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3rd Quarter Market & Economic Update

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"Investing is the intersection of economics and psychology." -Seth Klarman, Baupost Group

"The whole problem with the world is that fools and fanatics are always so certain of themselves, and wiser people so full of doubts." - Bertrand Russell (1872 – 1970) British philosopher and Nobel laureate

It is rare to watch the financial news and hear a market pundit suggest that they have no idea where the market is headed or why the market moved the way it did on a given day. They all seem so certain in their opinion. For many months I have seen one "market guru" after another talk about the great bull market that equities are experiencing. As I type this update at mid-day on the date listed above, the Dow Industrials (Dow) is at 26,088. For some perspective: on January 26, **2018**, the Dow closed at 26,616; that means the Dow is lower by almost 2% in the last 20 months. The S&P 500 is trading now at 2,890; on January 26, **2018**, the S&P 500 closed at 2872, for a gain of 0.62% over the last 20 months. The New York Stock Exchange Composite (NYSE) and the Russell 2000 are both down by 7.5% and 8.5%, respectively, over the last 20 months. So, where is this raging bull market I keep hearing about in the financial press? Yes, the market is up year-to-date, but investing is a long-term endeavor, not a one-month or one-year game. From my perch, investing and markets require flexibility regarding where we are in the economic cycle. Asset allocation should not be fixed, but flexible given where we are in the cycle. While I always have an opinion on the financial markets, those views are not fixed. As John Maynard Keynes was credited with saying, "When the facts change, then I change my mind."

As I have written often over the last decade, I believe we are in a secular bull market that has years left to run, but things change rapidly in this interconnected world, so I try to stay flexible. Part of the reasons for maintaining flexibility is that within every secular period, there are cyclical countertrends. That's another way of saying that within *secular* bull markets, there are *cyclical* bear markets which occur from time-to-time. For the last 12-15 months, we have kept a close eye on the weakening global economy. In fact, this is the third global economic slowdown since the end of the Great Recession a decade ago. While maintaining that a recession in the U.S. is not imminent, we have cautioned that the slowdown in the global economy would impact our economy. I think this is the main reason equities have been flat to down for the last 20 months. Unfortunately, there are lots of crosscurrents right now impacting global financial markets. On the positive side of the ledger, about 85% of global central banks are cutting interest rates. That is fantastic for consumers and businesses. Speaking of consumers, unemployment remains historically low and wages are rising across the economic spectrum. Other positives are trade agreements, now pending ratification from Congress, with Mexico & Canada (USMCA, or the new NAFTA) and Japan. On the negative side of the ledger are the on-going U.S.-China trade war, impeachment, Brexit, and a trade dispute between Japan and South Korea. While that Japan-South Korea trade issue may not resonate with most Americans, the dispute between two of our largest trading partners impacts world trade, and as such, impacts the U.S. You'll note that I mentioned impeachment on the negative side. I won't discuss politics or my opinion here, but rather the possible impact impeachment may have on the financial markets. The fact is impeachment is now a wildcard that may negatively impact some of the other things listed on both sides of the ledger. The USMCA treaty and the Japan trade deal need Congressional ratification, but is that possible with impeachment looming? Can Speaker Pelosi negotiate with the man she is trying to kick out of office? Will the Chinese, whose economy has weakened substantially, stall any trade deal due to the impeachment? If you're President Xi, then why not wait to see what happens with President Trump, either through impeachment or at the ballot box in November 2020? The answer to those questions may be answered over the next few months.

So how does this impact our portfolios? Frankly, with about $16 ***trillion*** of sovereign debt having negative yields and U.S. yields near record lows, a more tactical approach to asset allocation seems the most prudent course of action. I have often stated that I get research from people smarter than I, which helps us to gauge the macro risk and adjust portfolios accordingly. Here is what I wrote on October 5, **2018**, in my quarterly letter: *"…you may have noticed in late August, we decreased our risk exposure in all managed accounts. In other words, we increased the level of cash and reduced the value at risk in managed portfolios. Our models and indicators started signaling caution, so we took the necessary steps to reduce risk exposure*." Then on January 9 of this year, I wrote the following: "*The key is to buy assets low, so with the cash we raised in your portfolio, at much higher prices, we sit in a good position to be able to redeploy those funds at attractive levels. Thus, just as I encouraged everyone to get defensive back in October, I am now encouraging those with any idle cash sitting on the sidelines to consider adding some of that cash to your investment accounts*." While I certainly don't claim to be a wise man (see the 2nd quote on page 1), I usually have plenty of doubt when making the decision to buy or sell any asset or security. With the admission that doubt is always a part of investing, we made another tactical shift just yesterday. In our asset allocation programs (ETFs and mutual funds), we reduced our equity exposure while increasing our fixed-income, gold and cash positions. In our individual stock programs, we continue to hold more cash than is normal, having been a net seller of equities over the last month or two, while maintaining a significant position in gold. To be clear, my crystal ball is still broken, and I cannot see the future, but risk seems higher than normal right now given where we are in the cycle.

As Seth Klarman's quote on page 1 asserts, psychology plays an important part in investing. Equity markets are down a lot today as I type this missive. As economic statistics continue to weaken, the psychology appears to be turning more negative now, which bodes poorly for equities, but positively for bonds and gold. Now, the good news: if negative psychology leads to lower equity prices, then those with cash or other non-equity assets in their portfolios may be able to take advantage of these lower equity prices by tactically reallocating into equities as the pessimism grows. That means buying equities when prices are low, which is the name of the game.

I know I've covered a lot of items, so please do not hesitate to contact me with any questions or comments regarding the content of this update. You are truly an amazing group of clients, and it is an honor and a privilege to work with you. Thank you for your continued trust, confidence and loyalty.

Best regards,
Harvey E. Hutchinson IV
Harvey E. Hutchinson IV
President