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Third Quarter Investment Commentary
October 2019

"Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497." – Warren Buffett

The Quarter

- United Auto Workers strike at General Motors.
- House Speaker Nancy Pelosi announced an impeachment inquiry into President Trump.
- Federal Reserve reduces short term rates for the second time this year.
- US-China trade war continues to disrupt financial markets.
- Hong Kong engulfed by demonstrations, with some clashes turning violent.
- 10 year Treasury rate drops below 1.5% in August, finishing the quarter at 1.67%.
- S&P 500 finished with a 1.2% price gain during the quarter.

Economic and Market Review and Update

Economic growth continued to slow in the third quarter. U.S. GDP slowed from 3.1% in the first quarter to 2.0% in the second and is estimated to be below 2.0% in the third. Growth globally has slowed from ongoing trade tensions and heightened political uncertainty weighing on manufacturing activity, global trade and business investment. In Federal Reserve Chair Powell's recent post-FOMC press conference, he noted that "our business contacts around the country have been telling us that uncertainty about trade policy has discouraged them from investing in their businesses."

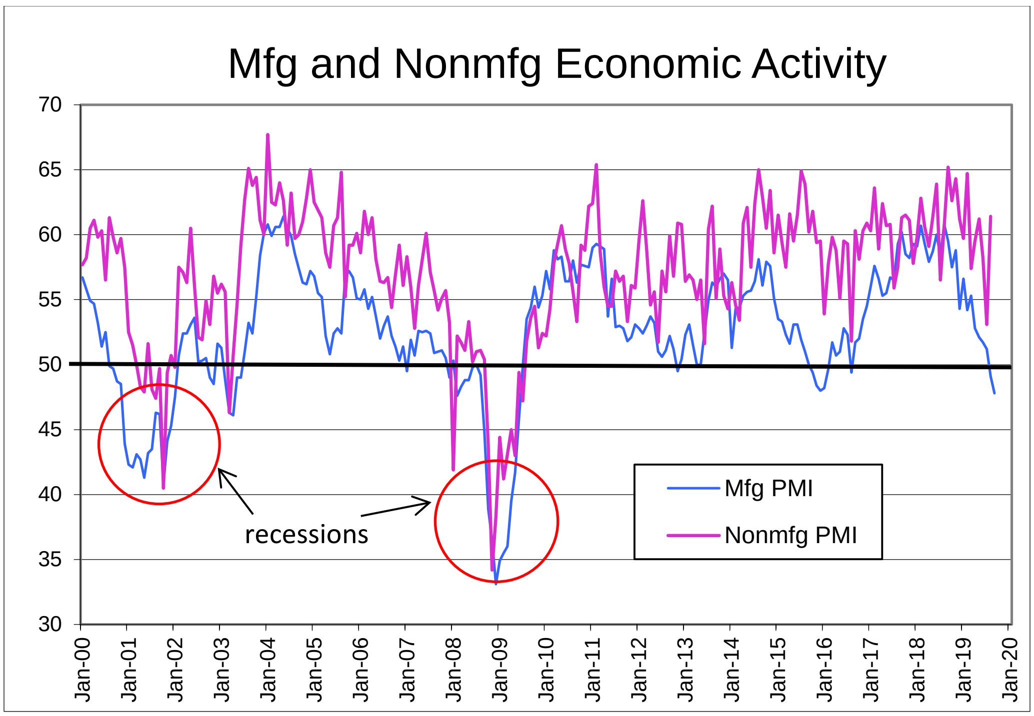
Consumer spending, representing 68% of U.S. growth, has held up offsetting the weakness in manufacturing, trade and business spending. Job growth continues (at a slowing pace) and wages are increasing.

The risk is ongoing uncertainty that has weighed on business investment spills over to other sectors in the economy. The graph below shows the manufacturing sector is contracting (index below 50) but has yet to spill over broadly into services. Business caution and slowing profits could lead to reduced hiring, further slowing economic growth.

Globally, policy makers have responded by reducing interest rates, increasing liquidity and turning to fiscal policy to stimulate economies. In the U.S., the Federal Open Market Committee (FOMC) lowered the federal funds target range to 1.75-2.00%, the second 0.25% reduction this year. They justified this move, "in light of the implications of global developments for the economic outlook as well as muted inflation pressures" and "to help keep the U.S. economy strong in the face of some notable developments and provide insurance against ongoing risks." However, not all board members were in agreement to a 25 basis point reduction as two dissented in favor of no change and another wanted a 50 basis point cut.

It is not clear that policy stimulus will be effective in preventing a recession in the U.S. Lower interest rates do not address the difficulty firms will have in their supply chain due to the trade war, or the increased costs from tariff increases. The cost of capital has not seemed to be a major deterrent to borrowing and investment, so a small reduction in rates might not have much impact. Lower rates could continue to induce a stock market rally that supports economic growth temporarily, stretching market valuations further and causing a more severe downturn later.

We do not have a lot of confidence that the trade war with China will be resolved in the near term or that changes in economic policy will be able to stave off a recession. Given these risks, we remain cautious and underweight equities.

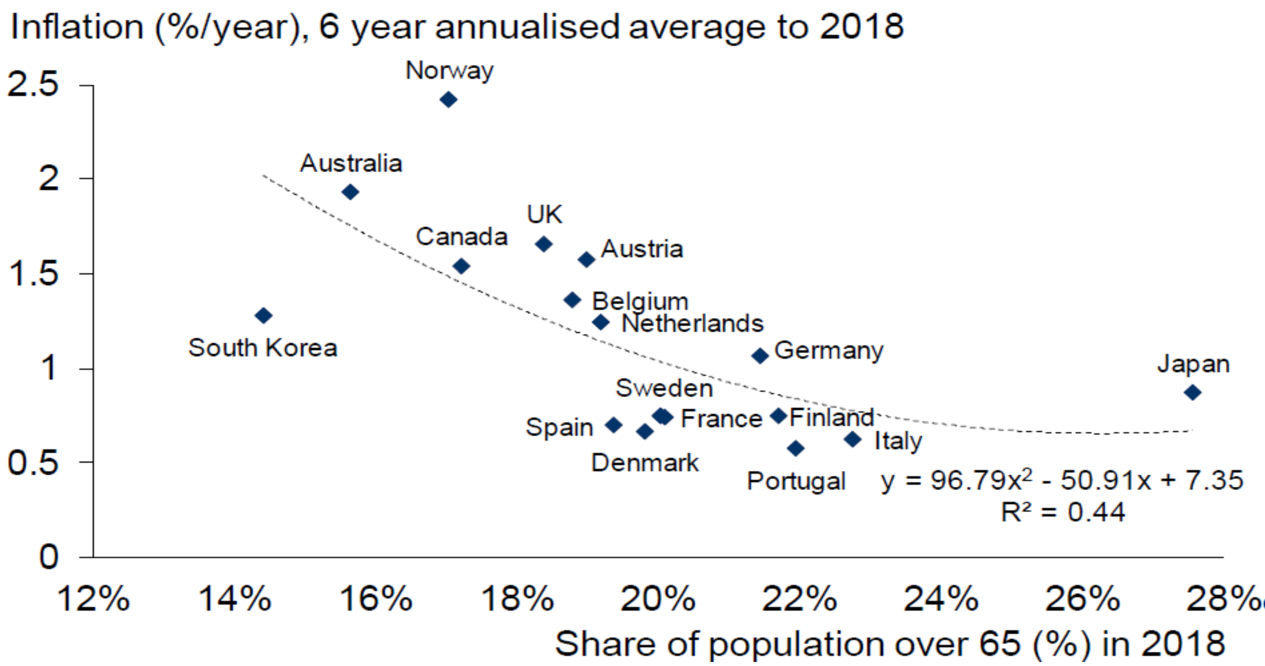


Future of Inflation

Most of the world's population is aging. There is a debate on whether this change in demographics is inflationary, disinflationary, or even deflationary. Surprisingly, there is not a lot of in-depth research on this topic. In 2015, the Bank for International Settlements (BIS) published a working paper that aging is modestly inflationary. The logic in this paper was that as a population ages, it no longer produces anything, so the supply of goods and services available goes down. If this is true, however, how do you explain the deflation that has gripped Japan for the last couple of decades; Japan has the most rapidly aging population of any major nation in the world. In early 2018, a study from Oxford Economics showed that the share of elderly, defined as 65+ (I am highly offended by this categorization), does not contribute to inflation.

A paper by Yoon, Kim and Lee in 2018 concluded the following after analyzing the economic data from countries with aging populations: “These results suggest that the ongoing demographic changes could have a significant deflationary impact in the years ahead, particularly on an economy experiencing a rapid decline and a significant aging of its population.”

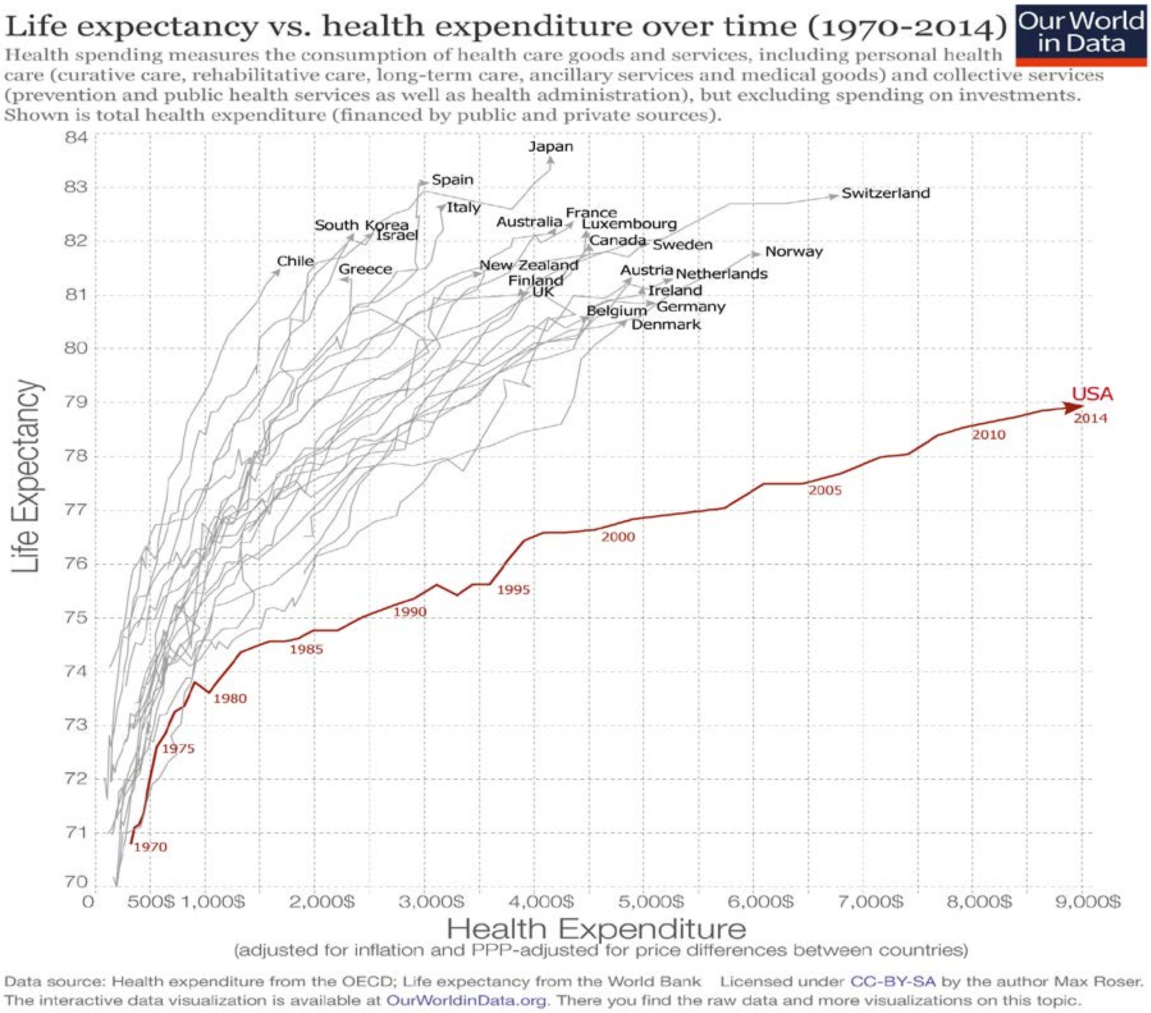
The following graph illustrates how inflation is affected by the share of the population over 65. As you can see, once the percentage exceeds about 20%, inflation really starts to slow down.



Source: Oxford Economics, United Nations, OECD

Health Care Debate

One of the largest expenses a family in the U.S. can have, and a central theme in the general elections next year, is health care, whether they are premiums, deductibles or co-insurance. Here in the U.S., we spend more per capita on healthcare, yet this spending is not manifesting itself in corresponding increases in longevity. As the chart below indicates, we are spending more and more on healthcare than are other (mostly developed) nations, yet those nations are continuing to experience much larger gains in lifespan. There is no doubt that something has to be done to overhaul our existing system. What exactly those changes would be continues to elude us. Within my (Kevin) circle of family and friends, there are ten healthcare professionals, including physical therapists, surgeons, family practice physicians and nurses. I often ask them what needs to be done to effect big changes in our system to manage costs and yet deliver quality healthcare. The universal answer is that the system is so complicated that they do not really know where to start. If they don’t know, how can anyone running for political office have any idea?



Closing Comments

Hopefully, we are finally at the end of a very wet six months and higher temperatures are behind us. The local weather people here in KC say that we are about 14 inches ahead of normal rainfall year-to-date. Judging by the times we have mowed the lawn this year, I would say that is possibly an inaccurate statistic.

We are now officially into Fall, my favorite season. Cooler temperatures, leaves changing colors, Halloween with little kids at the door, and Thanksgiving, which is a blast at our house. The political rhetoric is heating up, even with the elections over a year away. It should be very interesting. As always, we appreciate all of you as clients and continue to look forward to long business and personal relationships.

Kevin S. McGrew | Paul L. Watkins | Matthew D. Ison | Diane C. Dercher

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