Third Quarter 2019 Commentary

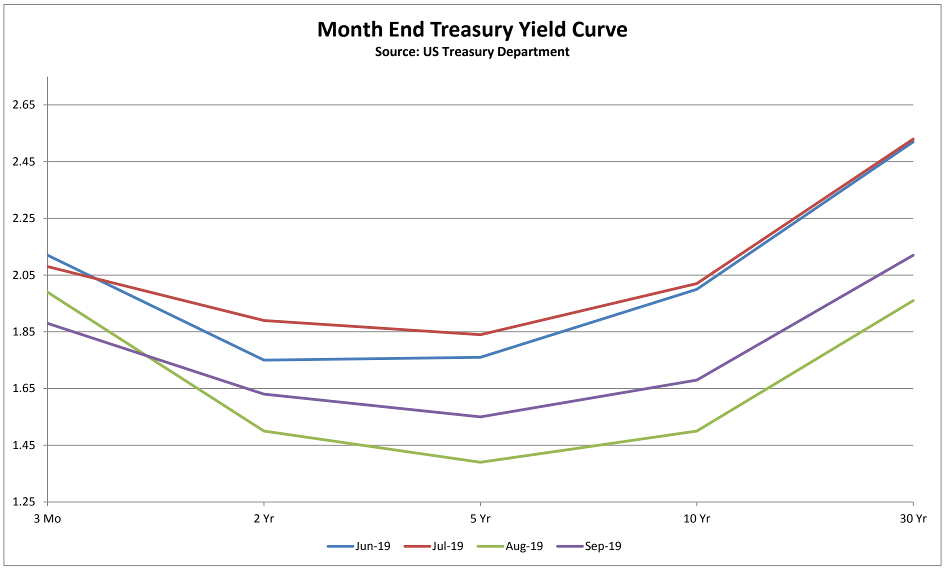
Markets

A volatile third quarter ended with global equity markets offering mixed returns for investors. The big-picture story remained largely the same in September as yet another month of geopolitical and trade tensions led to increased volatility, while political noise in the U.S. dominated media headlines. On the economic front, data continued to show weakening global growth—in some cases outright contraction—putting dovish central banks in a predicament as monetary "ammo reserves" are depleted relative to previous cycles.

The MSCI All Country World Total Return Index gained a meager 0.1% in the third quarter, while the S&P 500 rose 1.7% on a total return basis. It was a difficult quarter for small cap stocks, as the Russell 2000 Total Return Index fell 2.4%. International equity markets had a rough quarter and felt the brunt of the global slowdown as the MSCI EAFE Total Return Index fell 1.0% and Emerging Market equities dropped 4.1%. Year-to-date, however, all equity market indices are in positive territory, led by the S&P 500's stellar 20.6% return. Emerging market equities have been the laggard, returning just 6.2% thus far.

On the fixed income side, bonds gave up some of their August gains in September as the Bloomberg Barclays Global Aggregate Bond Total Return Index fell 1.0% and the Bloomberg Barclays U.S. Aggregate Bond Total Return Index lost 0.5%. For the quarter, however, both indices were positive, with Bloomberg Barclays Global Aggregate Bond Total Return Index advancing 0.7% and the Bloomberg Barclays U.S. Aggregate Bond Total Return Index rising 2.3%. Year to date, these indices are up 6.3% and 8.5%, respectively, far outpacing their yield-to-maturities—as of August 31, the yield on the Global Aggregate index was 1.2%, and the yield on the U.S. Aggregate index was 2.1% (source: State Street Global Advisors).

Observant fixed income investors likely noticed that this quarter was more volatile than the previous two quarters as bond markets took a much-needed breather in September. Changes in yields for U.S. treasuries were relatively muted from June to July; however, in August U.S. government bonds rallied sharply as the 10-year plunged by 52 bps to just 1.50%, its lowest level since 2016. Treasuries then gave up some of August's gains in September as the 10 year yield rose to 1.68%, an 18 bps increase from August's levels. As the chart demonstrates, the yield curve shifted around markedly in the third quarter.

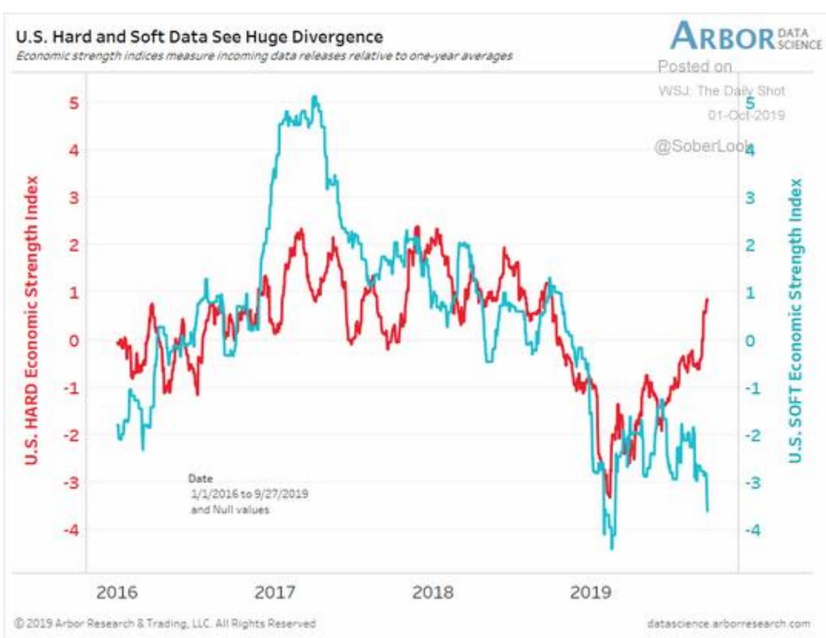


This quarter consequently provided bond investors with a crucial reminder about the risks of duration-driven rallies—sometimes gains can be taken away as quickly as they are given. To be sure, September's back up in rates was not as stark as August's decline in rates, and yet this quarter's interest rate movements were still a much-needed wake up call for many who piled into longer-dated bonds without considering the nature of the rally. As we've said in the past (and don't think it's unwarranted to say again), bonds don't mature at a premium, and 2019's year-to-date gains are multiples of what bonds currently yield when held to maturity, strongly indicating that bond markets have borrowed from future returns.

Linked to the interest rate volatility was the ever-present talk of global economies entering into a recession. Trade tensions, weaker-than-expected economic data, and more dovish central banks (i.e. central banks that are easing in response to moderating economies) led many in the investment community to discuss the possibility and timing of a recession in 2020, or perhaps even sooner. According to the *Wall Street Journal*'s September survey of over 60 economists, the chance of recession in the next 12 months stands at 35% (the survey's average), a far cry from the 18% probability in the previous September's report.

In a recent research note, Morgan Stanley highlighted several key risks markets are facing, including U.S.-China trade tensions, a strong U.S. consumer that could begin to weaken, and the real possibility of negative S&P 500 year-over-year earnings growth. Similarly, S&P Global, in a September 30th report called "Ebbing Growth, Rising Risks", commented how "economic growth expectations are faltering as political and trade tensions stymie investment plans and erode confidence." In a warning to those depending on central banks to turn things around, S&P issued this stark warning, "Renewed stimulus poses longer term risks as it further encourages financial risk-taking… There is little sign that the stimulus has boosted investment intensions or confidence."

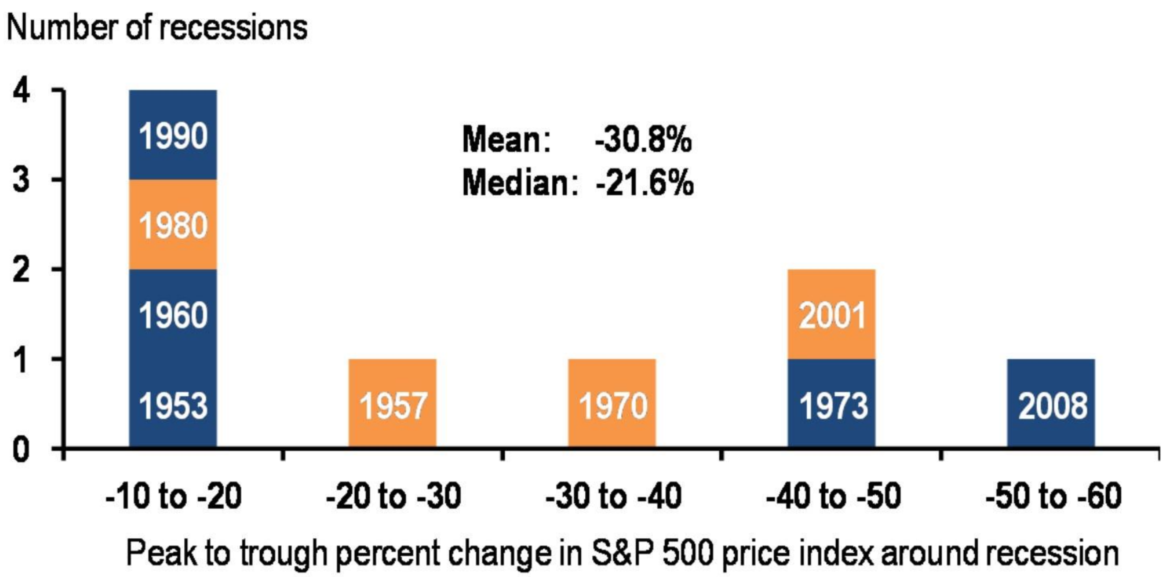
On the one hand, we understand these concerns and are very aware that global economies are slowing—especially in Europe, where manufacturing continues to slump. On the other hand, we believe that while there are definite signs of deterioration, immediate recession fears, at least in the U.S., are likely overblown. In the U.S. especially, there is a real chance we talk ourselves into a recession, even when underlying economic data is pointing towards growth. In fact, the risk-off sentiment we saw in U.S. financial markets in September suggests that August's recession fears were probably overblown, at least for the time being.



One data set that we track closely is the relationship between hard data—GDP, employment, income, spending, and so on—and soft data—consumer sentiment, manufacturing and services PMIs, business surveys, etc. As the chart above demonstrates there has been another divergence in the U.S. between hard and soft data, the magnitude of which we haven't seen since 2017. In this case, the divergence is in the opposite direction—instead of soft data outrunning the hard data, hard data has outrun the soft data. In other words, as manufacturing PMIs and sentiment metrics continue to fall, the hard data continues to point to economic growth, albeit at a declining pace. As time goes on, these two trends tend to converge, typically by meeting in the middle. We believe this convergence could happen soon, particularly if progress is made on the trade front.

Though we don't currently think a recession will occur between now and mid-2020, we definitely see the pressures mounting and we understand investors' curiosity about what happens to equity markets during a recession. According to data analyzed by JPMorgan, most recessions include a fall in the S&P 500 in the magnitude of 10-20%, with a median decline of 21.6%.

Figure 9: Histogram of S&P 500 declines around recessions



Source: NBER, BLS, J.P. Morgan

Since we don't believe a recession is right around the corner, we aren't running for the exits and don't believe investors should either. Nevertheless, we are confident in maintaining our defensive posture and will certainly consider taking additional chips off the table if we see things continue to worsen. In addition, we are continuously looking for tactical opportunities where we can deploy our cash allocation, especially as the credit cycle begins to turn and as global growth looks increasingly shaky.

U.S. Economy

The U.S. economy remains on solid footing, though many data points are highlighting the reality of moderation in growth. In their mid-September meeting, the Fed cut their benchmark rate another 25 basis points, for a cumulative 50 bps of rate cuts thus far in 2019. In the central bank's August summit in Jackson Hole, WY, Fed Chair Jerome Powell said the Fed "will act as appropriate to sustain the expansion," and the September rate cut appears to be the outworking of that sentiment.

For the third quarter 2019, the Atlanta Fed's GDPNow forecaster is projecting annualized growth of 1.8% (as of Oct. 1), while the New York Fed's forecast has third quarter GDP growth at 2.1% (as of Sept. 27), closer to the consensus 2.0% target. These forecasts, while not pointing to an impending recession, do indicate that the U.S. economy is slowing.

As we've emphasized in previous notes, right now the U.S. consumer is chugging along nicely—wage growth is still at cycle highs, the unemployment rate is extremely low, and household debt to GDP metrics are favorable. From a credit perspective, the average national credit score has reached 706, according to FICO, an all-time record. We believe that if these trends stay intact, the U.S. will avoid a recession in the short term on the back of a healthy and spending consumer. However, we are also watching several data points which may indicate that the consumer-driven growth cycle could be long in the tooth and susceptible to erosion.

For one, FICO scores and other consumer financial health metrics are lagging indicators, meaning they tell economists and investors what *has happened*, but not necessarily what is *likely to happen*. Of crucial importance is that, according to CNBC, new standards for public records—which FICO and other consumer reporting agencies use to determine financial health—have stripped all civil judgments and tax liens from credit reports, helping drive up FICO scores. In other words, a 706 FICO score now might not be all that impressive compared to a 706 score just a year ago.

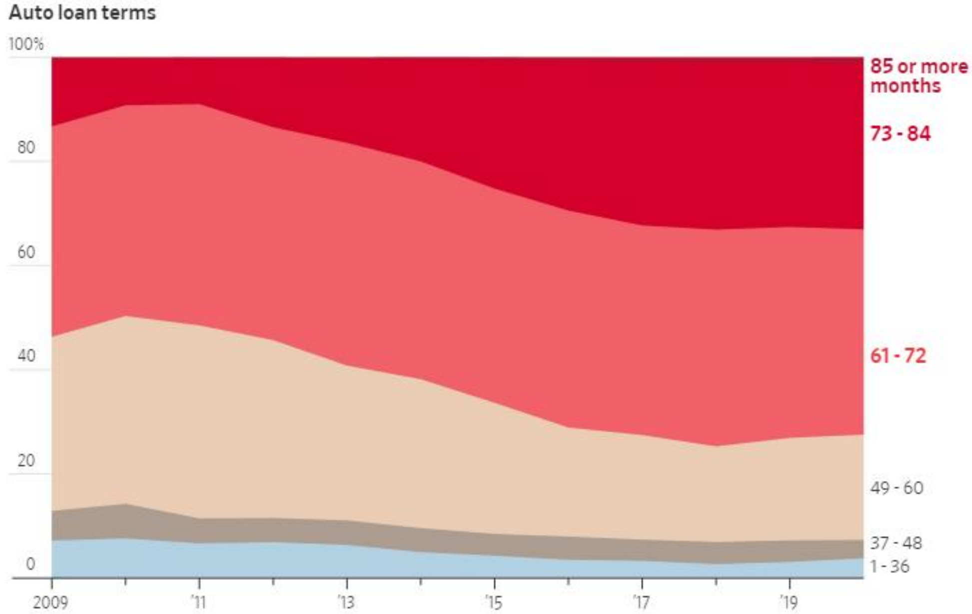
In addition, according to the Federal Reserve's consumer credit tracker, revolving credit increased at an 11.3% annualized rate in July (the most recent month of data currently available). One analyst, Matt Schulz at CompareCards.com, a subsidiary of Lending Tree, noted on the Fed's report, "In terms of revolving debt, we see spikes like this every so often, but they don't jump by double digits all that much." Schulz went on to give a somewhat ominous warning, commenting "Given some other signs that we've seen of Americans' confidence in their finances at the moment, I think this is a sign that things are getting a little bit tougher for folks."

Another data point worth watching closely is debt related to durable goods, such as automobile loans. The *Wall Street Journal* recently published a report entitled "The Seven-Year Auto Loan: America's Middle Class Can't Afford Its Cars" which went on to explain that the "median-income U.S. household with a four-year loan, 20% down and a payment under 10% of gross income—a standard budget—could afford a car worth $18,390." Yet according to Experian, the average auto loan has growth to about $32,119 per car, approximately 75% more than the average consumer can afford.

In order to buy their dream car, consumers are taking on increasingly risky financing options in light of record-low interest rates, such as stretching out the term length to unsustainable (in our view) lengths. According to the Federal Reserve, U.S. consumers hold a record $1.3 trillion in automobile debt, almost double from that held just a decade ago.

Stretched-out Debt

Auto loans are increasingly getting stretched out to keep payments manageable.



Note: For new cars only, as of the end of June 2019
Source: Experian

While automakers such as Ford, General Motors, and Fiat Chrysler (who sells the Jeep brand and the RAM pickup) are rejoicing at higher transaction prices and an ever-spending consumer, one has to wonder how long the party can last, as the average consumer must take on more debt to finance out-of-budget purchases. An upturn in layoffs or stagnation in wage growth could leave many households in undesirable positions, stuck in a 7-year auto loan for a $47,000 truck.

Some of corporate America's CEOs are also issuing warnings about the U.S. consumer. Fred Smith, Chairman and CEO of FedEx, commented in the company's most recent earnings call that "there is a lot of whistling past the graveyard about the U.S. consumer and the United States economy versus what's going on globally." This more pessimistic outlook was somewhat echoed by Kasper Rorsted, CEO of Adidas, who told CNBC that the clothing retailer is concerned about U.S.-China trade tensions and the U.S. consumer. According to Rorsted, it will be quite worrisome if the trade spat means less money in consumers' pockets, because "he or she will spend less money on all products, including ours."

Turning to corporate earnings, we believe the picture is dim for the remainder of the year. Corporate earnings growth for the second quarter was slightly negative, according to data gathered by FactSet, and it is very doubtful things will turn around in the third quarter. Third quarter S&P 500 earnings are expected to decline 3.7% on the back of 2.8% topline growth. As it stands at the time of this writing, fourth quarter earnings are projected to increase 2.9% and revenues are expected to grow 3.6%, according to FactSet. For the full year 2019, earnings and revenues are forecasted to grow just 1.3% and 4.1%, respectively. However, analysts are projecting a rebound in calendar year

2020—the current consensus is earnings growth of 10.6% and revenue growth of 5.6%, a reversal of what is expected to be a lackluster 2019 for corporate America.

In the U.S.' manufacturing sector, alarm bells are beginning to sound off as some PMIs and surveys point to contraction. The September Institute for Supply Management (ISM) PMI report printed at 47.8, another consecutive below-50 reading pointing to a contraction in the sector. Tim Fiore, the chair of the ISM's Manufacturing Business Survey Committee, commented how the report reflects "a continuing decrease in business confidence." Fiore also noted how "global trade remains the most significant issue, as demonstrated by the contraction in new export orders that began in July 2019. Overall, sentiment this month remains cautious regarding near-term growth." Investors received little consolation from IHS Markit's September manufacturing PMI, which came in at 51.1, up from 50.3 in August but still indicating "the worst performance across the sector since the same period in 2009." Those hoping that the Services PMI would come to the rescue were disappointed—the U.S. Service PMI came in at 50.9 in September, slightly above August's 50.7 reading but barely in growth territory. As noted by IHS' Chief Business Economist, "A disappointing service sector PMI follows news of lacklustre manufacturing and means the past two months have seen one of the weakest back to-back expansions of business activity since 2009, sending a signal of slower GDP growth in the third quarter."

Overall, we continue to have a moderating and cautious outlook on the U.S. economy and U.S. consumer. On the one hand, the U.S. consumer is keeping the economy afloat and by many accounts is still stable. With the consumer strong and spending, we don't believe a recession is around the corner in the U.S. On the other hand, weakening manufacturing and ongoing trade tensions are beginning to seriously affect U.S. consumers, and chinks are starting to emerge in the armor. The U.S. consumer is keeping the U.S. economy—and to a certain extent, global economies—going for now, but there are more catalysts to the downside than the upside. We are keeping a close eye on these data points and are watching for signs of erosion—the U.S. consumer is strong, but the best is likely behind us.

International

If the U.S. economy is beginning to show signs of wear, overseas economies are beginning to fully break down. Europe continues to struggle, as PMI readings were disappointing across the board. The IHS Markit final Eurozone Manufacturing PMI printed a disappointing 45.7, down from 47.0 in August and its lowest reading since October 2012. IHS Markit noted that "operating conditions in the euro area's manufacturing economy deteriorated in September to the greatest degree in just under seven years."

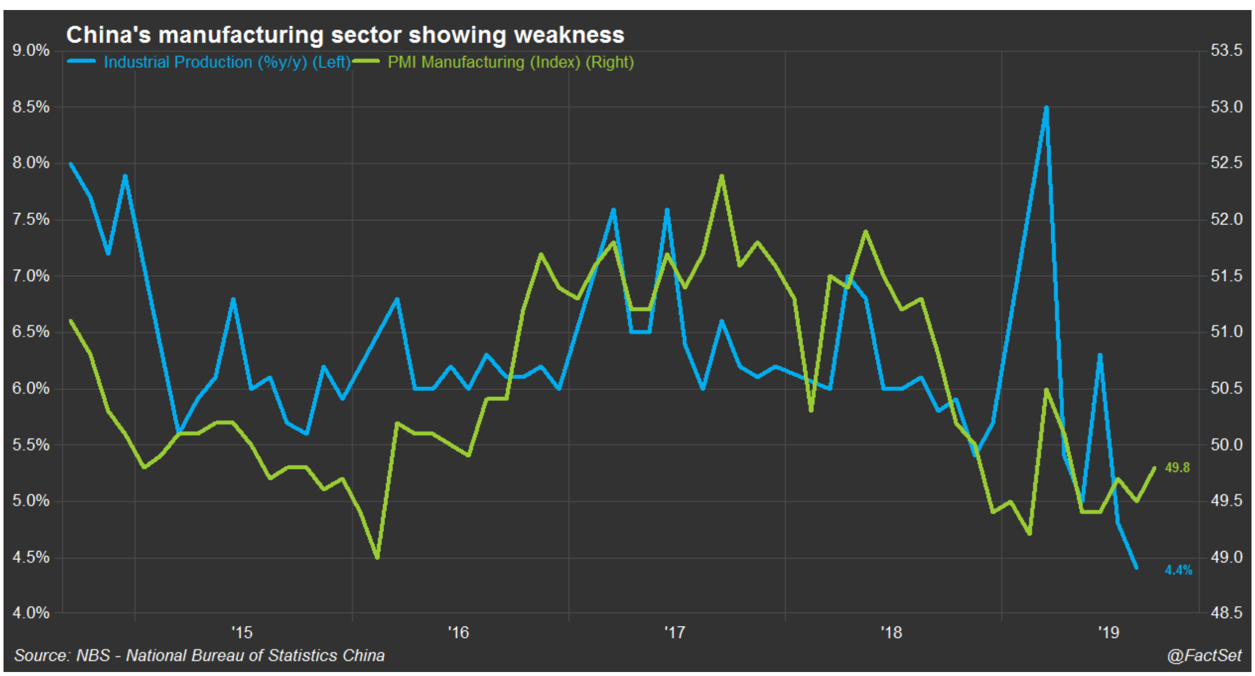
The silver lining, if there is any, is that France managed to stay above the crucial 50-no change mark, the only one of Europe's major economies to do so. Germany's print was by far the weakest and most significant, coming in at 41.7 in September, down from 43.5 in August and its lowest reading since June 2009. According to IHS Markit, "The downward trend in new orders – which fell the most in more than ten years – is a particular worry, and continues drive cutbacks in factory output, employment and prices." In response to a weak wave of prints and data points, Germany's five leading research institutes decimated their growth forecasts, cutting expansion projections to just 1.1% in 2020, down from 1.8% in April. Germany likely entered into a technical recession in the third quarter, after posting -0.1% growth in the second quarter earlier this year.

There is also increasing evidence that the slowdown in Europe's manufacturing sector is beginning to reach the services sector, which has held up much better this year. As a result, in mid-September, the European Central Bank lowered its benchmark rate by 10 basis points to an astounding negative 0.50% and committed to restarting its bond purchases to the tune of 20 billion EUR a month in November.

The IHS Markit Eurozone PMI Composite Output–which measures both manufacturing and services—fell to 50.1 in September, barely above the 50 no-change mark. The lowest reading since June 2013 signaled "a broad stagnation of the private sector economy at the end of the third quarter of 2019." IHS Markit also commented how "the PMI surveys painting the darkest picture since the current period of expansion began in mid-2013" and noted that the "downturn also shows further signs of spreading from manufacturing to services." The UK is feeling the pain along with its former EU partners, as Brexit uncertainties continue to take their toll. Its services PMI joined the manufacturing PMI, falling below 50 (49.5 in September vs. 50.6 in August), and the composite PMI fell to 49.3 from 50.2 in August, a new three-year low.

Across the world, China is also struggling amid trade tensions and an increasingly intense uprising in Hong Kong. While China was in the midst of celebrating 70 years of communist rule, Nomura cut its GDP growth forecasts to sub-6% for the third and fourth quarters (5.9% and 5.8%, respectively), citing escalating trade war tensions, weakening real estate markets, and an easing in construction.

A report published October 1st by FactSet also highlighted the struggles China is currently undergoing. It noted how "exports to the United States are down 9.4% year-to-date through August", while PMI numbers and industrial production data continue to disappoint:



China's rival Japan also doesn't appear to be faring much better, and its manufacturing PMI slipped further into contraction territory with a print of 48.9 in September. In addition, the Tankan Survey fell to a six-year low of +5 from the previous +7, while industrial production in August dropped 1.2% vs. expectations of a 0.5% fall. Commenting on the situation in Japan, IHS Markit says "Crucially, the stronger deterioration comes ahead of the consumption tax hike, and suggests that manufacturing and exports are both likely to have been drags on third quarter GDP… Japan continues to suffer from the trade-led global growth slowdown." Comparatively speaking, the moderation in the U.S. really doesn't seem all that bad.

On the whole, volatile markets took their toll on many portfolios in the third quarter, while uncertainty in a variety of sectors left investors unsure of how to deploy capital. A still-strong U.S. consumer is showing some signs of fatigue, while manufacturing across the globe continues to show moderation and, in many cases, outright contraction. In these news-driven and volatile markets, our Investment Management Committee is carefully watching these and myriads of other data points and economic trends, in search of opportunities to strategically and tactically deploy capital.

Summary of Multi-Asset Strategy Attribution

	Q3 2019
Equity	**Positive (+)**
Large Cap	**Positive (+)**
Small Cap	**Negative (-)**
Non-US Developed	**Positive (+)**
Fixed Income	**Positive (+)**
Investment Grade	**Negative (-)**
Mortgage	**Positive (+)**
U.S. High Yield	**Positive (+)**
Alternative	**Positive (+)**
DALT	**Positive (+)**
Cash (1)	**Neutral**

STAR™ Spectrum Model Changes – 3Q19

The STAR Spectrum portfolios were de-risked during First Quarter 2019, which proved helpful during August's volatility, and the Investment Committee remained comfortable with the current risk exposure for the STAR Spectrum models during the Third Quarter 2019. The VEGA Enhanced model initiated a Volatility-Based Reinvestment in August and reinvested 2% of the model's de-risked cash back into the underlying portfolio.

STAR™ Spectrum – 2Q19 Tactical Shifts

The market has experienced two noticeable draw backs in 2019 - in May and again in August. The Investment Committee believes volatility may persist in the near term and is maintaining the portfolios' reduced risk-exposures at this time. While volatility is believed to be a prevailing factor during the upcoming months, it is also believed that the market will continue to rise. With this in mind, the Investment Committee continues to look for opportunities to participate in market appreciation and avoid unnecessary risks where possible. Thank you for your continued support.

Sincerely,

Partnervest
STAR™ Spectrum Investment Team

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