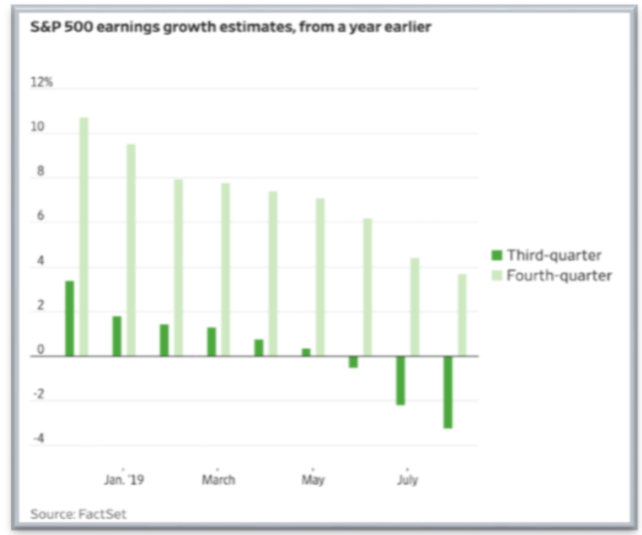
Quarterly Commentary 3Q'19

Signs of Slowing

There were growing signs of a slowing economy during the 3rd quarter, but markets held stable nonetheless. The US-based S&P 500 finished up 1.7% for the quarter and 20.6% for 2019 year-to-date, while the global MSCI All Country World Index was essentially flat for the quarter at 0.1% and up 16.7% year-to-date. Trends from the first half of the year continued: US stocks outperformed those of most other countries, large company stocks outperformed small, and growth continued to outperform value. Emerging markets, China in particular, lagged on trade pressures, slowing growth rates and increasing conflicts in Hong Kong.

Corporate Earnings Growth is Slowing



Low interest rates have helped propel stock performance throughout 2019, with rates down again in the 3rd quarter. The Federal Reserve cut the federal funds rate by 0.25% at both July and September meetings, and may cut again when it meets in late October. The Fed cuts were spurred by new data indicating slowing activity not just in manufacturing, but also in services and in the pace of hiring. The US trade war with China is now having a clear and measurable effect on economic activity in the U.S. and abroad. US corporate earnings growth has slowed significantly (see chart) and Europe reports concerning weakness. Spooked by trade tensions and unsure what a protectionist US might do next, corporations are increasingly reluctant to spend and hire. There are additional uncertainties weighing on the economic outlook: potential Trump impeachment hearings, a still-unsettled Brexit, and the lingering possibility of inflation.

Yet, Federal Reserve Chairman Jerome Powell describes the US economy as "solid". Consumer spending remains strong, U.S. unemployment is at a low 3.5%; and global growth remains in positive territory. The Fed continues to characterize the rate cuts as "midcycle adjustments" rather than a full-on policy reversal, which may change if the Fed sees a recession as imminent.

With interest rates low, it's been a notably strong year so far for US bond markets with the Bloomberg Barclays Aggregate Bond Index up 2.4% for the quarter and 7.7% year-to-date, with somewhat more modest returns for shorter and intermediate-term bonds (where Figure 8 portfolios are primarily positioned.) Interest rates declined across developed markets, for both short and long maturities, as investors seem increasingly willing to accept low returns in exchange for safety.

Figure 8's stock portfolios delivered competitive quarterly performance. Returns were helped by our substituting renewable energy stocks for the lagging oil and gas sector (notably, conventional energy has been the worst performing of the S&P 500's 11 sectors for the past 3 years running) and by strong Individual stock selection in real estate, technology, and the consumer sectors. Top contributors to performance included Nike, Starbucks, TJX and Costco, all on better-than-expected earnings. Apple rallied on strong sales of iPhone 11 and supplier Taiwan Semiconductor rebounded in tandem. The quarter's laggards included vision specialist Cooper on weak sales in emerging markets, Indian bank HDFC on a slowing growth outlook, and medical distributor Henry Schein on weak sales of dental equipment. During the quarter we trimmed gains in high-flying Starbucks and Apple, trimmed asset manager Blackrock on competitive pressures, and redirected proceeds to a new position in smart meter specialist Itron and to additional shares of Paypal, on what we see as temporary price weakness in the fast-moving world of fintech.

Strike!

On September 16, 48,000 autoworkers at General Motors went on strike, demanding higher pay, greater security of jobs and benefits, and a pathway to full employment status for temporary contract workers. The strike has suspended production at 50+ GM factories and warehouses, cost GM an estimated $600 million so far, and led to work stoppages and layoffs at supplier factories across the continent. As of this writing, it's the longest nationwide strike of the past 50 years and comes at a pivotal time in the auto industry. Powerful forces are combining to lower car ownership rates and the demand for new vehicle production. Key among these: the advent of the "sharing economy", the trend towards more sustainable transportation alternatives (mass transit, bike, scooter), and soon-to-come autonomous vehicles. In addition, increasingly popular electric vehicles require fewer parts and fewer workers to assemble. Both automakers and workers will likely need to make hard choices as they navigate negotiations now and into the future.

The GM strike also reflects the battle for workers to regain negotiating power, after a decade of economic recovery during which corporate profits expanded while worker pay largely did not. Worker rights have been further eroded by the trend towards using contract labor rather than hiring employees directly. Contractors typically earn much less and have fewer benefits than actual employees. The thriving technology sector in particular has embraced contract labor, with many tech giants now relying on a "shadow workforce" of contractors that often dwarfs the number of direct employees. Workers are starting to push back against the embedded inequities. In what may eventually be viewed as a bellwether event, 90 Google contractors voted on September 24 to unionize, joining with the United Steelworkers to better negotiate with Google for pay, benefits, and fairness. The Pittsburgh workers are a small part of Google's 121,000 contract and temporary workers but send an important signal about the power of workers at a time of rapid changing across industries.

On left, Sweden's Greta Thunberg one year ago, holding a one-person climate strike. On right, a representative photo of the 7.6 million people participating in the Global Climate Strike on Sept. 20 this year.
(Source: Common Dreams, Photo: Lucky Tran/Twitter/Jorg Carstensen/Getty Images)

We also got to experience a different kind of strike in the 3rd quarter. Sixteen-year old Greta Thunberg of Sweden inspired a powerful group of young activists to lead 7.6 million people in demanding an end to fossil fuels with the Global Climate Strike. Students and workers around the world joined the walkout, supported by many forward-thinking companies and investors, to demand aggressive changes in climate policy change. Together, the striking UAW members at GM, the newly organized contract labor force at Google, and young Greta Thunberg are powerful demonstrations of Margaret Mead's famous words: "Never doubt that a small group of thoughtful, committed citizens can change the world; indeed, it's the only thing that ever has." We expect these activists – and the actions they inspire -- to be an unstoppable force, and to play major roles in shaping the evolution of the global economy.

The Sustainable Development Goals (SDGs) are set of 17 goals adopted by world leaders to protect the planet, eradicate poverty and promote global prosperity. Figure 8 has committed to use the SDG framework to define our own social and environmental impact.