MIDWEST CAPITAL
ADVISORS™

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To Our Clients and Friends:

We are pleased to bring you our report for the third quarter of 2019 from our larger, brand new offices at 630 Kenmoor Avenue SE in Grand Rapids.

The third quarter saw a flurry of developments relating to trade, monetary policy and politics. Both the U.S. and China added tariffs on one another's goods, before later easing some of these tensions[1]. The Federal Reserve cut rates for a second time this year, and the European Central Bank cut rates for the first time in three years, solidifying a global dovish monetary policy tilt. Attacks on the heart of Saudi Arabia's oil infrastructure sent crude oil prices reeling and ramped up the specter of further conflict in the Middle East. The yield curve inverted[2] for the first time in over a decade, signaling to some investors that recession is imminent[3]. And House Democrats opened an impeachment inquiry of President Donald Trump.

Not surprisingly, these events have stirred up equity market volatility. When the dust settled, however, the S&P 500 and Dow 30 ended the quarter up better than 1% and within 2% of record highs[4]. A quick look at the stocks that led the Dow higher during the quarter reveals investors betting on one key theme that indicates a belief this expansion will continue: the U.S. consumer[5]. It is well known that the consumer is a key driver of economic growth.

But let's look ahead. In stark contrast to the 3rd quarter, stocks started off the 4th quarter with a retreat, essentially wiping out all the gains of the 3rd quarter, as bond yields fell on news that the U.S. and worldwide economies continued to soften. 2018 notwithstanding[6], the 4th quarter is typically positive for stocks. In fact, over the last 30 years, returns of the S&P 500 Index in the 4th quarter have averaged 4.7%. Averages can be deceiving, however and there is no assurance that 2019 will be positive, much less "average", especially with so many key variables in play. Let's look at a few of the key market-influencing

[1] For example, on September 11, China said it is encouraging companies to buy U.S. farm products, including soybeans and pork, and will exclude those commodities from *additional* tariffs, in the latest move to ease tensions before the two sides resume trade talks later this month. Source: Bloomberg.

[2] On Wednesday, August 14, the yield on the 10-year U.S. Treasury bond dipped below (barely, by 1 basis point or 0.01%) the yield on the 2-year U.S. Treasury.

[3] Yield curve inversion has a strong track record of predicting a recession; each of the last seven recessions (dating back to 1969) was preceded by the 10-year falling below the 2-year. Source: Yahoo Finance. Interestingly, recessions historically have not materialized until many months — somewhere between 22 months on average — after an inversion. Source: Yahoo Finance.

[4] The S&P 500 Index closed up 1.70% for the quarter and is now up 20.55% for the year. The MSCI World ex USA (gross dividends) index was down 0.85% for the quarter and is now up 14.13% for the year, and the Bloomberg Barclays U.S. Aggregate Bond Index gained 2.27% for the quarter and is now up 8.52% for the year. Source: Dimensional Fund Advisors.

[5] The four best performing stocks in the Dow during the third quarter were Procter & Gamble (PG), Apple (AAPL), Nike (NKE) and Home Depot (HD). Walmart (WMT) was the index's sixth-best performing stock, rising 7.4%. Taken together, this group is a pretty good indication that investors were betting on the U.S. consumer in the third quarter.

[6] In 2018, the S&P 500 Index lost 13.5% in the 4th quarter, totally erasing a 9.1% YTD gain through September.

areas that are active in the news media and political circles (there's a lot to talk about, so bear with us!).

Economic Activity. ISM manufacturing data came in at the lowest rate since June 2009[7], again fanning fears of a recession. The ISM said that global trade remains the most significant issue, citing the contraction in new export orders that began in July 2019, and adding "Overall, sentiment this month remains cautious regarding near-term growth[8]." That manufacturing has been weak is not news, although the magnitude of the drop might have been.

The ISM Non-Manufacturing Index, released yesterday, showed that the services sector is continuing to grow, but at a slower rate. The number, 52.6, is far lower than the 55.3 consensus of economists surveyed by Dow Jones and is the weakest reading in three years.[9]

The significance of the impact of these two numbers on the overall health of the economy going forward is uncertain. To us the key is whether the ISM data bleeds over into companies' capital spending and hiring decisions and whether the all-important consumer continues to drive the economy as it has so far this year.

Employment. Investors were spooked by Wednesday's ADP/Moody's monthly jobs report, which showed private payrolls rose by 135,000 in September. This would be the slowest gain since June and below expectations for a gain of 140,000, according to consensus economists polled by Bloomberg[10]. August's headline private payrolls figure was downwardly revised to show a gain of 157,000, from a gain of 195,000 previously reported[11].

The Department of Labor somewhat rode to the rescue with "official" U.S. September payroll numbers earlier today. Its report showed an increase in nonfarm payroll employment of 136,000 and that the unemployment rate declined to 3.5%[12]. The pace of hiring has slowed considerably since 2018, when the economy added an average of 223,000 jobs per month.

While the September jobs report is slightly better than the disappointing August jobs report[13], it does not conclusively indicate that employers see enough potential in face of economic uncertainty and slowdown to justify hiring workers in significantly higher numbers. This may mean that the continuing trade war with China (that is already beginning to delay capital expenditure spending plans by businesses) is also filtering its way into hiring plans[14].

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[7] The September PMI was 47.8 percent, a decrease of 1.3 percentage points from the August reading of 49.1 percent. Any reading over 50 is considered expansionary. Source: Institute for Supply Management.

[8] Source: September 2019 Manufacturing ISM® *Report On Business®*

[9] Source: CNBC

[10] Source: September ADP National Employment Report published October 2, 2019.

[11] Id.

[12] Source: Bureau of Labor Statistics. The last time the unemployment rate was this low was in December 1969! The September 30, 2019 *Wall Street Journal* reported that economists were expecting nonfarm payrolls to be up by 140,000, with unemployment remaining steady at 3.7%, so the numbers are essentially in line with expectations. This has calmed the markets considerably.

[13] In August, the U.S. economy created 130,000 jobs versus estimates for 160,000. July's employment figures were revised down by 5,000, underscoring how the effects of the trade war are gaining momentum.

[14] According to Yahoo Finance, one prominent finance chief at a major tech firm says more discussions are cropping up among key clients about delaying contracts amid continuing trade uncertainty. Further, the source says more companies it partners with are starting to look for ways to cut costs to counteract cautiousness among their own book of business. That could mean hiring plans among big companies could increasingly stall into year-end.

Employers may also be signaling that the Federal Reserve's interest rate cuts are not enough to offset the growing effects of the trade war with China.

A somewhat disappointing aspect of the report was wage growth: Average hourly wages didn't grow between August and September. Year-over-year (YoY) wage growth ticked up just 2.9%, which was lower than expected, and the weakest growth since July 2018. The key question from this is whether the all-important consumer[15] can continue to spend at a rate that will keep that sector of the economy growing without higher wage growth.

Interest Rates. The combination of weak ISM numbers in both the manufacturing and service sectors, along with softer employment numbers makes another interest rate cut in 2019 (perhaps as early as the FOMC's next meeting October 29-30) very likely[16]. It is important to understand what the Fed can and cannot do. It can lower (or increase when it needs to) short-term rates, which will stimulate borrowing for business investment by making it less expensive. This might cause at least a temporary normalization (i.e., upward sloping) of the yield curve. What it cannot do, however, is affect longer-term interest rates, which are really a function of bond investors' confidence in the economy[17]. If fixed income investors don't keep the long end of the curve bid up higher than even a reduced short end, yield curve flattening, or even inversion, could happen again, thereby raising recession fears, if not probabilities. The current Fed Funds Rate is 2.00% (down from 2.25% a year ago), which still gives the Fed a decent amount of ammunition. This is in sharp contrast to other central banks whose comparable rates are zero or even negative.

Recession. Let's recall what a recession is. The textbook definition of a recession is two consecutive quarters of negative gross domestic product (GDP) growth. What is now being called the "Great Recession" officially started in December 2007 and ended in June 2009, a period of 16 months. Stripping out the Great Recession[18], recessions since the end of World War II lasted six months to 16 months, averaging 10.4 months.

Will it happen? This is a tough one, especially because current GDP estimates of 2.7% YoY (despite Q3's estimate of 1%) are still far from being negative and so much could change if the trade war subsides and the reduction (or elimination) of a major component of uncertainty prompts businesses to start hiring more, raise wages and make capital investments. Many of the credible voices we listen to believe a slowdown is more likely than a textbook recession[19].

If it happens, when will it happen? The yield curve inversion is indicative of a coming recession but, importantly, it does not say when it will arrive. The time from inversion to onset is long and variable and ranges from 10 ½ months to 36 months[20], with the average being around 20 months.[21]

Clearly recessions are not good for equities because corporate earnings drop and, in order to maintain reasonable price-to-earnings ratios, stock prices also drop. Interestingly, however, in the

[15] We are talking primarily about the bottom 90% (those earning less than $130,000 per year) of consumers. This group spends 101% (yes, 101% due to borrowing) of their after-tax income, so when wages do not increase neither can spending. Source: JP Morgan 4Q 2019 *Guide to the Markets, page 19.* This can have a big impact one way or the other on GDP numbers. The top 10% spend only 69% of their after-tax income. *Id.*

[16] It is pretty clear the stock market has priced this in.

[17] Fed stimulus is also not going to end the trade war.

[18] For what it's worth, Moody's chief economist Mark Zandi called this a once in a 50- or 100-year event.

[19] See for example comments made by David Kelly, CFA, chief global strategist for J.P. Morgan, during his October 2 Market Insights commentary.

[20] This is per Kathy Bostjancic, chief U.S. financial economist at Oxford Economics.

[21] This from Forbes contributor Stephen McBride on August 28, 2019.

periods leading up to the actual recession, the stock market has done pretty well.[22]

Trade. Ultimately, resolution of the trade dispute (vs. fiscal stimulus, which is really treating only the symptoms, not the ailment) is the way to stimulate domestic and international trade and minimize the effects of, if not head off, a recession. High-level talks between the U.S. and China are set to take place in Washington, D.C., mid-month, and it is the outcome of these (vs. rumors and sound bites), good or bad, that will more clearly indicate whether the trade differences have a path toward resolution anytime soon. President Trump has reportedly said that he did not believe there would be (nor did he "need") a comprehensive resolution of the trade standoff prior to the 2020 election, and the Chinese seem to be willing to wait it out till then as well. We believe this is likely more posturing than fact; we really need to see what happens when the two sides meet in October (assuming that meeting happens). Anything short of both (a) positive commentary from both sides and (b) tangible steps to an agreement shortly thereafter is likely to cause the markets to retreat.

Earnings. U.S. companies will report second-quarter later this month, which will provide investors with a clearer picture of the health of the economy[23]. Earnings growth has been ebbing since peaking in the third quarter of 2018[24]. This will give investors and economists one more data point indicating how companies are handling the worldwide economic slowdown. Expectations continue to be modest (and to a certain extent are already priced into the market). Any indications that companies are finding ways to make money during the continued worldwide economic slowdown (and/or any positive earnings surprises) are likely to be well received by the equity markets, especially if trade matters appear to finally have a path toward resolution.

Historically, October is a volatile month and, given all the factors that are in play, 2019 is likely to be no exception. The key is to not view equity markets over short periods of time. That being said, if you are at or near retirement or some other event for which you have been investing, make sure your exposure to the equity markets is at an appropriate level.

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[22] For example, when the yield curve inverted in December 2005, the S&P 500 Index peaked in October 2007, rising approximately 25% during that time. And, looking at the last three cycles, following the initial yield curve inversion the S&P 500 rallied a median 34%. Source: Canaccord Genuity's chief market strategist, Tony Dwyer, August 29, 2019.

[23] For Q3 2019, 82 S&P 500 companies have issued negative EPS guidance, while only 31 S&P 500 companies have issued positive EPS guidance. The estimated YoY earnings decline for Q3 2019 is -3.7%, which is below the 5-year average earnings growth rate of 7.3%. If -3.7% is the actual decline for the quarter, it will mark the first time the index has reported three straight quarters of year-over-year declines in earnings since Q4 2015 through Q2 2016. It will also mark the largest year-over-year decline in earnings reported by the index since Q1 2016 (-6.9%). Source: FactSet 9/27/2019 "Earnings Insight".

[24] According to Ned Davis Research, profits reached a high of $2.321 trillion in the third quarter of 2018 and fell to $2.252 trillion in the first quarter of 2019, a drop of approximately 3%.