Q4 2019 Economic Outlook

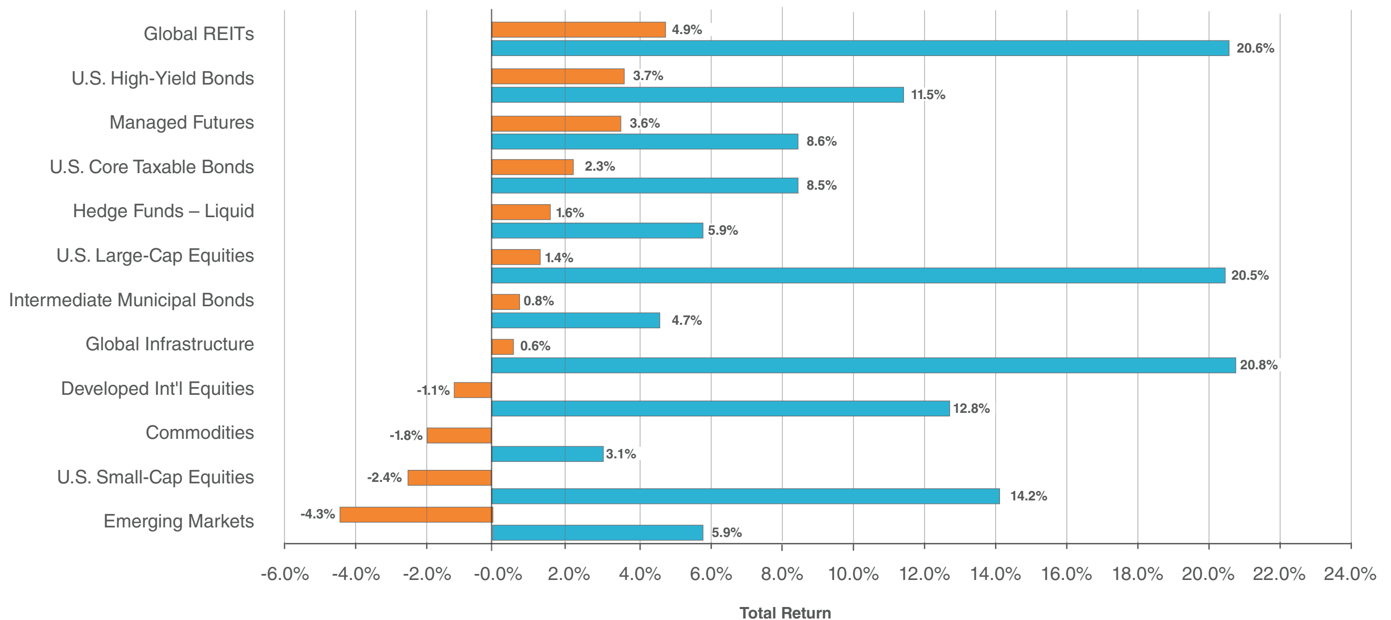
By the LNWM Investment Strategy & Research Group

Rising Risks, Not Sinking Ships

News regarding politics, trade and international relations have dominated capital markets recently and will likely continue through the end of the year. Combine these developments with recent weaker economic data and you have the necessary fuel to feed the fire of recession fears. Within our Investment Strategy and Research Group, there are a wide variety of issues that keep us up at night but they usually center on fundamentals, such as corporate earnings, interest rates, and GDP growth. While all of these factors are typically affected by current events, it seems that investors are now pricing in the impact of trade and geopolitics in a way we haven't seen before.

> "All of life is the management of risk, not its elimination."
>
> – **Walter Wriston**

As an example, at the time of writing this, the market was awaiting some announcement regarding the US-China trade war and was up more than 2% solely on the rumor that an announcement was imminent. The importance of US-China trade should not be underestimated, although the current round of negotiations is more painful for economies outside the US, for now. Should rumor of a trade agreement move the market 2%?



Source of Data: Morningstar, Bloomberg, Hedge Fund Research. Please see the disclosure and definitions.

The US-China trade war and relevant tariffs are nothing new, yet US GDP growth has generally remained above 2% annualized and unemployment is well under 4%, below what many economists would call the natural rate of unemployment. Admittedly, some of the US buoyancy is the result of 2018 tax cuts whose impact is beginning to wear off. We think this "wearing off" is driving slower manufacturing data and the recent slowdown in wage growth. Counteracting this are the healthy balance sheets of US consumers and a solid job market (though slowing), with still more available jobs than available workers.

The Federal Reserve will be in a very difficult position when it meets next at the end of October. So far in 2019, they've cut rates twice, which has provided support for the equity market. In our view, per the Fed's mandate of full employment and price stability, they should not cut rates again this year. US GDP growth remains above the Fed's long-term target and inflation has been very muted with no sign of change in this trend.

On the other hand, the Fed is keenly aware of the potential impact on growth of the current trade war(s). Be it trade wars or politics, growth is slowing and Fed Chair Powell has already expressed his desire to provide stimulus to head off recession. It is fear of recession that will likely cause the Fed to lower rates again by year-end, a move we do not think is necessary at this time, and which could limit the ability to deal with a real slowdown.

Politics and Portfolios

In the US, the political situation continues to worsen as a presidential impeachment inquiry has begun, further dividing an already politically divided nation. While Democrats are determined to prove presidential wrongdoing, Republicans are finding it increasingly difficult to defend certain actions of the President yet remain generally united against "the alternative." Somewhat surprisingly, market reaction has been muted regarding impeachment, which we think is evidence that the entire situation is being interpreted as political. The current state of affairs in Washington will likely cause firms to hold off on further investment, particularly in an election year. In other words, we think the political turmoil will continue and the effect on the broader economy will increase going into 2020.

Performance

The third quarter of 2019 was generally good for riskier assets, as equities were up nearly 2% and credit spreads remained tight. Year-to-date, US large-cap stocks are up around 20% although that masks the losses experienced in the 4th quarter of 2018, which we've now more than recovered.

The US economy has indeed been exceptional, largely continuing on an expansionary path while the rest of the developed world has slowed dramatically. US "exceptionalism" will not go on indefinitely; lower interest rates will only do so much given the global nature of our economy. Continued growth will depend on positive signs from our trading partners, although there is little indication of this currently. For this and other reasons, we intend to maintain our conservative stance for the foreseeable future by taking opportunities to reduce market risk. In doing so, we accept that that we may not keep up should markets surprise to the upside. We never try to time the markets but do focus on valuations, which we think are stretched in the US given the current environment.

What We've Done and Will Be Doing

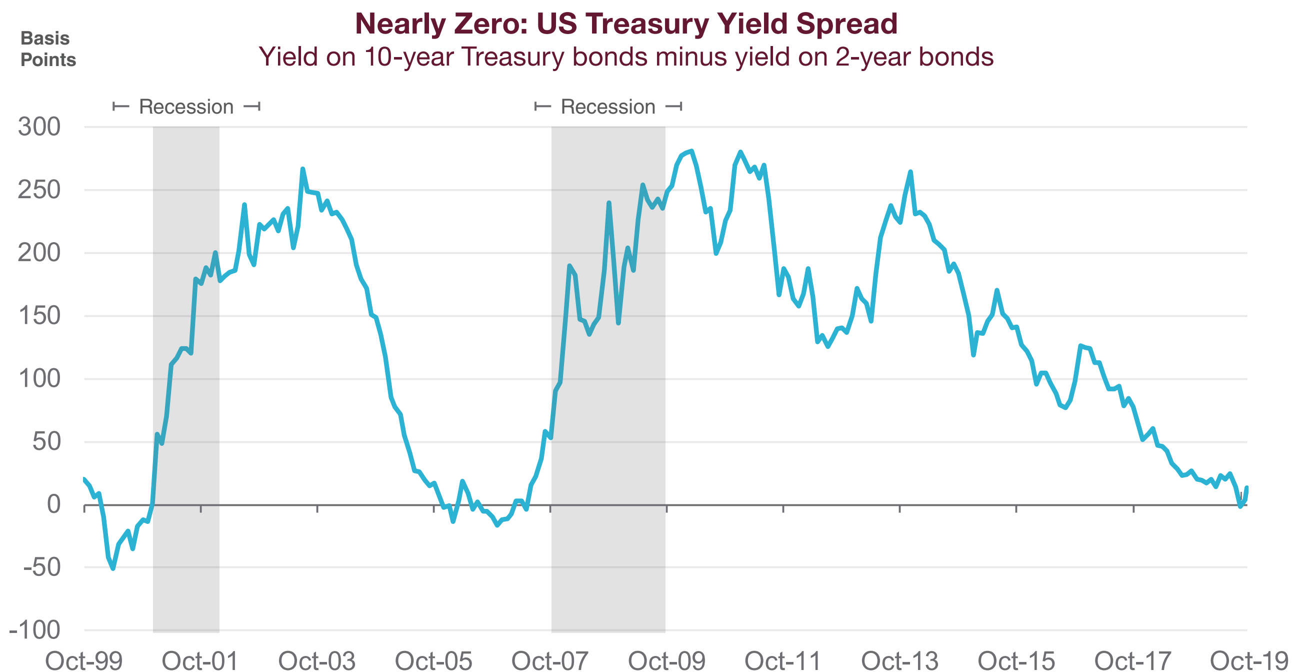
Our most significant changes during the third quarter of 2019 were in our fixed-income positions. Of those, the decision to redeem from a long-standing opportunistic manager in favor of a smaller, lower-fee manager was noteworthy. The decision was based on numerous factors including manager size, positioning, cost and performance. We also trimmed our position in emerging markets debt, which had performed well since the beginning of the year. It was becoming clear that the ongoing US-China trade war would create stronger headwinds for emerging market debt, and this has since proven to be the case. Finally, in liquid hedge funds, we added a new manager to diversify our existing lineup.

Looking forward, we are beginning our annual asset allocation process, which will allow us to make strategic changes at year-end while being mindful of tax consequences. We are also raising capital for a new renewable power fund, following the success thus far of our first fund in this sector. Finally, we are focused on our non-liquid hedge fund exposures as we continue to believe these to be an important part of our client portfolios. We believe this exposure will reduce risk and add differentiated sources of return vs. traditional strategies. We have been working with several external providers to establish the most effective method to gain the desired exposure, which we expect to be smaller in size but more concentrated.

Q4 2019 Key Economic Drivers

- **Global Trade** – This has been a focus for the past couple of years as the Trump administration has advocated for increasing the pressure on China and other trading partners (Mexico, Europe, Canada). However, capital market volatility has been increasingly driven by news related to trade in recent months. Further, we think trade tariffs will begin to impact corporate earnings, and we will learn more about the extent as earnings reporting season is currently under way.
- **Central Banks** – Always an area of focus, we now have the European Central Bank (ECB) transitioning from the leadership of Mario Draghi to Christine Lagarde, who we think will largely continue existing policies. The ECB has expressed a continued willingness to be accommodative as growth has proven illusive and the looming Brexit deal could be a headwind in the near term. In the US, futures markets have priced in at least one more cut in the Federal funds rate by the end of 2019, although we remain unsure if this is warranted, given the health of the US economy and the need for “dry powder” should we edge closer to a recessionary environment.
- **US Presidential Election** – Normally, this would be of concern during the election year; however, given the current ongoing impeachment procedures, we are not in a “normal” election cycle. Thus far, there has been a very muted market reaction to any related announcement. However, as the process moves forward and candidates emerge, markets will begin to price in the probability that tax and trade policies, among other things, will change. We think this will lead to increased market volatility and further give corporate decision makers reason to hold off on investments.
- **Geopolitics** – Most recently, the US decided to remove troops from a portion of Northern Syria, which has led to Turkey and Russia increasing their presence in the area. That, combined with recent Iranian actions against Western-bound oil tankers, will be the geopolitical stories of the remainder of the year. The US has threatened retaliatory sanctions on both. More than once in the past, an oil price shock has been the driver of recession, but we think this is less likely today given that the US has become the world’s largest oil producer. Nevertheless, an unstable Middle East will only make for greater uncertainty, particularly for Europe.

Interest Rates in Context



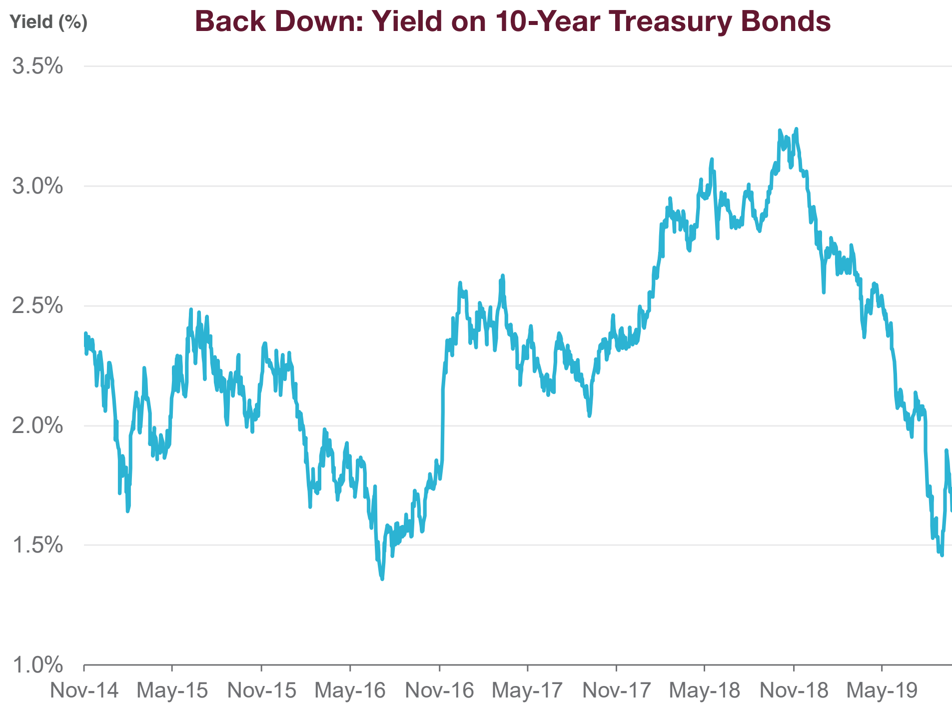
Source of Data: Bloomberg.

Does an inverted yield curve mean a recession is in the offing? We get this question a lot, so we thought we would revisit this topic. An inverted curve occurs when short-term yields are higher than longer-term yields (the line in the chart above would drop below zero), and this occurence has in the past preceeded recessions. In the third quarter, depending on how one measures it, the yield curve flirted with inversion on multiple occasions.

As we've said in the past, we don't think an inverted yield curve alone can be used to predict the end of an economic expansion, although we cannot deny that the probability of a recession in the months ahead increases with a flat or inverted curve.

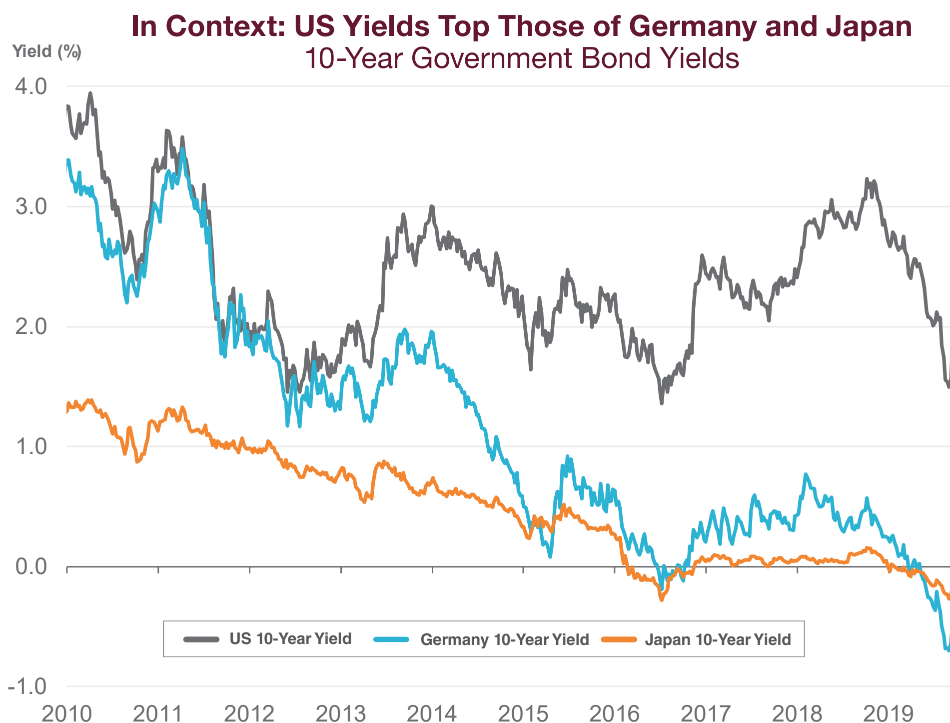
According to a study by asset manager AQR, subsequent one-year growth rates are positively related to the shape of the curve – steeper curves lead to stronger growth. However, the results are not conclusive. The study also examined asset returns, which again showed a positive relationship between slope and return.

We think of greater importance is the level of interest rates. The 10-year US Treasury yield began 2019 at 2.66%; it is currently at about 1.75% after trading as low as 1.60% in the quarter. Across the globe, about 35% of government bonds issued by developed countries have negative yields (below zero) making US Treasuries attractive even at the current relatively low yields. Given this, we think demand for US Treasuries will remain robust, in turn helping to keep yields low. We think this will also limit expected returns for equities and other riskier assets given that yields on US Treasuries are considered the risk-free rate and serve as the building block on which expected returns on other assets are based.



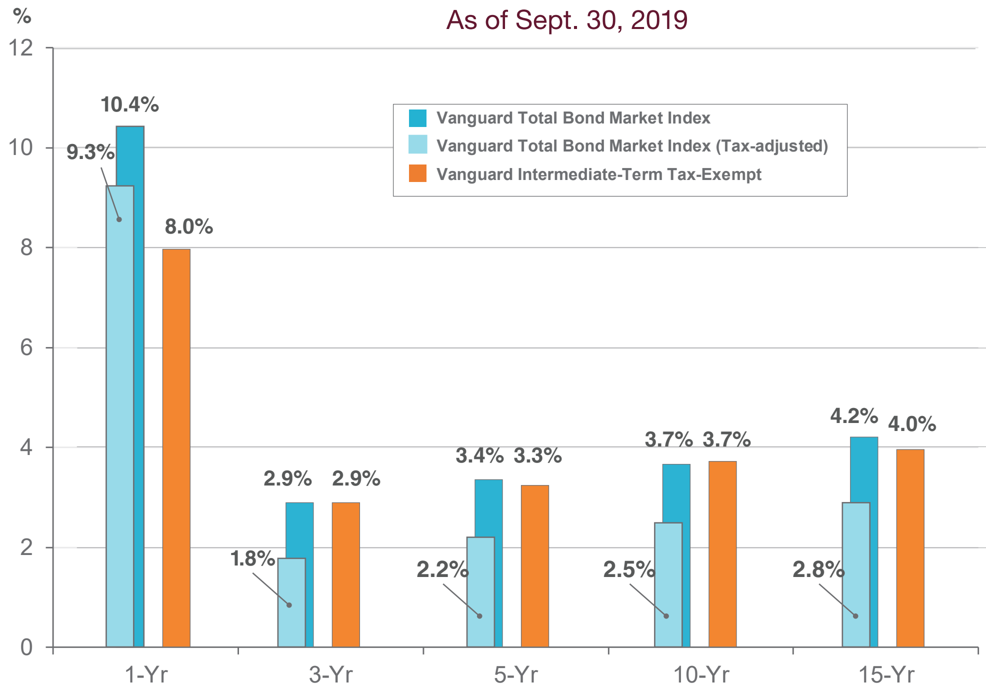
SOURCE OF DATA: Bloomberg.

Falling interest rates have had an enormous impact on fixed-income portfolios, boosting the prices of longer-term bonds. While interest rates were rising through the end of 2018, this year has seen rates drop back down to historical lows on investor concern about slowing growth and ongoing trade wars. US interest rates may continue to fall as we move toward the end of the decade-long economic expansion, and longer-term, high-quality debt would remain in a position to benefit.



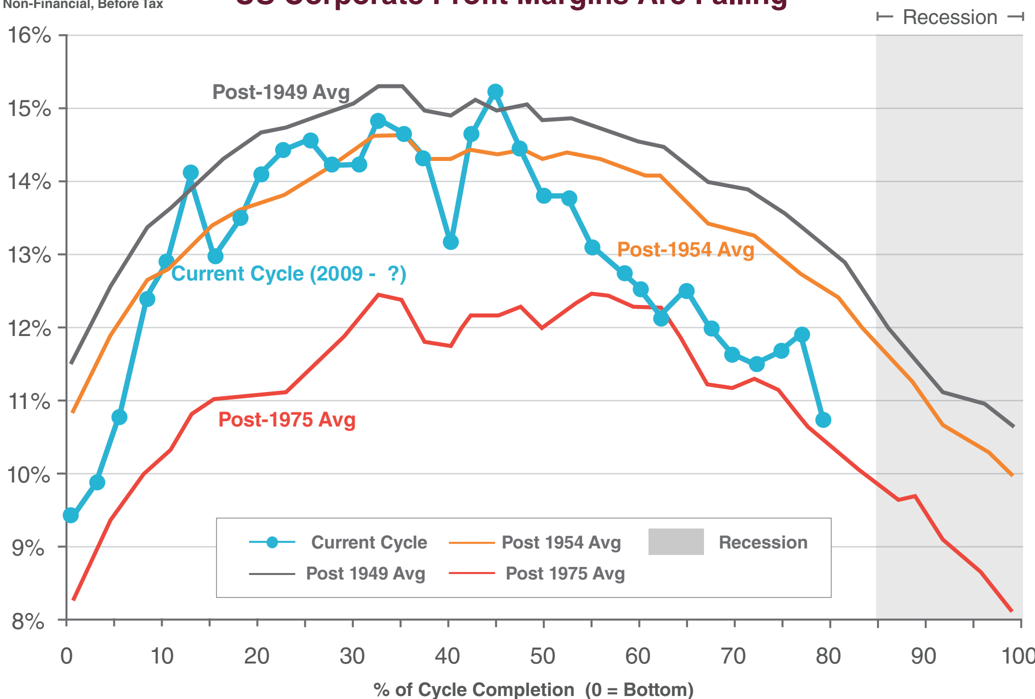
SOURCE OF DATA: Bloomberg.

Government bond yields in many developed economies are negative, including in Germany and Japan, while US Treasury yields remain substantially above zero. The yield advantage of US Treasuries should spur extra demand from overseas investors, and coupled with an accommodative Fed, should keep US yields from rising substantially above current levels.



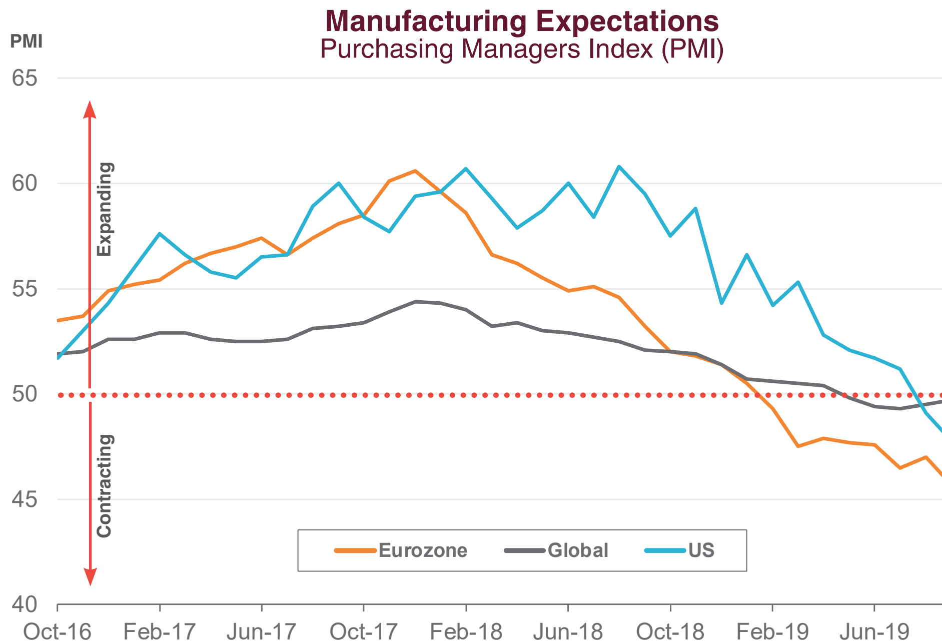
SOURCE OF DATA: LNWM, Morningstar.

So far in 2019, returns on municipal bonds have lagged corporate and US Treasury bonds, due to lower coupons and relatively less interest risk. For high-net-worth clients, we believe municipal bonds are generally preferable to taxable core fixed income on an after-tax basis. The chart at left shows that the taxable Vanguard Total Bond Market fund has outperformed its tax-exempt municipal peer over the last one-year period. However, on a tax-adjusted basis (assuming the highest marginal tax rate), the municipal bond fund has soundly outperformed over longer time frames.



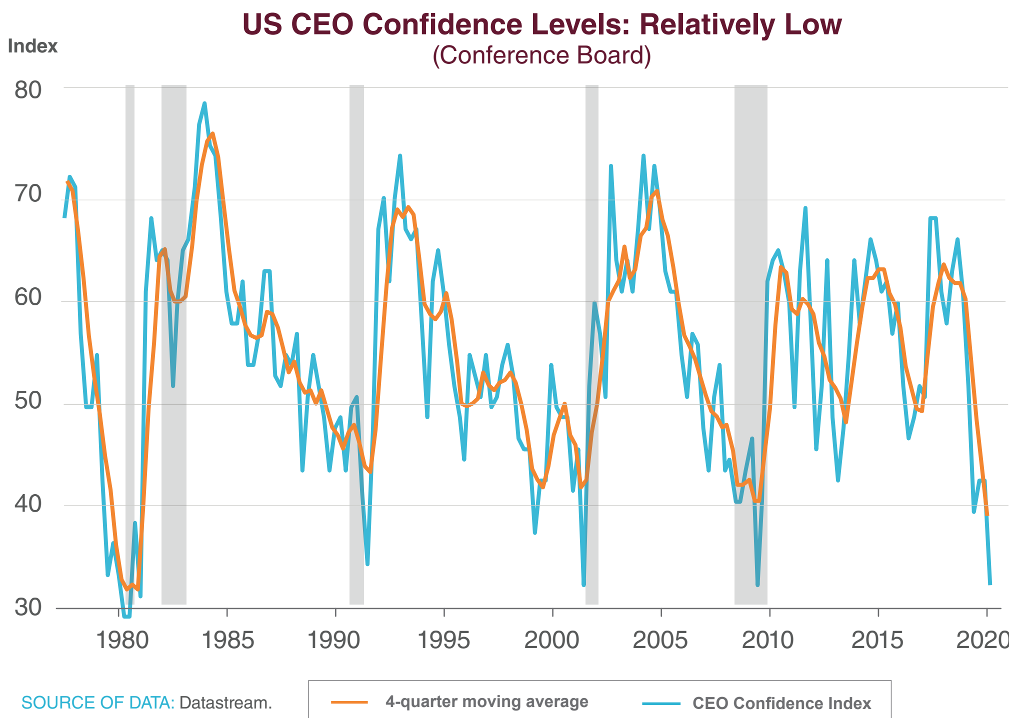
SOURCE OF DATA: WSJ, Societe Generale.

While the length of US economic cycles vary, US corporate profit margins have followed a clear arc through the course of previous expansions. The current level of profit margins indicates the US economy is very near the end of the current expansion, which is now into its 11th year, the longest on record.



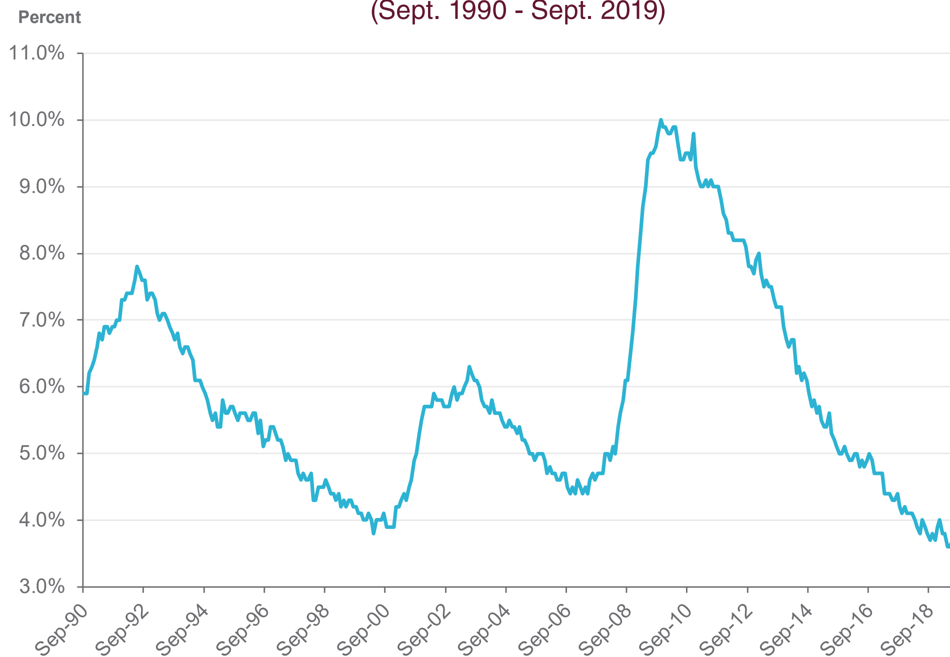
SOURCE OF DATA: Bloomberg.

We are beginning to see deterioration in US economic data. Case in point: manufacturing data for August and September 2019 fell to levels not seen since 2009. The drawn out trade war between US and China is taking a toll on manufacturing expectations (see chart), which are indicating a globally contracting economy. In the Eurozone, the European Central Bank (ECB) cut interest rates as new orders for goods and services fell, and the downturn in German manufacturing continued.



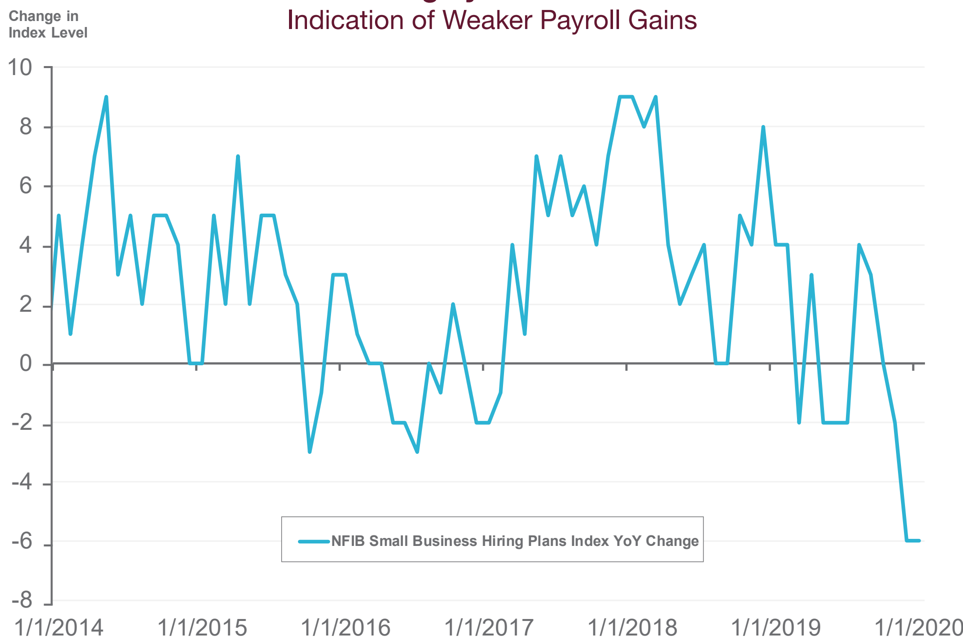
SOURCE OF DATA: Datastream.

During the past several decades, declining CEO confidence has been a good predictor of recessions, as businesses curtail expansion plans, reduce hiring and shore up their balance sheets. As seen in the chart at left, CEO confidence (as measured by a Conference Board survey) has fallen to a level typically seen just before or during previous US recessions (gray areas in the chart).



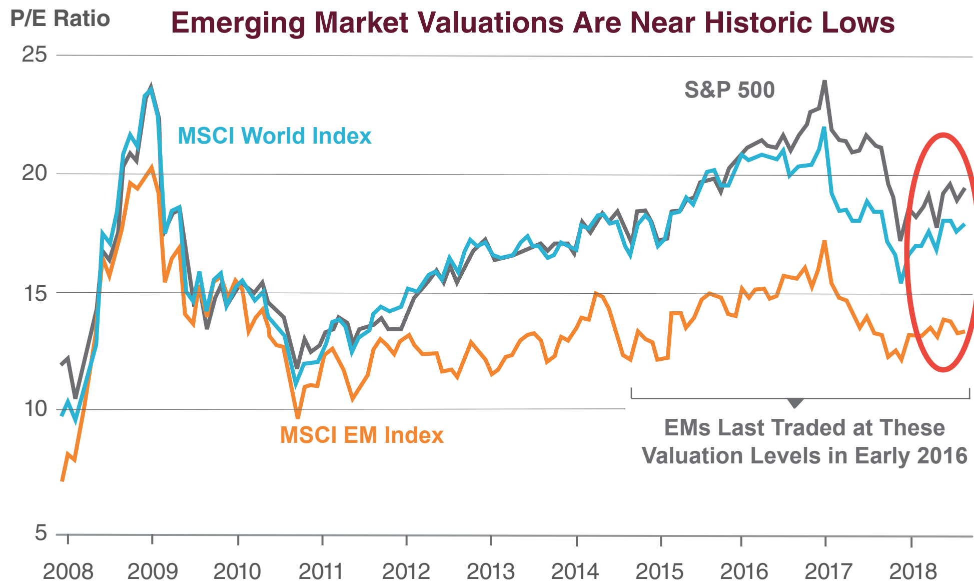
SOURCE OF DATA: Bloomberg.

As we've noted before, the US consumer is the engine of the US economy. As long as Americans are able to find ample job opportunities, they are likely to continue to spend at current levels. To date, the US labor market remains healthy even if there are signs that the unemployment rate does not have much room to fall further, given that it recently hit a 50-year low of 3.5%.

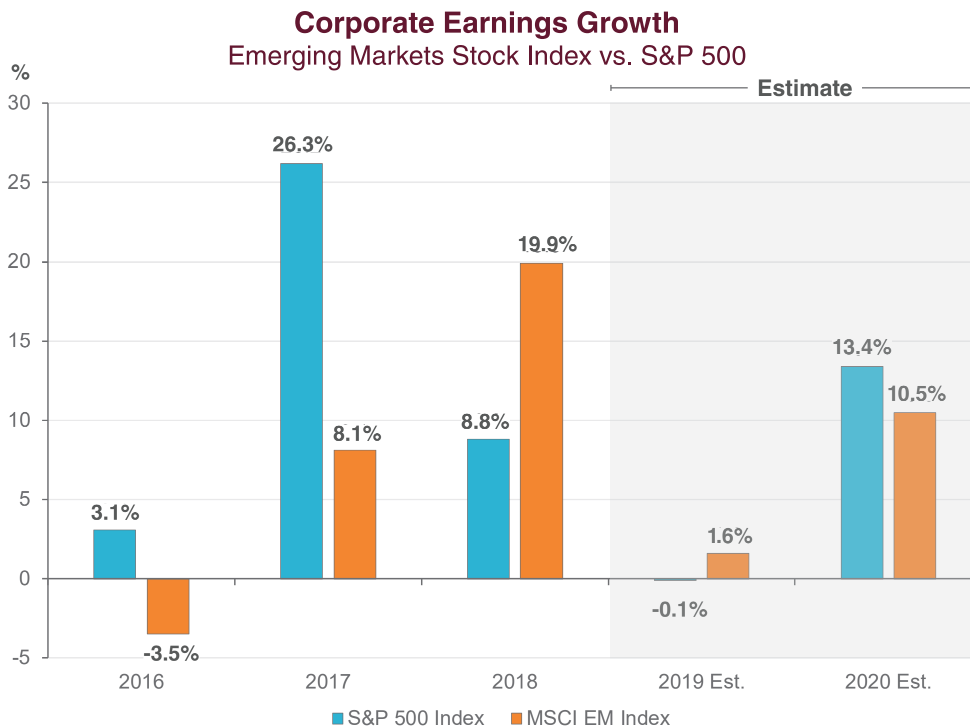


SOURCE OF DATA: Pantheon Macroeconomics, WSJ, Bloomberg.

The level of employment is a strong gauge of economic growth but it is a "lagging" indicator (it shows where we were, not where we are headed). By contrast, a leading indicator is the NFIB survey of small business expectations, which currently suggests that US payroll gains are likely to weaken in the future. Small business employment is important because roughly 33% of all US workers are at companies with fewer than 100 employees, and 50% work at companies with fewer than 500 employees.



SOURCE OF DATA: FactSet Market Aggregates.

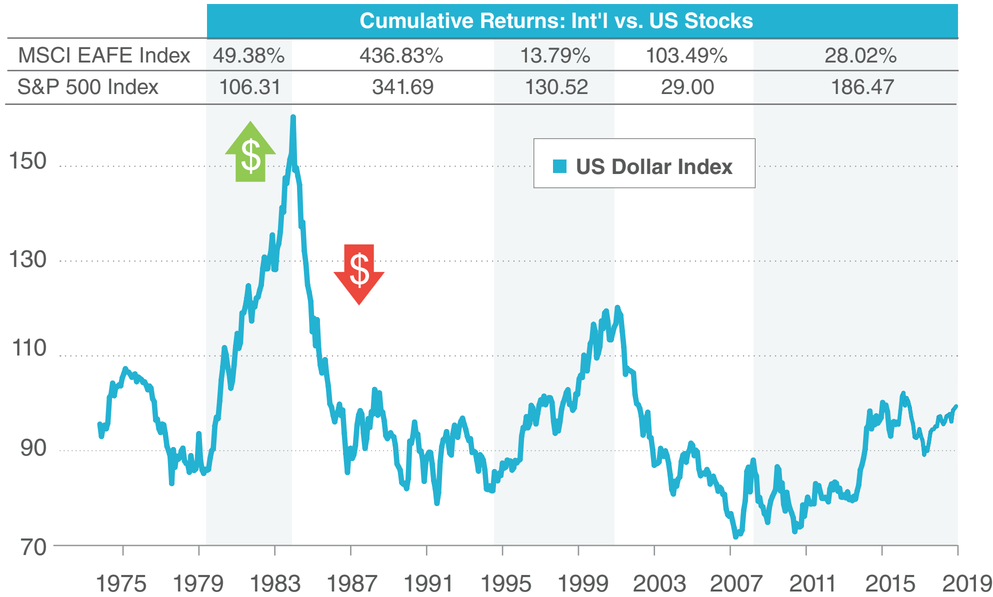


SOURCE OF DATA: FactSet Market Aggregates.

Economic growth in emerging markets (EM) is likely to exceed that of developed markets in 2020, due to stronger monetary stimulus and fiscal reforms in several of the major EM economies. Additionally, EM equities continue to trade at a significant discount to developed markets, as measured by the ratio of price to earnings (P/E). We believe a discount is appropriate; however, we think this valuation gap should narrow given continued growth at the country level and improving earnings at individual EM companies.

Foreign Stock Returns and the US Dollar

When the US dollar is strong, foreign stocks tend to underperform and vice versa



	Cumulative Returns: Int'l vs. US Stocks				
MSCI EAFE Index	49.38%	436.83%	13.79%	103.49%	28.02%
S&P 500 Index	106.31	341.69	130.52	29.00	186.47

Source of Data: FactSet.

US dollar strength can be a major headwind for foreign equities given that key input costs (commodities) are purchased in dollars, which can hurt profit margins over time. As the chart indicates, the highest relative returns for international markets have been during times of dollar depreciation. We currently view the US dollar as slightly overvalued, which could translate into better returns in international equities in the near future.

THE BENEFITS OF DIVERSIFICATION

Total return by asset category relative to a diversified* allocation.

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019 YTD	15-Year Annual-ized Return	15-Year Annual-ized Volatility#
Best Performance ↑	Global REITs 37.96%	MSCI EM 34.00%	Global REITs 42.35%	MSCI EM 39.42%	10yr Treas 20.06%	MSCI EM 78.51%	US Small Cap 26.85%	10yr Treas 17.15%	Global REITs 28.65%	US Small Cap 38.82%	Global REITs 15.89%	Muni Bonds 2.45%	US Small Cap 21.31%	MSCI EM 37.28%	Muni Bonds 1.64%	Global REITs 20.69%	US Large Cap 9.17%	MSCI EM 21.43%
	MSCI EM 25.55%	COMM. 21.36%	MSCI EM 32.14%	COMM. 16.23%	US Bonds 5.24%	Global REITs 38.26%	Global REITs 20.40%	US Bonds 7.84%	MSCI EM 18.22%	US Large Cap 33.11%	US Large Cap 13.24%	US Large Cap 0.92%	US Large Cap 12.05%	MSCI EAFE 25.03%	US Bonds 0.01%	US Large Cap 20.53%	US Small Cap 8.19%	Global REITs 18.70%
	MSCI EAFE 20.25%	Global REITs 15.35%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	Muni Bonds 4.23%	MSCI EAFE 31.78%	MSCI EM 18.88%	Muni Bonds 7.62%	MSCI EAFE 17.32%	MSCI EAFE 22.78%	10yr Treas 10.72%	10yr Treas 0.91%	COMM. 11.77%	US Large Cap 21.69%	10yr Treas -0.03%	US Small Cap 14.18%	MSCI EM 7.82%	US Small Cap 18.64%
	US Small Cap 18.33%	MSCI EAFE 13.54%	US Small Cap 18.37%	Diversified 10.91%	Illiquid HF -19.03%	US Large Cap 28.43%	COMM. 16.83%	US Large Cap 1.50%	US Large Cap 16.42%	Diversified 15.60%	US Bonds 5.97%	US Bonds 0.55%	MSCI EM 11.19%	Diversified 17.29%	Global REITs -4.74%	MSCI EAFE 12.80%	Global REITs 7.81%	MSCI EAFE 16.48%
	Diversified 13.73	Diversified 10.39%	Diversified 17.36%	Illiquid HF 9.95%	Liquid HF -23.25%	Diversified 27.48%	US Large Cap 16.10%	Diversified -3.56%	US Small Cap 16.35%	Illiquid HF 9.14%	US Small Cap 4.89%	Global REITs 0.05%	Diversified 7.11%	US Small Cap 14.65%	Illiquid HF -4.75%	Diversified 12.30%	Diversified 6.56%	COMM. 16.17%
	US Large Cap 11.40%	Illiquid HF 9.27%	US Large Cap 15.46%	10yr Treas 9.76%	Diversified -30.77%	US Small Cap 27.17%	Diversified 12.00%	US Small Cap -4.18%	Diversified 12.54%	Liquid HF 6.73%	Muni Bonds 4.66%	MSCI EAFE -0.81%	Illiquid HF 5.46%	Global REITs 11.42%	US Large Cap -4.78%	10yr Treas 10.87%	MSCI EAFE 5.29%	US Large Cap 14.06%
	COMM. 9.15%	US Large Cap 6.27%	Illiquid HF 12.89%	US Bonds 6.97%	US Small Cap -33.79%	Illiquid HF 20.01%	Illiquid HF 10.24%	Illiquid HF -5.25%	Illiquid HF 6.37%	Global REITs 4.39%	Diversified 3.79%	Illiquid HF -1.11%	Global REITs 4.99%	Illiquid HF 8.58%	Liquid HF -6.74%	US Bonds 8.52%	Illiquid HF 4.72%	Diversified 10.85%
	Illiquid HF 9.05%	US Small Cap 4.55%	Liquid HF 9.25%	US Large Cap 5.77%	COMM. -35.65%	COMM. 18.91%	10yr Treas 7.90%	Global REITs -5.82%	US Bonds 4.21%	Muni Bonds -0.32%	Illiquid HF 2.98%	Diversified -2.23%	US Bonds 2.65%	Liquid HF 5.98%	Diversified -7.07%	Illiquid HF 6.74%	10yr Treas 4.33%	10yr Treas 6.93%
	10yr Treas 4.83%	Liquid HF 2.72%	US Bonds 4.33%	Muni Bonds 4.79%	US Large Cap -37.60%	Liquid HF 13.40%	MSCI EAFE 7.75%	Liquid HF -8.88%	10yr Treas 4.18%	US Bonds -2.02%	Liquid HF -0.57%	Liquid HF -3.64%	Liquid HF 2.51%	US Bonds 3.54%	US Small Cap -11.01%	Liquid HF 5.90%	US Bonds 4.21%	Illiquid HF 5.79%
	US Bonds 4.34%	US Bonds 2.43%	Muni Bonds 3.74%	Liquid HF 4.24%	MSCI EAFE -43.38%	Muni Bonds 7.18%	US Bonds 6.54%	MSCI EAFE -12.14%	Muni Bonds 3.56%	MSCI EM -2.60%	MSCI EM -2.19%	US Small Cap -4.41%	MSCI EAFE 1.00%	Muni Bonds 3.49%	COMM. -11.25%	MSCI EM 5.89%	Muni Bonds 3.52%	Liquid HF 5.40%
	Muni Bonds 2.92%	10yr Treas 1.99%	COMM. 2.07%	US Small Cap -1.57%	Global REITs -47.72%	US Bonds 5.93%	Liquid HF 5.19%	COMM. -13.32%	Liquid HF 3.51%	10yr Treas -7.83%	MSCI EAFE -4.90%	MSCI EM -14.92%	Muni Bonds -0.10%	10yr Treas 2.07%	MSCI EAFE -13.79%	Muni Bonds 4.73%	Liquid HF 0.91%	US Bonds 3.18%
Worst Performance ↓	Liquid HF 2.68%	Muni Bonds 1.67%	10yr Treas 1.36%	Global REITs -6.96%	MSCI EM -53.33%	10yr Treas -9.71%	Muni Bonds 3.13%	MSCI EM -18.42%	COMM. -1.06%	COMM. -9.52%	COMM. -17.01%	COMM. -24.66%	10yr Treas -0.16%	COMM. 1.70%	MSCI EM -14.57%	COMM. 3.31%	COMM. -3.13%	Muni Bonds 2.72%
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019 YTD	15-Year Annualized Return	15-Year Annualized Volatility#

***Diversified asset allocation:** 20% U.S. Large Cap Equities; 20% U.S. Municipal Bonds; 20% Hedge Funds (10% Absolute Return, 10% Market Directional); 15% Int'l Developed Equities; 5% U.S. Small Cap Equities; 5% Emerging Markets Equities; 5% Global REITs; 5%, Commodities; 5% Managed Futures.

#Annualized Volatility as measured by standard deviation (the dispersion of outcomes around "the mean," or average result). When the standard deviation is lower, realized results tend to be closer to expected results (and vice versa). Standard deviation is not intended to reflect the entire range of gains or losses possible from an investment.

Past performance is no guarantee of future results. Data as of 6/30/2019. Returns are for period and index indicated (see Disclosures page for index definitions). "Diversified Allocation" returns assume quarterly rebalancing.

Source of Data: Morningstar.

The chart above highlights annual returns on a diversified portfolio consisting of the asset classes noted in the footnote, for each year from 2004 to 2019 (as of Sept. 30, 2019). The last two columns show 15-year annualized returns and price volatility for the diversified portfolio as well as for the asset classes. Thus far in 2019, we've seen the resurgence of large-cap US equities. No asset class has been negative during the first half of 2019, and we remain most surprised by the magnitude of the returns.

ABOUT THE AUTHOR

Gino Perrina, Ph.D., CFA is the Chief Investment Officer at Laird Norton Wealth Management and has more than 15 years of experience in investment analysis, strategy and risk management. Prior to joining LNWM in November 2015, Gino was a Managing Director at BlackRock Inc. in New York City, responsible for managing risk in the firm's alternative asset portfolios (+$100 billion in total investment). He was also Managing Director of Research and Risk Management at BlackRock Alternative Advisors (2006 to 2010), Head of Fixed Income Research at Russell Investments (2010 to 2012) and a fixed income analyst and portfolio manager at Microsoft and IAC/InterActive Corp.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With nearly $5 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 600 individuals, families, business leaders, private foundations and nonprofit organizations.

LNWM ASSET CLASS RETURNS CHART INDEX DEFINITIONS

Intermediate Municipal Bonds: Barclays Municipal Bond 1-10 Year Blend Index that measures the performance of municipal bonds with maturities between one and 10 years.

U.S. High-Yield Bonds: ICE BofAML US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

U.S. Core Taxable Bonds: The Barclays Capital U.S. Aggregate Bond Index covers the USD denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

U.S. Large-Cap Equities: The Russell 1000 Index is an index of approximately 1,000 of the largest companies in the U.S. equity market.

U.S. Small-Cap Equities: Russell 2000 Index, a measure of the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the U.S. small capitalization securities market.

Developed International Equities: MSCI EAFE Index, a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. As of June 2014, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

Emerging Markets: MSCI Emerging Markets Index, a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2014, MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

Commodities: The Bloomberg Commodity Index is made up of 22 exchange-traded futures on physical commodities. The commodities are weighted to account for economic significance and market liquidity and weighting restrictions on individual commodities and commodity groups promote diversification.

Global REITs: FTSE EPRA/NAREIT Global Equity REIT Index, a measure that tracks the performance of listed real estate companies and REITs worldwide.

Managed Futures: The SG CTA Index provides the market with a reliable daily performance benchmark of major commodity trading advisors (CTAs). The SG CTA Index calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment.

Hedge Funds – Liquid: HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

Hedge Funds – Illiquid: HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in U.S. dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

DISCLOSURE

All investments involve a level of risk, and past performance is not a guarantee of future investment results. The value of investments and the income derived from them can go down as well as up. Future returns are not guaranteed and a loss of principal may occur. All investment performance can be affected by general economic conditions and the extent and timing of investor participation in both the equity and fixed income markets. Fees charged by LNWM will reduce the net performance of the investment portfolio.

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