TODD
Asset Management

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The Art of Re-Election

Todd Asset Management Q3 2019 US Market Commentary

	3Q 2019	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	1.7%	20.6%	4.3%	13.4%	10.8%	13.3%	13.2%
Russell 1000 Value	1.4%	17.8%	4.0%	9.4%	7.8%	11.3%	11.5%

** Annualized Total Returns.*

Markets have been held hostage to developments on trade and tariffs that have leaned on confidence since December of last year, and have shown dramatic movements based on the expectations of a Deal or no Deal in the trade war. We have believed for some time that the trade war would start to see some resolution as the President combines his "Art of the Deal" strategy with Re-Election hopes. In early October, we got that as the US and Chinese negotiators held productive meetings that the President called "Phase One" of a deal. We believe this marks a period of de-escalation of the trade war that could allow for better economic performance. Truthfully, even though we do not anticipate a US recession, tensions need to ratchet down to change the current perception that the economy is weak. While the S&P has effectively been stuck in a trading range since January of 2018, we believe the prospects for better clarity on trade, Brexit and the potential for no recession should pave the way for more constructive action into early next year.

Recession worries have dominated conversation for the past few months. These fears have been tied in investors' minds to progress on the trade front, for better or worse. After the market bottomed in May of this year, it rallied through July in anticipation of a rate cut from the Fed. This was important, as the Fed had not cut rates since 2008 and the Yield Curve in the US had inverted by some measures. The day after that cut, President Trump announced plans to impose tariffs on all goods imported from China, leading to a sharp pullback in markets. As the month progressed, the Administration softened this position, but still raised tariffs on September 1 for over $110B in imported products.

We believe recession fears are overstated. While manufacturing is clearly under pressure, it is cyclically due for a recovery (see charts following), and lower rates/global stimulus could prompt that over the next few quarters. Additionally, the market has already lowered long term interest rates much more than the amount the Fed is expected to ease. Lower rates are supportive of housing and financed purchases. Finally, the employment picture remains very firm, and hourly wages are rising. We believe these have more impact on the US economy than additional tariffs that amount to less than 0.5% of US GDP.

Despite those factors, growth worries continued to mount during the quarter as leading indicators and manufacturing indexes weakened. This led the Fed to cut rates a second time, during September, despite the fact that US growth still appears solid. They cited implications of global developments for the economic outlook and muted inflationary pressures as their rationale for the cut. The vote was divided though, and left investors wondering if more cuts are likely this year. The consensus is that one more cut can be expected from the Fed.

Bond yields plummeted in the quarter, with the 10 year government bond yield declining from 2.1% to 1.5%, more than cutting that rate in half from last year's November peak of 3.2%. Concerns about a global slowdown have forced most central banks into an easing mode, and the European Central Bank took interest rates more negative during the quarter. Lowered international rates coupled with a flight to safety mentality arising from the tariffs, Brexit and slowdown concerns are what brought US rates down so dramatically.

The markets recent action still feels like an echo of 2016 and 2012. As you may recall, in each of those prior periods, global short term interest rates rose, and the manufacturing side of the economy slowed. Economic concerns grew, and bonds rallied to the point that the US 10 year yielded less than 1.5% each of those times. These episodes were followed by more central bank easing, and a resumption of growth. The ten year yields recovered to over 3% in each of those instances, and confidence in economic growth recovered. We see parallels in the current situation, though we probably need to see some of the outstanding concerns addressed before investors feel more confident.

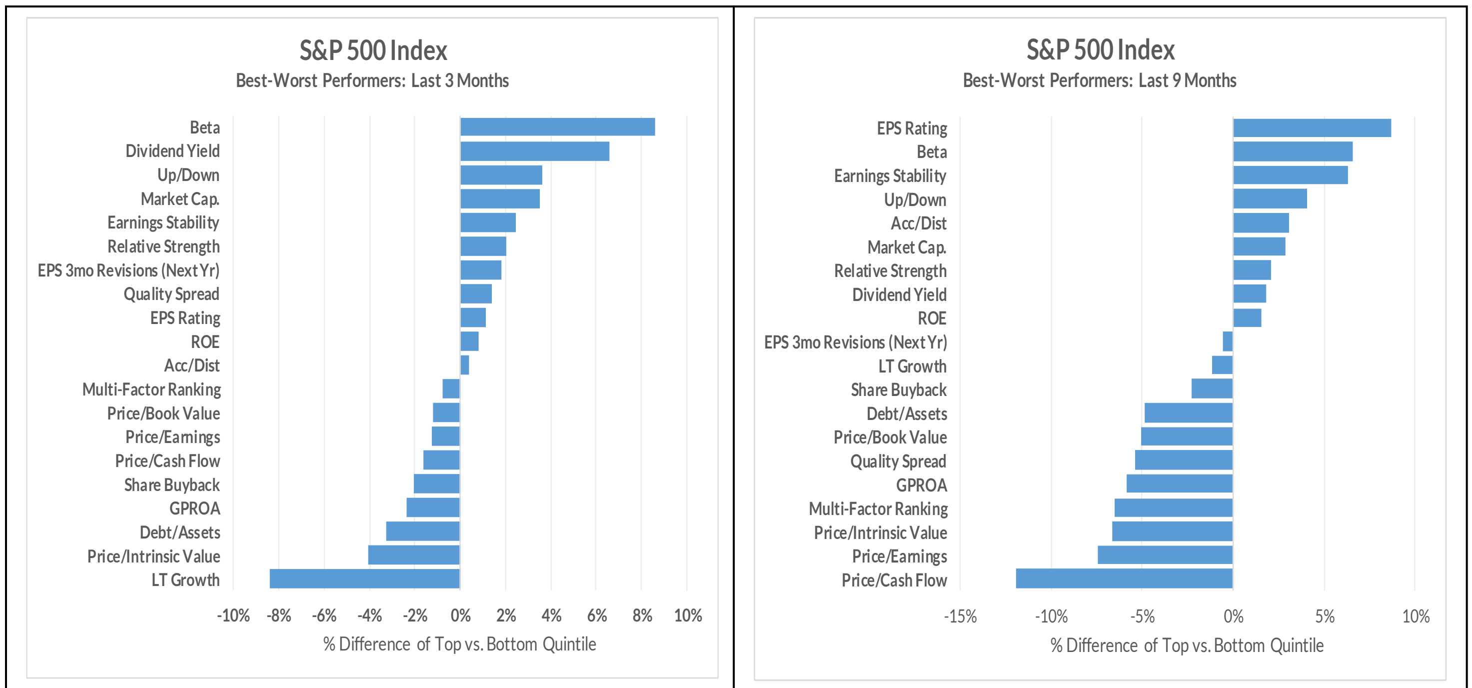
As we look forward, we anticipate that several items are probably going to occur:

- We expect one more rate cut from the Federal Reserve before year end probably hoping to end the yield curve inversion. Following that, we think they will stand pat through the election, as central banks tend to be reluctant to change monetary policy during election years.
- We believe economic growth has moderated a bit, but is not likely to slip into recession. Employment remains strong, incomes are up, and services remain firm despite the worries about manufacturing.
- Manufacturing goes through regular three year cycles where activity waxes and wanes. Our sense is that we are near the bottom of this episode.
- Brexit is a wildcard, and we need to monitor those developments to see if a UK/European recession is likely.
- Trade talks between the US and China are continuing. While the "deal" that was recently announced was modest, it does represent a de-escalation of hostilities. If

this truly represents a moderation of tensions, then we would look for better economic visibility, and better sentiment towards stocks. We anticipate more progress on this front.

Equity markets have been resilient, though they have not produced any dramatic new highs over the past 18 months, and appear mired in a range. To break out of that range, we need some resolution in one direction or another. If manufacturing recovers, as we expect, then at some point over the next year dramatic new highs are likely. If the Mexican standoff we are in with China ends in tears, coupled with a messy Brexit or some geopolitical event, then the market probably revisits the lower end of the range we've traced out since last year. Future developments will tell the tale. Until then, we think chances favor a continued expansion.

Factor Analysis

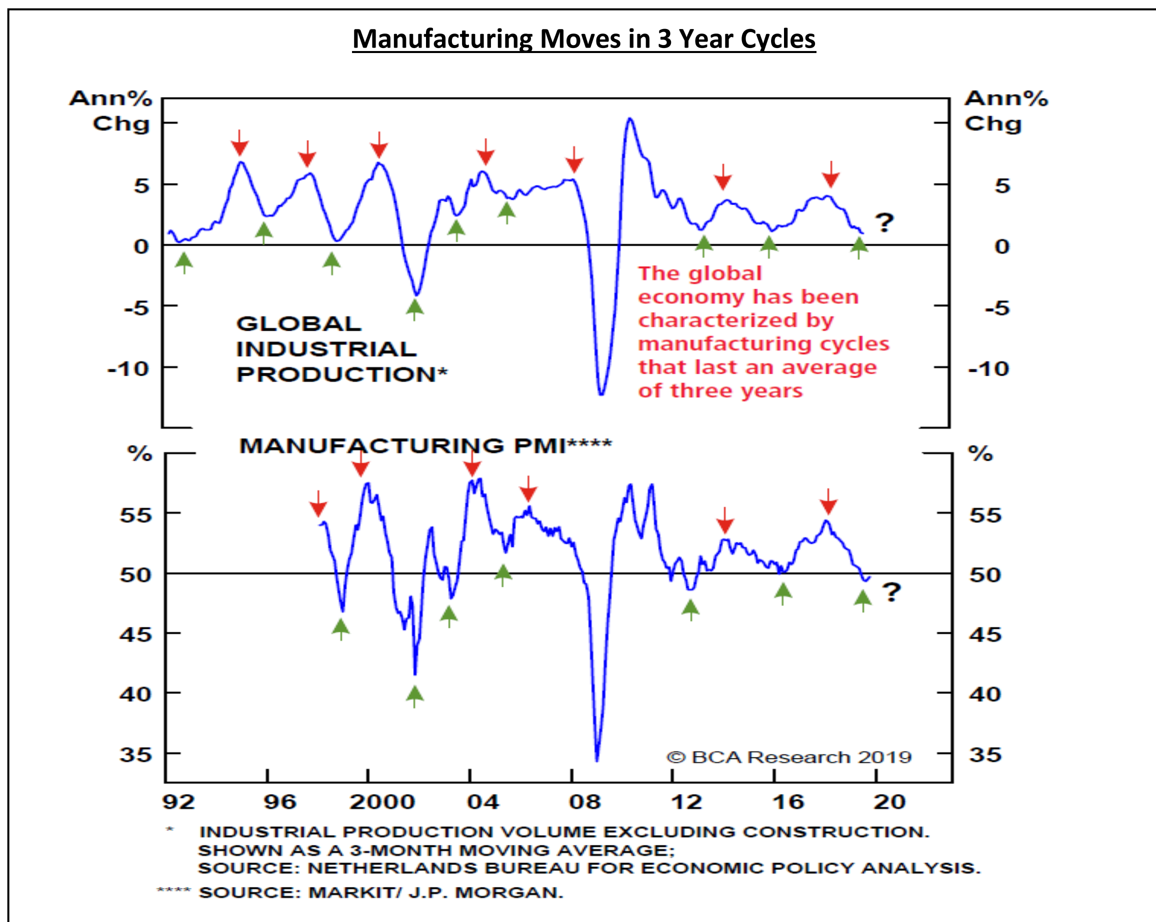


Source: Bloomberg, William O'Neil + Co and Todd Asset Management

The charts above present the customary factor analysis we prepare each quarter to see which characteristics the market was rewarding over various time frames. As a reminder, we use the S&P 500 as our universe, and compare the spread of returns of the top quintiles for each factor versus the bottom quintiles. During the most recent quarter, visibility seemed to be the characteristic investors were after. Given the uncertainties swirling during the quarter, that makes sense. Rates declining forced investors into the dividend trade again, despite the fact that most dividend yielders are expensive. We also saw investors rewarding stocks with good technical credentials, earnings stability and positive

EPS revisions. At the other end of the spectrum, all value indicators as well as measures of quality like low debt to assets, GPROA (gross profit return on assets) and share repurchase were not in vogue. Also, the most aggressive of the growth companies took a beating, probably on the back of some failed IPOs in the technology space. The year to date attribution looks very similar to the quarter to date version.

Interesting Charts We saw this quarter



Manufacturing Moves in 3 Year Cycles

Global Industrial production has slowed and Manufacturing PMIs have weakened worldwide, causing recessionary concern lately.

The chart above, from BCA Research, highlights that these are cyclical concerns and the cycles last 3 years.

If they are correct, this downturn has almost run its course and a recovery driven by lower rates, resurging auto sales and global stimulus should prompt better action in these statistics. US Corporations should be incentivized to take advantage of temporary Investment Tax Credits. This would suggest Bond Yields have nearly bottomed as well.

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Low Government Bond Yields Force Investors into Equities

"T I N A"- There is No Alternative

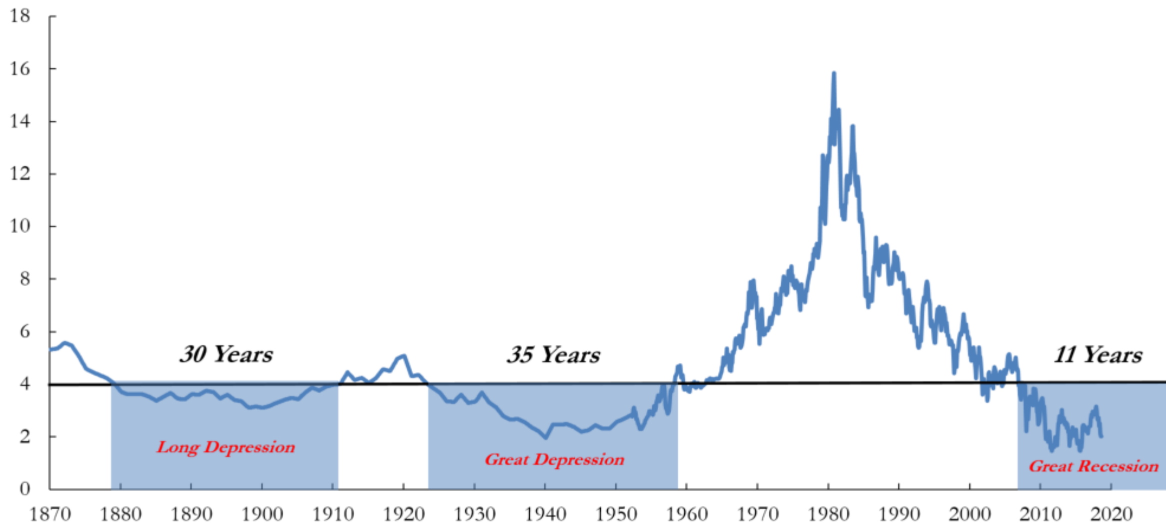
Country	10 Year Government Bond Yield	Dividend Yield
Germany	-0.59%	2.29%
United Kingdom	0.48%	3.88%
Japan	-0.20%	1.80%
France	-0.32%	2.42%
Italy	1.42%	3.27%
Spain	0.16%	2.76%
Netherlands	-0.48%	2.01%
Switzerland	-0.99%	1.76%
Australia	0.95%	3.84%
United States	1.71%	1.88%

Sources: Bloomberg, iShares

Data as of Aug. 7, 2019

Government bond yields are negative in much of the world, and low in an absolute sense almost everywhere. Stocks on the other hand, offer yield and growth of yield compared to bonds.

Meet TINA- "There is no alternative". Investors with actuarial return assumptions, liquidity needs, transparency requirements and needing understandable strategies are likely to view stocks as the best alternative to meet investment goals.



Source: Robert Shiller, Sidney Homer, Bloomberg and Todd Asset Management as of 7/31/2019
Data before 1953 is government bond yields from Sidney Homer *"A History of Interest Rates"*. Data from 1953 through 1961 is 10-year Treasury yields from Robert Shiller *"Irrational Exuberance"*. Data after 1961 is 10-year Treasury yields from Bloomberg.

- The chart above highlights US long term interest rates that have been available to investors since 1870.
- In the past, when rates have dropped below 4%, they have tended to stay there for 30 to 35 years. We have noted the event that started these periods in red.
- If this historical precedent holds, long term rates may remain low for a generation. This could make investors reassess where they will get the expected returns on investments.

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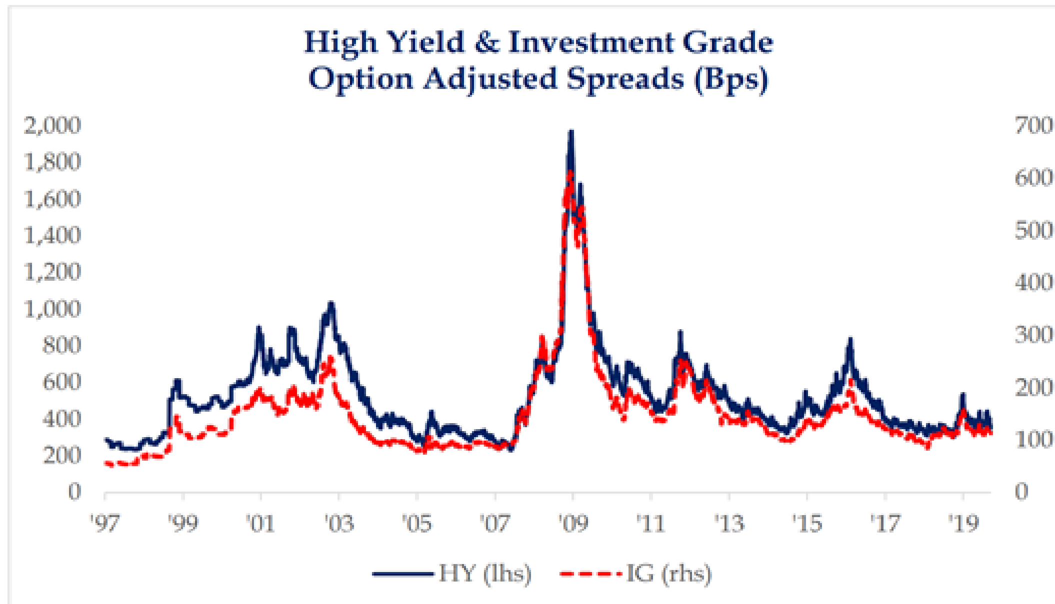
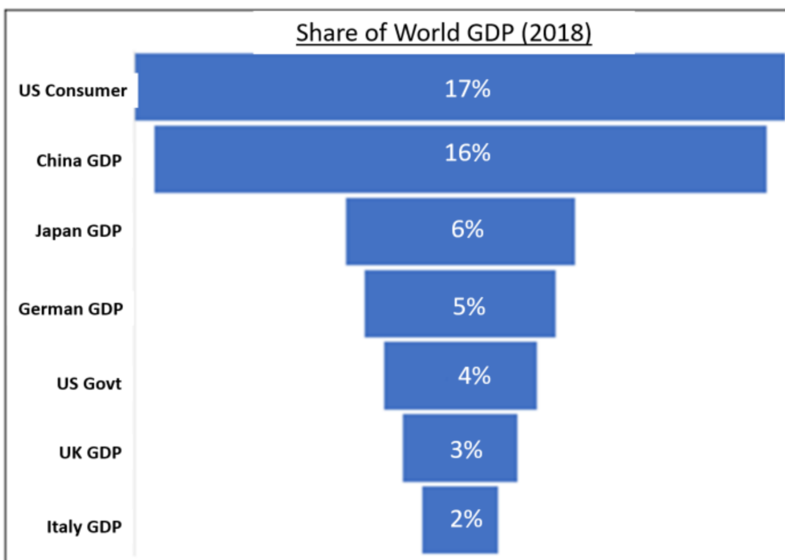
INVESTMENT GRADE & HIGH YIELD CORPORATE SPREADS HAVE WIDENED BUT REMAIN IN CHECK



One measure of market stress is the spread of Investment Grade and High Yield bonds compared to the 10 year government bond. These normally spike in periods where investors are worried about economic weakness and investors seek safety. As you can see from the chart above (compliments of Strategas) those spreads are relatively low. Corporate Bonds are not indicating a recession yet.



The chart to the left shows the relative sizes of different segments of the world economy. The reason many pundits spend so much time examining the health of the US consumer and the Chinese Economy is that together, they represent approximately one third of global GDP.

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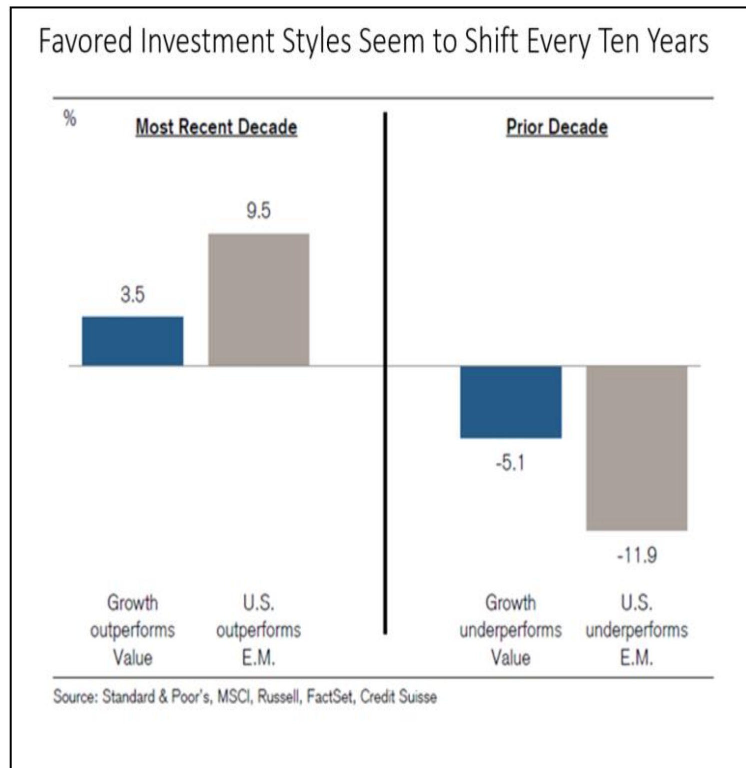
Some pundits believe Value and International Investing will never work again. We would caution against this conclusion. Ten years ago, investors said Growth and US investing would never work again, just in time for that cycle to turn for a decade. Twenty years ago, a similar situation unfolded for Value and International styles.

Investing is cyclical, and cycles turn on a regular basis. While Value and International are out of vogue now, our sense is that lower rates, some clarification on the world growth outlook and a weaker dollar could cause both of these cycles to turn again.



Summary

Politics have been playing a larger role in the economic outlook in the past couple of years than we can ever remember them playing in the past. The balance of an economic shot in the arm from tax cuts and regulatory reform have been offset by the economic uncertainty injected by the trade war. As we look at the real economy, we see little evidence of inflation and few signs that an economic excess has built up. Capital Spending decisions are being deferred until better clarity on geopolitical uncertainty is resolved. We believe the first small step in resolving those uncertainties has been taken with the trade discussions. There is still the unknown of a potential Impeachment looming, but it appears most of "Main Street" is doing OK. The swing states are going to be important, and economic trends there have not been as robust since manufacturing and agriculture have been somewhat weaker. A de-escalation of the trade war would probably help those sectors, and are within the administration's ability to change. Any de-escalation in tensions would help market sentiment and probably be warmly greeted by stock markets worldwide.

As always, if you need any additional information, please feel free to contact any of us.

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10/16/19
S&P 500 – 2,999
Russell 1000 Value – 1,256

Disclosure

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S&P 500 Index is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.

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