and boring part of the investment world, are anything but that today. Maybe bonds are not as contentious as Hong Kong streets have been the last three months, but they are right up there, sans the Molotov cocktails. In a WWIW for investors and savers, bonds present a dilemma between the ongoing and important risk diversification benefits that bonds offer in a portfolio versus the prospects for minimal future returns. Conversely, if you are a borrower, it is the most glorious of times to be in debt, especially if you are a foreign government whose bonds have negative yields and it costs nothing to borrow more. Who doesn't love free money?

Here's an interesting financial stat to drop on your friends at your next cocktail party, preferably at least three cocktails in for a greater mind-blowing effect. Bond yields have never been lower in the history of mankind as they are today. By history of mankind, we mean going back 5,000 years to 3,000 B.C. or when saying B.C. would draw a blank stare. Incredible, yet true. Take that in for moment, like you would your first sip of a Château Lafite 1869 that Jeff Bezos of Amazon serves at his next cocktail party you attend. In fact, drop the bond yields have never been lower in the history of mankind line on Jeff and he may be so impressed that he gives you a bottle to take home.

The collapse in global bond yields is the major investment story of 2019. Recently, nearly $17 trillion (that's a t, not a b) or 30% of total outstanding debt issued in the world traded with negative yields (gulp!). This total includes $1 trillion of corporate bonds like those issued recently by Siemens, which have company specific credit risk not inherent in sovereign bonds. Despite this WWIW, nearly $325 billion of assets have flowed into global bond funds so far during 2019, on pace for the greatest year on record. To keep the too hard to believe WWIW stuff going, there are 1,100 publicly traded stocks globally with dividend yields above 3%, compared to the trillions of debt with negative yields. Sound preposterous? Welcome to WWIW.



It used to be that you bought bonds for income and stocks for capital appreciation. In today's WWIW, bonds are being bought for capital appreciation and stocks are being bought for income. The 10-year U.S. Treasury bond yield at 1.67% as of 9/30/19 was lower than the 1.9% dividend yield on the S&P 500 Index. In Europe, the Stoxx 600 Index (their S&P 500 Index equivalent) yields 3.6%, while virtually all sovereign bonds in Europe have negative yields. Ever heard of a German car company called BMW? Its stock has a dividend yield of 5.5% while a 10-year German bund has a yield of -0.57%. That pretty much sums up the WWIW we find ourselves in today.

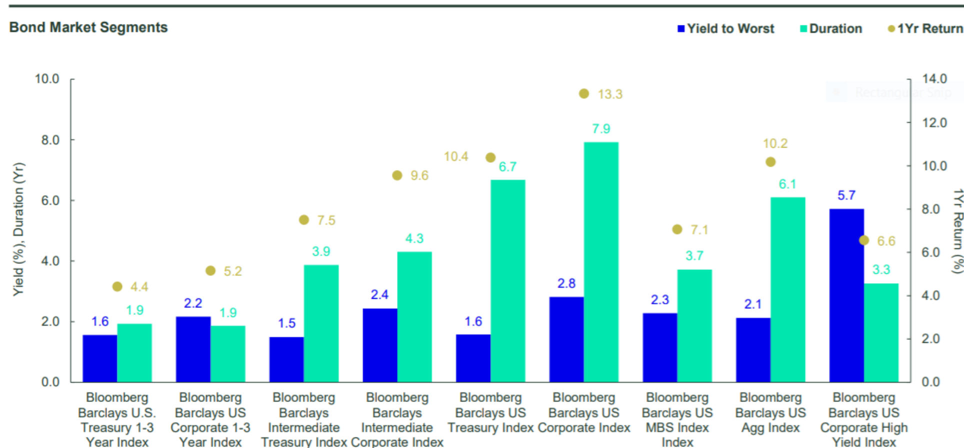
Sure, everyone with a 401k or IRA loves it when the stock market when it is up over 20% but the main reason stocks are up that much this year (yet close to 0% since January 2018) is because global bond yields have collapsed and global central banks (now over 30 of them) are cutting interest rates. In the U.S., 2019 may end the year with flat or negative earnings growth from original expectations of +10% earnings growth and yet stocks have returned just over 20% year to date through 9/30/19. That's what a WWIW gets you. The broad U.S. bond market is +8.5% year to date through 9/30/19 and if you owned longer maturity bonds your returns are nearly +20%. As my Dad sometimes says, not bad Duke, not bad at all.

A majority of the return in bonds this year represents capital appreciation as bond prices rose and yields plummeted. The negative bond yield world outside the U.S. is pulling yields lower in the U.S. too since bonds here still actually offer positive yields, even if they are paltry. U.S. corporate bonds issued just a few year ago with 4%-5% coupon rates can now be refinanced for much lower rates. If you're a European high-quality corporate credit like Siemens, you can sell bonds to investors and pay no interest. Now that's a WWIW. Any CFO worth their salt is tripping over themselves to get in line for a debt refinancing. As global bond yields have plummeted, it's not surprising that 2019 will be likely be one of the biggest years in history for bond issuance or that the amount of global public debt is approaching $60 trillion (double gulp!).

In a multi-asset portfolio, no one expects to get rich from their bond allocation. The main purpose of bonds is to provide stability and income and to help diversify and lower overall investment risk. In today's WWIW, bonds increasingly offer little income and the risk profile of bonds has increased. How so? In the next chart, the yellow circle above each category of bonds is the total return each bond benchmark generated the past one year through 8/31/19. Let's use the Bloomberg Barclays Aggregate Bond Index (second in from the right) as an example, which returned 10.2%, a very large return for bonds

in any year. Notice the blue bar for the index shows the yield at a measly 2.1%. The difference between total return (yellow dot) and yield (blue bar) represents the capital appreciation kicker earned from bonds as global yields collapsed over the past year. In other words, around 75% of the total return from bonds the last year was from capital appreciation.

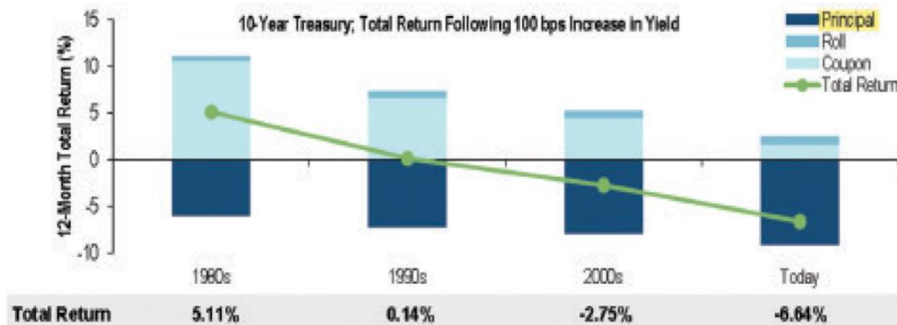
Not everything is wine and roses in bonds because there is a growing risk side of collapsing bond yields to highlight. As yields decline, the duration or interest rate risk of a bond increases, particularly for longer maturity bonds. Referring again to the chart below, note that the duration of the Bloomberg Barclays Aggregate Index is 6.1 years (green bar). Duration is a measure of a bond's sensitivity to interest rate movements. The higher the duration, the higher the potential price risk. Note in the middle of the chart that the U.S. Treasury Index and the U.S. Corporate Index have even higher durations of 6.7 and 7.9 years, respectively, which means those particular segments of the bond market have the highest risk to rising interest rates. As bond yields have collapsed over the past year, they have also delivered the highest returns as shown by the yellow circles for each index.



Source: Bloomberg Finance, L.P. As of August 31, 2019. **Past performance is not a guarantee of future results.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

In our 2013 Investment Outlook, when financial markets were faced with a similar low yield setup, we discussed what could happen if or when bond yields headed higher. Given the global collapse in bond yields, the growing amount of global debt outstanding, and trillions of global bonds sporting negative yields, it's worth revisiting this topic today.

When bond yields rapidly decline, there is a nice capital appreciation kicker to the total return of bonds as was shown in the prior chart and as reflected in bond returns year to date. However, when bond yields head higher, there is the opposite effect and bonds incur capital losses. Interestingly enough, when the next chart was produced back in 2013, the yield on the 10-year U.S. Treasury yield was 1.8% compared to approximately 1.7% as of 9/30/19. So, the math of the chart works exactly the same as it did back in 2013. Go to the far-right bar on the chart, which shows what a 1.0% increase in yield would mean for the total return of a 10-year U.S. Treasury bond. The total return would be -6.6% including the income received from the bond. Referring back to the prior chart, note how the current duration of the Bloomberg Barclays Treasury Index is 6.7 years, almost identical to what it was in 2013's low yield world. Therefore, a 1% rise in yields from today's levels would produce a similar negative return as shown the next chart.



Source: Soberlook

None of this bond discussion is meant to suggest a rapid rise of bond yields is immediately in front of us. In fact, the global economic slowdown in place today is putting more downward pressure on bond yields. That being said, what happens if the rate cutting actions of global central banks over the past six months does have the effect of stemming this recent soft patch of global growth and economic growth stabilizes and begins to re-accelerate into 2020? What happens if Trump and Xi both decide they need a trade deal bad enough and get a deal done in the near future? Any guesses on what should happen to bond yields under this scenario? Anyone? Buehler? Buehler? To provide an answer to that question, it is helpful to compare how four Vanguard bond funds of longer maturity profiles performed in 2013 as bond yields started to head higher versus how they performed this year as bond yields collapsed. During 2013, the 10-year U.S. Treasury yield started the year near 1.75% and finished the year near 3.00%. In 2019, the 10-year U.S. Treasury yield started the year at 2.69% and was at 1.67% as of 9/30/19.

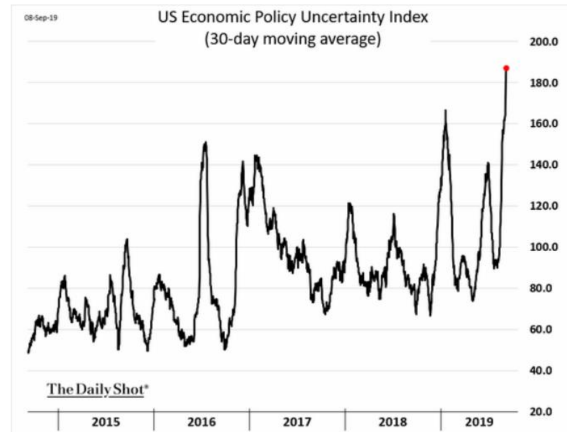
	2013	2019YTD
Vanguard Long Term Treasury Fund	-12.7%	+20.0%
Vanguard Long Term Investment Grade Fund	- 5.9%	+21.3%
Vanguard Intermediate Treasury Fund	- 2.7%	+ 6.9%
Vanguard Intermediate Investment Grade Fund	- 1.3%	+ 9.9%

If we have a recessionary outcome in the U.S., then U.S. bond yields may go even lower, leading to even more price appreciation. For investors with balanced portfolios consisting of both stocks and bonds, in a more normalized investment world, they would likely consider increasing their bond weight to get more defensive if recessionary conditions take hold. But in today's WWIW, such a move would carry more risk than normal given today's low yield levels and may actually add more risk to a portfolio when you are seeking to reduce risk. Today's WWIW presents an interesting dilemma, but not in a fun way. As for non-U.S. sovereign bonds (ex emerging markets) with negative yields, they may be the worst investment in the history of investments, right up there with the Dutch tulip bubble and tech stocks during the dot com bubble. To make any potential returns in non-U.S. sovereign bonds, you have to believe in the greater fool theory of investing. In today's WWIW, there are plenty of fools to go around. Just make sure you're not one of them.

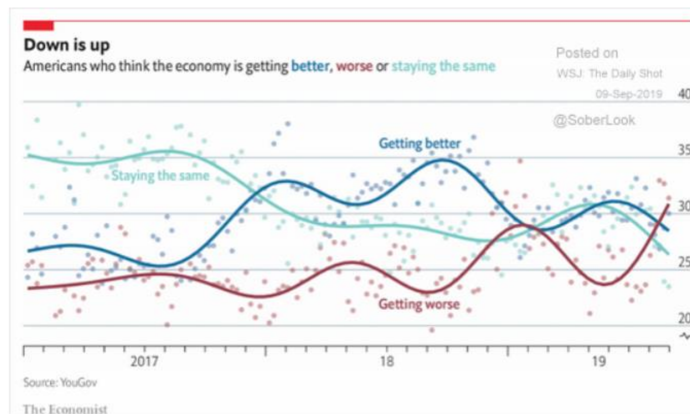
Global Macro Uncertainty Reigns

The tariff war between the U.S. and China has been a major factor on slowing global growth. Not only is the issue of tariffs adding to uncertainty, but the talks have been going on forever, adding to the inability of companies to plan or invest for the future with such a critical issue unresolved. The next chart shows how U.S. economic policy uncertainty has skyrocketed since the trade war started. The most recent

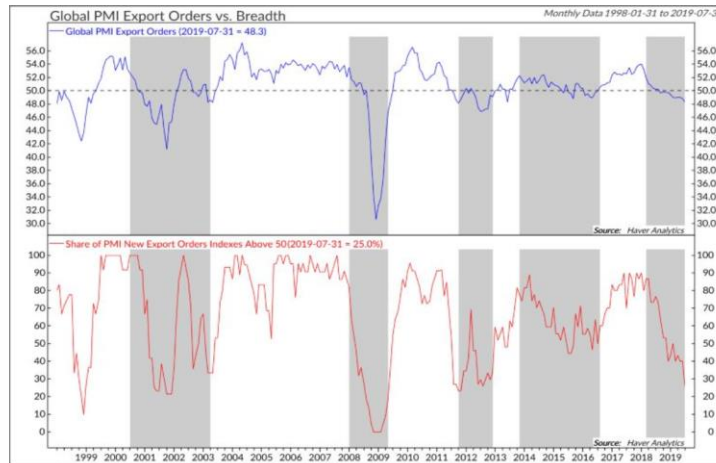
dramatic pop higher was during August when Trump announced he would add more Chinese goods to the tariff list and increase tariff rates even higher on Chinese goods already under tariffs. Global stock markets reacted quite negatively to this news during August.



The uncertainty of the trade war and the constant negative headlines it produces has flow through effects on consumer confidence. As the trade war has extended on, Americans are becoming less positive on their outlook for the U.S. economy. Since the start of 2019, an increasing number of Americans believe the economy is getting worse.

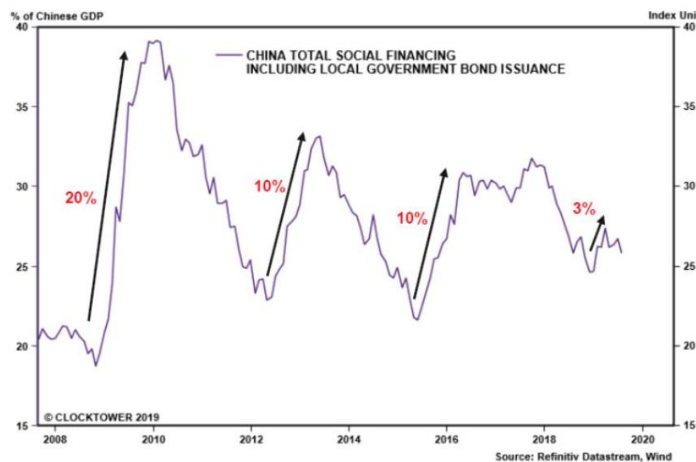


Not only does this high level of macro uncertainty make consumers more cautious, it makes it extremely difficult for investors to invest with any conviction and companies to plan with any confidence. The trade war's impact is not isolated to the U.S. and China even though the dispute is between those two parties. The next chart captures export orders data from across the globe. The top half of the chart shows that exports globally have fallen below the 50 line, which marks the demarcation between growth and contraction. In addition, the bottom half of the chart shows that only 30% of countries today have exports order levels above the 50 level, meaning that 70% of countries that report this type of data are in export contraction territory. The export data clearly shows there are broader residual negative impacts of the U.S./China trade war.

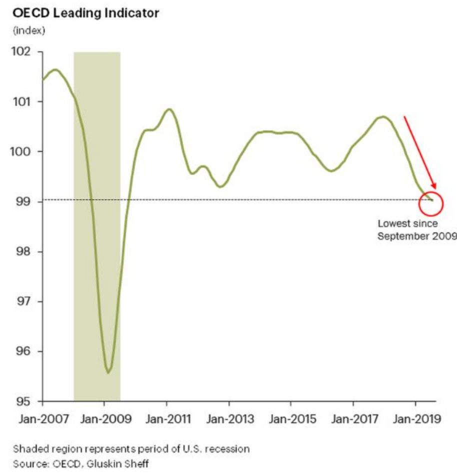


Source: Ned Davis Research / Haver Analytics

China today represents a significant 20% of global GDP growth given the current low levels of economic growth in western economies. What happens to its economy is critically important. Over the past decade, China has been able to initiate large stimulus packages to drive economic growth higher. The next chart shows how China has used debt to stimulate its economy over the past decade and during several global economic slowdown periods. Notice the extremely large fiscal stimulus China was able to implement when the Global Financial Crisis hit in 2009 and again in 2012 and 2015 during global growth slowdowns. However, during the most recent global slowdown, in light of China's already high debt level it amassed during prior stimulus efforts, China has less financial wherewithal to stimulate its economy today via extremely large debt issuance.



These negative economic datapoints are flowing through the global economy as reflected in the next chart showing the decelerating profile for the Leading Economic Indicators Index from the OECD. The ongoing trade war, unless resolved, will continue to weigh on the global economy into 2020. The outcome of U.S. / China trade talks this month will be critical to the forward outlook for global growth.

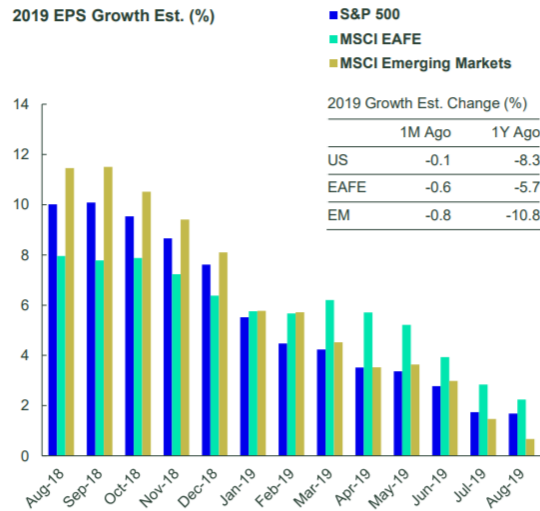


Even though China only represents just 6% of all U.S. imports, the U.S. is not immune to what is happening outside the U.S. and American companies are taking an increasingly cautious stance. The next chart on the left shows how weak capital spending intention trends in the U.S. in recent months most likely means weak capital spending out into mid-2020. The table on the right shows the components of the NFIB Small Business survey from September. Note how capital expenditures and sales expectations readings are already very low. It may take a substantive trade deal in October to reverse these trends as companies would likely gain more confidence in making investments for the future rather than being as cautious as they are today.

Indicators Used (Source: NFIB)	Current Rank
Optimism Index	77
Hiring Plans Index	86
Capital Expenditure Plans	28
Job Openings Hard to Fill	96
Credit Conditions Availability of Loans	69
Outlook for General Business Conditions	56
Uncertainty Index	76
Sales Expectations	37
Good Time to Expand	80
Average	**67**

Global Earnings Trends

Slowing global economic growth, if meaningful enough, will eventually translate into slowing corporate earnings growth around the world. The next chart shows the progression for 2019 earnings growth expectations for the three major stock asset classes: U.S. equities (S&P 500 Index), developed markets non-U.S. equities (MSCI EAFE), and emerging market equities (MSCI EM). The data in the chart below starts in August of 2018 and goes through August 2019.

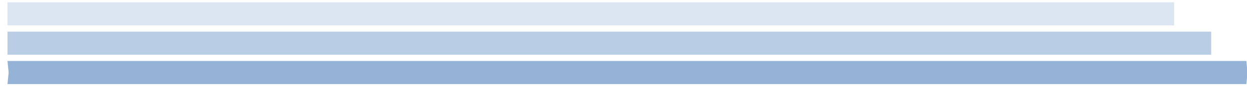


During the summer of 2018 (left side of chart), earnings growth expectations for 2019 for all major investment regions were between 8%-11%. Earnings growth expectation for the S&P 500 Index (blue bar) was at 10%. Fast forward to the right side of the chart and note how all major investment regions now show earnings growth for 2019 in the low single-digits. Since we are only in October and still have another three months to finish out the year, and given the fact the global growth has slowed throughout 2019, there is good possibility that 2019 earnings growth will end up flat or possibly slightly negative. Yet, U.S. stocks having gained 20.5% year to date through 9/30/19 while the MSCI EAFE Index is up less at +12.8% and MSCI EM Index is the worst performer at just +5.9%. In the WWIW of negative bond yields, and with global central banks all getting in on the interest rate cutting scene, stocks have ended up being the big beneficiary, but in a perverse way. It's not because earnings fundamentals are solid but rather because collapsing bond yields are forcing investors into stocks to seek out higher returns and despite a deteriorating earnings outlook.

U.S. Stocks Are A Very Crowded Pool

One place that global investors have overly flocked towards are U.S. stocks, not only during 2019 but over the past several years as well. Growth outside of the U.S. has been weaker and issues such as China's economic slowdown, Brexit, and collapsing bond yields and their negative impact on European banks. All of these factors have weighed more heavily on non-U.S. stock returns. At the same time, the U.S. economy has had better economic growth and the U.S. stock market has more technology behemoths, which have helped the broad U.S. stock market returns do much better even in a slowing global growth world. All that being said, how much of that is priced into U.S. stocks given their large outperformance trend of recent years? The next two charts attempts to answer this question.

The top chart on the next page shows the relative performance of U.S. stocks versus European stocks going back to 1950. When showing relative relationships, using standard deviation to assess how one index is doing relative to another is helpful. Over time, when relationships reach or exceed the +/- one standard deviation parameter, it usually means the relationship has become overextended. Today, U.S. stocks outperformance versus European stocks has now blown out way beyond one standard deviation and now reflect a quite extended performance relationship. Keep in mind this chart shows nearly a 70-year history so getting to +/- one standard deviation is rare occurrence. The U.S/Europe stock market

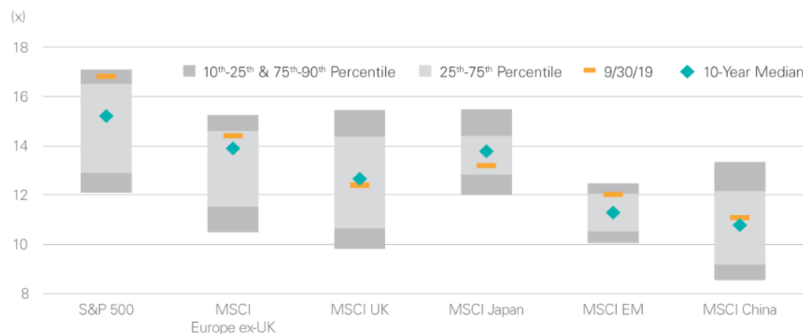


relative performance relationship only hit +/- one standard deviation level seven times before, with the most recent relationship the most extended at any time over the past 70 years.

Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data

In terms of global stock fundamentals, the next chart shows how valuations of regional or country indices compare to each other based on the past 10 years of history. The yellow dash in each column reflects the current valuation using the forward price/earnings multiple and is placed in its valuation range over the past 10 years for each country or region. On the left side of the chart, note how U.S. stocks as represented by the S&P 500 Index are the highest valued market with its yellow dash trading in the top 5th percentile of its past 10-year forward PE valuation range. In contrast, most non-U.S. stocks are trading at more attractive valuations relative to their past 10-year histories with the UK and Japan having the most attractive valuation profiles globally. Note that four of the six regions/countries shown in the chart have dashed yellow lines above their 10-year median, meaning that stocks, broadly speaking, are trading rich relative to their median 10-year forward PE valuation. A big reason behind this fact is that in this WWIW of extremely low bond yields globally, investors stay with stocks even if stock valuations are not cheap and even as the global earnings outlook has worsened.

Forward P/E (Next 12 Months) through Past 10 Years



As of 30 September 2019
Median and percentiles calculated based on month-end values. The figures above represent expected returns. Expected returns do not represent a promise or guarantee of future results and are subject to change.
Source: FactSet

While trailing returns for non-U.S. stocks may not look very appealing compared to returns generated by U.S. stocks, it is fair to say that large cap U.S. stocks have the most extended valuations across global stock markets today. As such, the risk/reward setup for non-U.S. stocks offer a compelling consideration for investors today.

Summary

The plunge in bond yields has been the major story of 2019. We are now in a WWIW where a significant number of global stocks have dividend yields higher than the vast majority of bonds. At the same time, corporate earnings fundamentals are still deteriorating and earnings expectations for 2020 appear too high in the context of a slowing global economy. The U.S / China trade war continues on with no end in sight and it is having a meaningfully negative impact on the global growth outlook and business confidence. Stock valuations, most especially in the U.S, are not cheap, but the collapse of bond yields makes stocks attractive on a relative basis and in the context of limited options for an investor to make better returns elsewhere. If the Fed continues to cut interest rates, yields on money markets (cash) will decline and bond yields at today's low and even negative levels make the risk/reward setup for bonds increasingly less attractive. Central banks appear determined to try an arrest the latest slide in global economic growth. If they are successful, and global growth stabilizes and improves, then bond investors face the prospect of negative returns ahead. That being said, how much can more rate cuts really stimulate economies when existing rates are already at historically low and negative levels? The current investment environment is fraught with difficult choices never before faced by U.S. investors and it doesn't look to get any easier, especially if the political situation in the U.S. becomes even more problematic than it already is. Hang in there because a WWIW may be with us for some time.

Mark J. Majka, CFA
Chief Investment Officer

October 10, 2019

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