



A flight to safety in Q3

While a 60/40 portfolio gained, it was driven mostly by long-term Treasurys

Q3 2019

Main Points

Lower bond yields, suggestive of sluggish economic growth, drove a flight to safety in Q3.

Bonds and stocks both gained in Q3, but long-term Treasurys trounced stocks in the U.S.

Prospects of Fed rate cuts led to a July rally to new highs, but stocks have been in a trading range since.

Stocks see-sawed again through the third quarter. With prospects of a trade agreement and a second Fed rate cut in September, the S&P 500 rallied to 2,976.74 by the end of the third quarter.

Large-cap stocks were top performers. All Russell large-cap indices outpaced their mid- and small-cap counterparts.

Bond proxy sectors, like Utilities, Real Estate, and Consumer Staples, were the top gainers.

In U.S. dollars, **U.S. stocks outperformed** both developed international and emerging markets.

Precious metals gained. Gold was up 4.00% in the quarter and hit a new six-year high of \$1,550 per ounce. Silver and platinum posted gains of about 9-11%.

Commodities plunged in Q3. The widely followed S&P GSCI Index dropped 5.11%. The index is production-weighted, so crude oil's 8.17% drop dragged down the index.

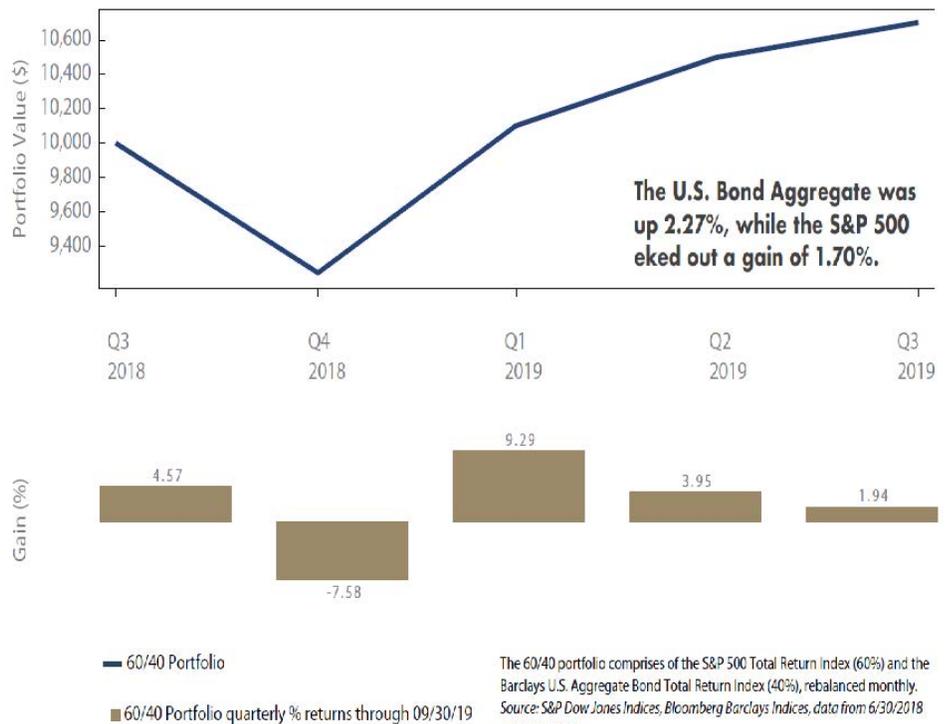
Over \$14 trillion in negative yielding bonds globally and mounting evidence of sluggish economic growth contributed to lower Treasury yields. In fact, U.S. T-note yields fell to their lowest levels since July 2016.

There was a clear flight to safety in the quarter.

Bonds outpaced stocks. The Long-Term U.S. Treasury Bond Total Return Index was up 7.92%, while the S&P 500 eked out a 1.70% gain on a total return basis.

A typical U.S. 60/40 portfolio (S&P 500 Total Return/Barclays U.S. Aggregate Bond Total Return) put in a positive performance for the quarter at 1.94% (**chart right**), but gains were mostly driven by long-term Treasurys.

Bonds outperformed stocks, driven by long-term Treasurys



Stocks

Q3 was choppy, but stocks hit new highs

The S&P 500 hit a new high of 3025.86 on July 26. Bond market gyrations, along with intermittent trade tensions, led to a 6.1% intra-quarter drop in the S&P 500.

The benchmark still managed to gain 1.2% in Q3. Its 18.7% price gain year-to-date is the **best first nine months since 1997.**

Based on the Ned Davis Research S&P 500 Cycle Composite for 2019, which is a combination of the historical one-, four-, and 10-year cycles (**chart right**), the S&P 500 peaked earlier than normal. The composite suggests potential weakness through late October.

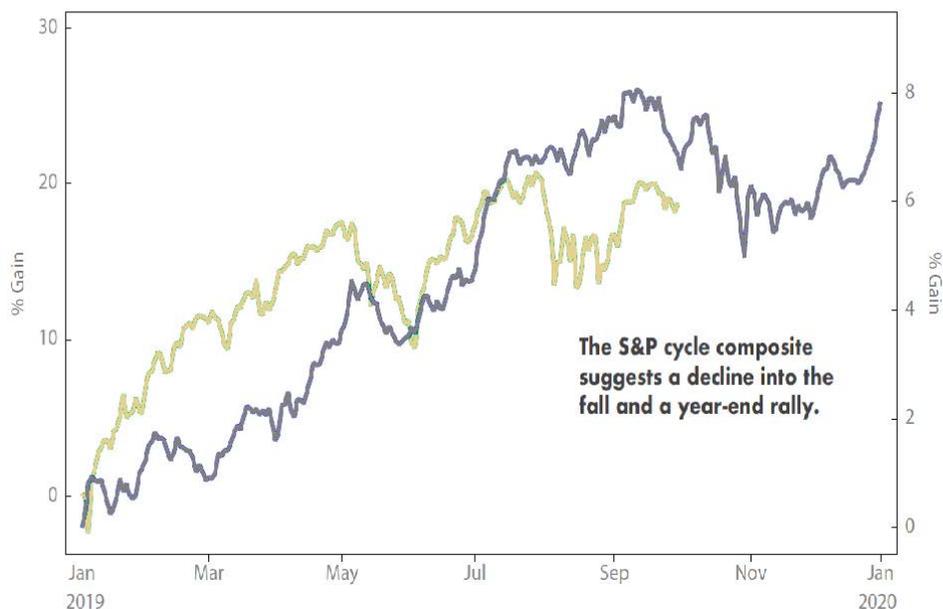
The breadth of the stock advance in 2019 is evident in **all nine style boxes posting double digit returns year-to-date.**

For the year, Growth has beaten Value across all three cap tiers. However, **Growth/Value results were mixed in Q3.**

The Russell Top 200 Growth outpaced the Russell Top 200 Value by 0.66%, but the Russell 2000 Growth trailed the Russell 2000 Value by 3.60%.

The mixed picture was punctuated by **the second-biggest two-day rotation from Growth to Value since the financial crisis** on September 9-10. Violent rotations have tended to persist for five months, on average.

S&P 500 peaked a bit earlier than history implied



— Actual S&P 500 through 9/30/19 (scale left)
— S&P 500 Road Map* for 2019 (scale right)

*Road Map concept: Composite based on the average of the seasonal, presidential and decennial cycles from 1928 to 2018, courtesy of Ned Davis Research, Inc.
Source: S&P Dow Jones Indices, data from 1928 to 2019

Eight out of 11 sectors posted positive gains in the quarter. As a result, nine out of 11 sectors are up more than 10% for the year.

Bond proxies led Q3. The three highest dividend yielding sectors, Utilities (+8.40%), Real Estate (+6.88%), and Consumer Staples (+5.36%), were the top performers. Bond proxies mirrored Treasury yields throughout the quarter.

Technology was again the top contributor in Q3, thanks to the fourth-best returns (2.97%) and biggest weight (21.5%) in the S&P 500 Index.

Energy and Health Care posted the worst losses in Q3 (-7.25% and -2.71%), as falling crude oil prices weighed on Energy and political rhetoric associated with the 2020 U.S. presidential election weighed on Health Care.

Q4 Outlook

The cycle composite (**above**) for Q4 suggests a possible decline into the fall and a year-end rally. From a historical perspective, **a second Fed rate cut is good news for the market bulls.**

According to Ned Davis Research, the stock market has responded positively to the second cut, with the Dow Jones Industrial Average (DJIA) jumping an average of 20.3% one year later.

Recessions matter. The weakest stock market performances have come when the Fed tried, and failed, to prevent a recession. If the U.S. economy avoids a recession, the average gain is 18.2%. If the economy enters a recession in the next 12 months, the average loss is -10.8%.

Fixed Income

Bonds rallied on easy policy and economic concerns

Even before the latest escalation of the U.S./China trade war, bonds have been performing remarkably well over the past year.

Over \$14 trillion in **negative yielding bonds globally and mounting evidence of sluggish economic growth contributed to lower Treasury yields** in Q3, but by Labor Day much of the bad news was priced in, setting the stage for a violent reversal.

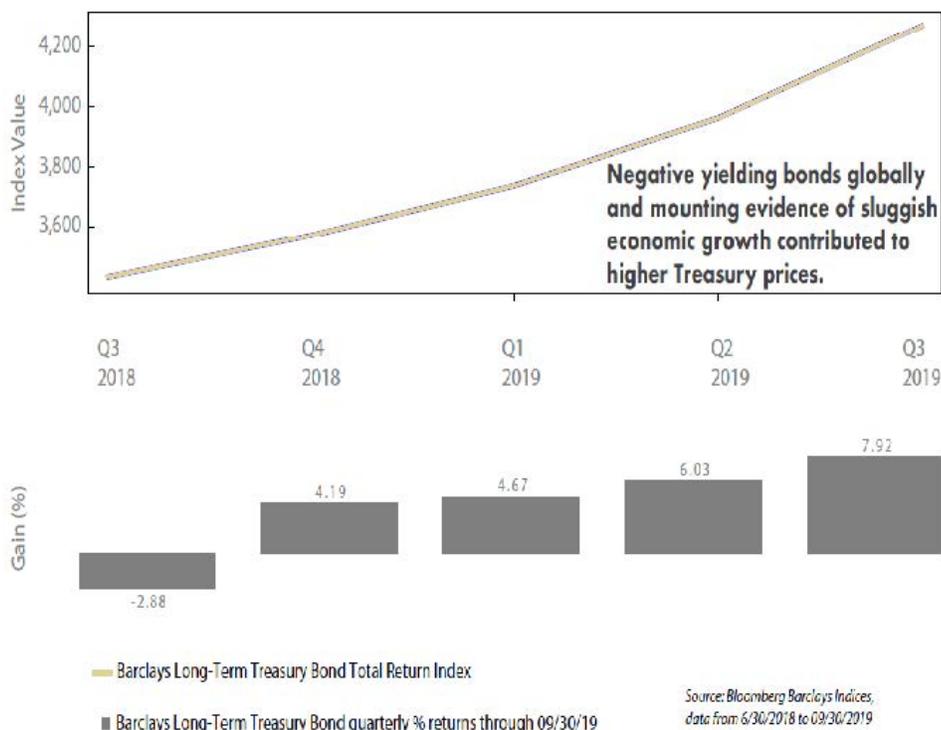
The 10-year U.S. Treasury yield fell as low as 1.47% in late August and early September, bounced sharply in September, and settled at 1.68% at quarter end.

Given the drop in yields, it was not surprising that **the longest duration U.S. bonds had the best performance**. The Barclays Long-Term Treasury Bond Total Return Index was up 7.92% (chart right).

Credit also performed well. U.S. investment grade corporates, which also has a relatively long duration of 7.8 years, took the second best spot in the U.S., gaining 3.05% on a total return basis. Global corporate credit returned 1.21%.

High-yield bond indices were weighed down by weakness in the Energy sector. As a result, the U.S. high yield index total return was only 1.33% for the quarter. Global high yield was weak, down -0.67% for the quarter, weighed down by Europe and Emerging Markets.

Long-dated Treasurys took top honors, again



With the strength of the U.S. dollar, global bond returns didn't fare that well on a dollar-adjusted basis. The Barclays Global Aggregate Total Return Index only gained 0.71% in Q3.

Q4 Outlook

As expected, the fed funds target range was cut by 0.25% to 1.75% to 2.00% in September. With its second rate cut of the year, **the Fed has now established an easing cycle**. Another rate cut is possible by yearend if trade uncertainties linger.

According to Ned Davis Research, of the ten historical easing cycles, the Fed has executed a third cut about six weeks later, which would be consistent with the next Fed meeting on October 29-30. The two

big exceptions were 1981-82 and 1984-85.

Bond market performance between the second and third rate cuts has been mixed.

Ten-year Treasury yields fell (bond prices rose) six times and rose four. The yield curve steepened on five occasions and flattened on four. Corporate spreads were little changed, on average.

Given the spike in repo rates, the rate charged for short-term collateralized loans, the Fed is likely to expand its balance sheet and implement a standing repo facility.

This should help calm investors. The focus can then shift to economic and profit growth, which will be needed as we move into 2020.