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Third Quarter 2019

More of the Same With More Uncertainties

It was Groundhog Day for the third quarter as markets moved eerily similar to the second quarter this year. In almost exact fashion as Q2, Q3 started with healthy gains, followed by declines in August, only to recover in the third month and end the quarter in positive territory. Both the S&P 500 and Dow returned 1.19% for the quarter while the NASDAQ actually lagged the other two major U.S. indices, falling -0.09%. The three major U.S. indices are up 18.74%, 15.39% and 20.56%, respectively, for the year. Despite being up 15-20% for 2019, the S&P 500 and Dow are up 2.15% and 1.73%, respectively, over the trailing year which takes into account the correction in December 2018. Both indices are off 1.62% from their all-time highs. The NASDAQ is down 0.58% over the trailing year and is still 3.97% below its all-time high.

While strong earnings were a catalyst for early gains in Q2, the major driver for Q3's early advances were news of a trade truce between the U.S. and China. Investors had also been anticipating a rate cut from the Federal Reserve, which they did get in late July – the first since the financial crisis in 2008. Rate cuts are stimulative for the economy and can act as a tailwind for markets.

Things began to unravel in early August as the trade truce proved to be short-lived and warning signs began to flash from the bond market. President Trump announced new tariffs of 10% on $300B worth of Chinese imports citing a failure by the Chinese to fulfill promises to increase purchases of U.S. agricultural products. Later that month, China retaliated with tariffs of their own on $75B worth of U.S. imports, after which the president responded with tariffs on all $550B worth of Chinese imports.

Additionally weighing on markets was the uncertainty around U.S. monetary policy. When the Fed cut interest rates by 0.25% (25 basis points) in late July, they did so with a reluctance to signal whether more cuts were coming. The lack of guidance from the Fed only added fuel to the fire with regard to volatility.

Shortly following the rate cut in July as investors' confidence in the Fed, the economy, and the trade landscape began to decline, money began to flood into longer-term bonds. As demand for bonds rises, rates begin to fall, and vice versa. As demand for intermediate and longer-dated bonds began to increase with investors fleeing to safe assets, demand for short-term bonds began to fall. This led to short-dated bonds yielding more than longer-dated bonds, otherwise known as an "inversion of the yield curve" – something we discussed in past updates. The U.S. 10-year Treasury yield fell from 2% in June to as low as 1.5% in late August. Plummeting rates led to further gains in bonds as a whole with the Barclays U.S. Bond Aggregate returning 2.27% in Q3 and up over 10% over the trailing year.

The most widely followed metric with regard to the yield curve is the "10-2 spread" – the difference between the 10-year Treasury yield and the 2-year Treasury yield. Historically, when the 10-2 spread goes negative and the yield curve "inverts" – slopes downward – it indicates that the economy is headed for a recession. While that can be unnerving, the caveat to that is we do not know when exactly that recession may come, if at all. Remember, past performance is not indicative of future performance. However, while history may never repeat itself, it often rhymes.

While seven recessions over the last 50 years have been preceded by an inversion of the yield curve, each of those recessions came as soon as seven months to as long as two years following an inversion. In the last five occurrences since 1978, the S&P 500 has returned an average of 13.5% in the year following an inversion and 14.7% and 16.4% over the following two and three years, respectively. Since 1978, the S&P 500 hit its peak anywhere from one to 22 months following a yield curve inversion for an average of

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13 months before going into decline. The bottom line is that no single indicator can predict a recession and even if this signal is indicating a recession, there is still room for equities to run.

Despite the trifecta of headwinds, markets again showed impressive resilience in the final month of the quarter, similar to the last month of Q2. In early September, after the president delayed the implementation of some of the recently announced tariffs, both the U.S. and China agreed to a face-to-face meeting in October, easing some of the trade tensions in the market.

The Fed cut rates again in mid-September and this time signaled more willingness for future cuts should the economy continue to face significant headwinds. The yield curve normalized in early September following better-than-expected economic data. The markets rebounded significantly with all three major indices being within striking distance of July highs.

ANNOUNCEMENT

Please join us in welcoming the newest addition to the FAS team,

Kailey Short!

Kailey joined FAS in September 2019 as a client service specialist. She has worked a number of years in the financial services industry. She will be acting as a liaison between FAS clients and account custodians in our Client Services Department. We are confident Kailey's expertise and attention to detail will make her an asset to our team as well as our clients.

The volatility we continue to see should come as no surprise to investors. As we have stated numerous times, we are in both the longest bull market and longest economic cycle in post-WWII history. As the expansion continues to get long in the tooth it seems as if the markets are getting more skittish when it comes to surprises or unexpected events. However, as the last two quarters have proven, the markets continue to be extremely resilient and remind us that volatility doesn't automatically translate to negative returns. Healthy corporate earnings, stable growth, low unemployment, an accommodative Fed and increasing optimism around a U.S.-China trade deal was apparently enough positive news to offset the volatility last quarter.

2019 Performance Figures

	3rd Qtr.	YTD
DJIA (Dow)	1.19%	15.39%
S&P 500	1.19%	18.74%
NASDAQ COMP	-0.09%	20.56%
MSCI EAFE	-1.71%	9.85%
Russell 2000 Small Cap	-2.76%	12.96%
Barclays US Aggregate Bond Index	2.27%	8.52%
MSCI World All Cap	0.08%	15.72%

Impeachment proceedings can and will throw a wrench in things regardless of your political views. Nevertheless, impeachment proceedings have nothing to do with most of the aforementioned positives pointed out above. Markets despise uncertainty and react accordingly when given the opportunity.

We understand markets will always face uncertainties, specifically at the start of a new quarter, and we are committed to monitoring these situations and their impacts on client portfolios. Corporate earnings and economic fundamentals are what ultimately drive the long-term path of the markets and they remain solid.

Volatility can be unnerving, regardless of the cause, whether it be noise or an actual breakdown in fundamentals. That is why it is so important to ensure you are in an appropriate allocation with respect to your investment objectives, have implemented a plan with your adviser, and remain patient and stick to that plan regardless of the noise, volatility and uncertainty.