Argent
Wealth Management, LLC

Investment Outlook
Fall 2019

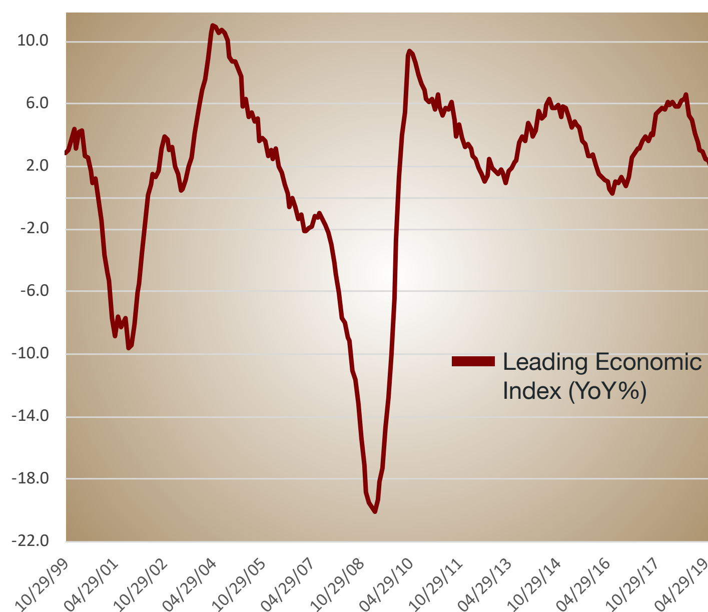
Third Quarter 2019 Review; Fourth Quarter 2019 Outlook

It's Time for Increased Caution

This past quarter saw the rangebound conditions we expected, though there was a sharp, brief swoon in August. Risk markets rallied into quarter-end as optimism rebounded due to some resolution of trade tensions and additional interest rate cuts by the Fed.

We utilized the market rebound toward cycle highs to get more defensive in our portfolios. A critical reason for this action was a clear and distinct deceleration of U.S. economic growth. Leading Economic Indicators (LEI) continue to trend negatively as do some other key economic data. While the consumer side of the economy remains solid for now, consumer sentiment is also slipping. Combined with continued trade tensions, election worries and limited ammunition from the Fed, we believe prudence is the correct course of action.

Over the quarter, there was a lot more action beneath the surface than broader indices might suggest. While the broadest U.S. indices such as the S&P 500 eked out small positive returns, many other indices were negative.



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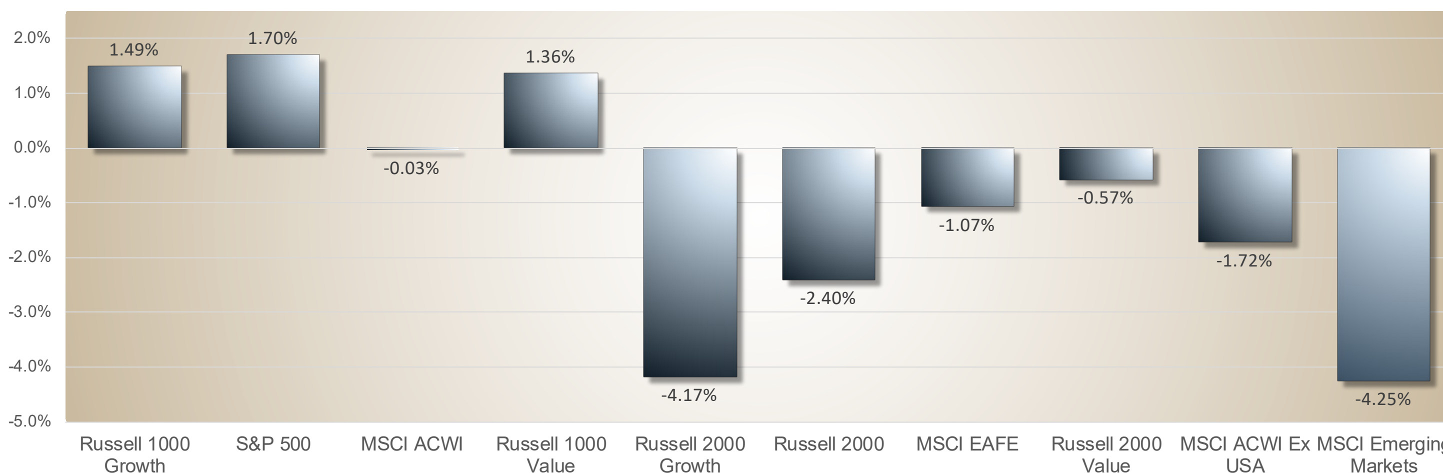

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Among the long list of negatives were mid and small cap markets and most non-U.S. indices. Emerging markets were down over 4%, as these markets tend to be sensitive to economic growth and to commodity prices. The composition of equity sector returns confirmed this more cautious stance. The top performing sectors were the classically defensive Utilities (+9.3%) and Consumer Staples (+6.1%). Lagging sectors were concentrated in the economically sensitive areas of Energy (-6.3%) and Materials (-0.1%).

Fixed income markets captured this cautious trend in an even more exaggerated way. The longest maturity and highest quality bonds rallied sharply. The 20+ year Treasury index rallied a stunning 8.15% as the yield on a 30-year Treasury bond plunged to an all-time low. More credit-oriented indices lagged badly but were positive. The Aggregate Bond index returned 2.27% while the High Yield index was up 1.24%.

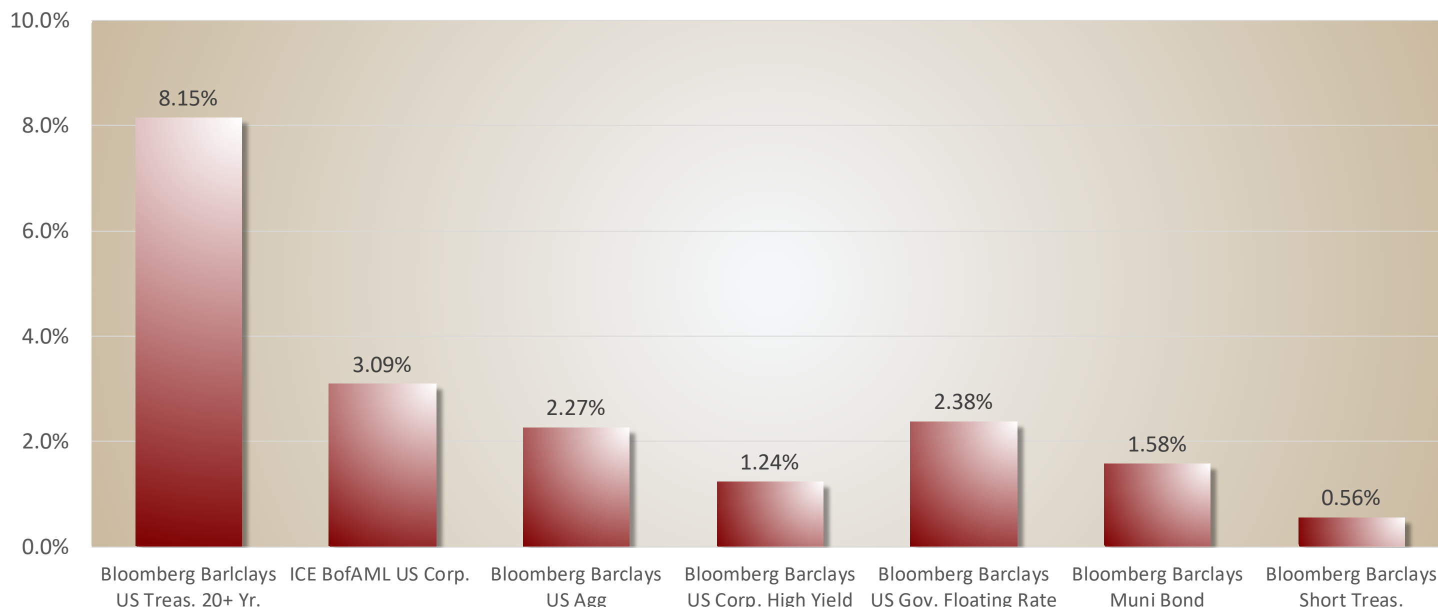
Stock and bond investors now confront a challenging dilemma. Many of the most defensive stock sectors that hold up best during periods of volatility and slowing economic growth are priced at historically high levels. We believe the right types of stocks to own currently are those with strong balance sheets, strong cash generation and growth prospects. These are typically known as quality and/or dividend growth stocks, and there are many stocks in this category that can be bought at reasonable to attractive valuations. For fixed income investors, with the yield on longer Treasury bonds at historic lows, there is limited room for appreciation in the "safest" bond investments. Therefore, we prefer to own shorter maturity investment grade, quality corporate bonds that have higher yields than 20-year Treasury bonds.

Maturity	Approximate Yield: Investment Grade Corporate Bonds	Yield: U.S. Treasury Bonds
2 Year	2.15%	1.45%
5 Year	2.40%	1.40%
7 Year	2.66%	1.49%
10 Year	2.88%	1.58%

Sources: As of 9/30/2019. Approximate yield for investment grade corporate bonds is the current yield of Blackrock's iShares ETFs with corresponding maturities. Other sources used are FactSet and Morningstar.

While Odds of Recession are Higher, The Next Recession May Be Shorter and Shallower Than 2000 or 2008

While odds of recession have risen, we are not expecting the next recession, when it comes, to resemble the past two severe recessions. Those recessions had the two largest post World War II stock market drawdowns. Both were characterized by starting conditions that were materially different from what we find now.



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The 2000—2003 recession started with a bubble valuation of more than 30x earnings and resulted in a 49% drawdown on the S&P 500 peak to trough. A critical reason for the recession's severity was that so much of the market bubble was in the most widely owned equities. Large technology stocks such as Cisco and Microsoft were priced at over 50x earnings. Additionally, many other tech companies were not profitable and had no potential to become profitable. At the same time consumers were feeling strain from rising interest rates and oil prices.

The 2008 Great Recession began with a different kind of bubble and resulted in a 57% drawdown peak to trough. The bubble this time was within credit markets and in the financial sector. Banks, consumers, and brokerage firms entered the downturn with record amounts of leverage.

While the initial trigger of the 2008 financial crisis was associated with sub-prime mortgages, it ended up far deeper than that. Banks and brokerage firms had record amounts of high yield and senior secured loans on the books. As the values of these assets plunged, much of the financial sector went bankrupt or became insolvent.

This kind of "credit contraction" results in a very long period of sub-trend growth even when it is over. Capital cushions of banks need to be rebuilt, and increased regulation further restrains growth. The housing market took many years to heal as banks and mortgage companies stopped lending to potential home buyers. In addition, as with the 2000-2003 recession, interest rates and oil prices were rising.

Today, the Federal Reserve Bank is lowering rates, and the conditions for an oil price spike are not present given the post-2008 rise of the U.S. onshore oil market. Typically, corrections of the equity market during economic slowdowns without an aggressive Federal Reserve, high valuations/bubble conditions or a commodity price shock are contained to the minus 20% range.

This Time the Bubble Is Different (WeWorks)

This time the bubble is different and less problematic. Unlike the painful tech and credit bubbles, which affected many individual investors, the current bubble is largely concentrated within the narrower pre-IPO private equity and venture capital markets.

The WeWorks situation may prove to be a turning point. A recent private market valuation of this company was reported at an amazing $47 billion. As the company is losing money and has serious governance issues, it was unable to access the public market at even a fraction of that valuation. It is debatable if the proper current value of the company is even $10 billion.

Characteristics of Recessions and Related Stock Market Declines

Recession	Related Market Sell-Off % Decline	MACRO ENVIRONMENT Commodity Spike	Aggressive Fed	Extreme Valuations/ Bubble
Recession of 1949	-21%			♦
Recession of 1953	-15%			
Recession of 1958	-22%			♦
Recession of 1960-61	-14%			♦
Recession of 1969-70	-36%		♦	
Recession of 1973-75	-48%	♦		
Recession of 1980	-17%	♦	♦	
Recession of 1981-82	-27%		♦	
Early 1990s Recession	-20%	♦	♦	
Early 2000s Recession	-49%	♦		♦
Great Recession	-57%	♦	♦	♦

Source: Ned Davis Research

Fortunately, implications for broader markets are not dramatic as the so-called “unicorns” (over $1 billion private companies) are a relatively small proportion of total equity markets. Further, ownership is concentrated in private and institutional portfolios, with smaller slices owned by mutual funds. While the losses here may be dramatic on a company level, impact on the larger retail investing public will be limited.

We view this collapse as healthy as it may prevent a larger and more problematic bubble. Investor psychology has already turned quickly, with investors demanding a path to profitability as well as more prudent governance. The last two recessions are still in the back of investors’ minds, keeping a healthy fear that prevents large bubbles from forming.

Positioning

Within equity markets, we find the best values and best potential with the solid, large cap, dividend growth companies. These are companies in a variety of sectors that have a respectable starting dividend of generally 2% to about 3.5% and the ability to increase the dividend over time. This, combined with a strong balance sheet and the ability to grow earnings, results in a powerful total return potential.

By contrast, we do not find much value in the Utilities and Consumer Staples sectors as the valuations of these stocks are high and growth potential limited. The same is true with the more aggressive areas of the growth universe whereby expectations remain too high and there is too much sensitivity to growth. Finally, while the deep cyclicals such as Energy and Financials are already cheaply priced, their earnings are at high risk in a recessionary scenario. Exceptions within Energy are some attractive midstream companies (transporters of oil and natural gas), which are less economically sensitive and generate high amounts of cash.

Within fixed income, we remain focused on the higher quality “spread” sectors: investment grade corporates, mortgages, senior secured loans and municipal bonds. We also find the best values in the shorter term and intermediate term maturities.

When to Add Risk Again?

With odds of a deep and severe recession not high, where and when should investors add risk back to portfolios?

Perhaps the most important factor in that decision is related to investor sentiment and positioning. Today investors remain too optimistic and overly exposed to equity and other risk markets. It has been a long and great bull market. That needs to change before a true turning point is achieved.

Turning points can be swift and, by definition, when most investors least expect them. All major market bottoms are associated with extreme pessimistic sentiment. Further, equity and other risk markets tend to lead actual recovery in the economy by 6 to 12 months. Most likely investors seeking confidence and comfort that economic conditions have improved will miss the periods of the best returns.As such, we expect to be adding risk if a correction in the 10-20% range occurs. Before adding risk we would look for more pessimism, stabilization and steepening of the yield curve and more positive technical and trend signals from a higher percentage of stocks in the market.

We are likely to add risk when it is uncomfortable to do so. Both investors and the financial press will be extremely pessimistic, as is typical at every major market bottom. That is also why we expect to add risk back to portfolios in a disciplined, structured and incremental way. Scaling or “averaging in” helps greatly in managing emotions, smoothing volatility and generating the best returns.

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