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VIEWPOINTS

This issue of Viewpoints will present a case for why, with respect to security prices over the next 6-12 months, we expect the impact from profit headwinds will ultimately outweigh the benefits from a new regime of easy money. We'll also explore ways in which changes in monetary and fiscal policy and the rise of populism could influence our portfolio construction over the longer term. As the market's expectations for growth and inflation have trended lower in recent quarters, our decision to increase our allocation to Treasuries and defensive equities over the past one-to-two years has played out well, and the last thing we want to do is overstay a winning position, but for now we believe our emphasis on these groups remains justified.

Since our last note in July, evidence has mounted that a global manufacturing recession is well underway as a result of additional tariffs, further economic weakness globally, and heightened political uncertainty. Many export-oriented economies are already in an outright recession, most notably Germany. In the U.S., a variety of measures of corporate sentiment also portend a slowing economy and a turning cycle:

• September's Purchasing Manager's Index (PMI), the key barometer of manufacturing conditions, missed expectations by the largest margin in history and had its greatest month-over-month contraction since the Great Recession.

• The NFIB Small Business Optimism index fell to 101.8 in September from 103.1 in

August, down from a peak of 108.8 in 2018, indicating pessimism among small business managers relating to hiring plans, sales expectations, capex and expansion plans, and general economic conditions.

• The Conference Board Measure of CEO Confidence fell in the third quarter to its lowest level since Q1 2009.

• Insider selling of company shares from corporate executives (i.e. individuals who presumably know more about their business prospects than anyone) totaled $14.2 billion in September, representing a 10-year high. In six separate months in 2019 insiders have sold over $10 billion worth of shares.

• September's ISM non-manufacturing index, representing U.S. service providers (the employers of the vast majority of Americans), fell steeply from August levels and continues its downward trend since last fall.

It isn't difficult to conceive a scenario where pending dovish action from the Federal Reserve stimulates risk-on behavior for a period of time. More likely, in our view, is that monetary easing at this point in the cycle will be akin to pushing on a string, as it has in the early stages of each of the 11 post-war recessions. To the extent a short-term boost in risk-assets does occur as a result of more accommodative monetary policy, such a rally would only serve to promote existing financial imbalances and to exacerbate the severity of the eventual correction.

The primary drivers of corporate profit margins, the mother's milk of stock prices, are interest rates, labor costs, taxes, and pricing power.

Wall Street analysts' consensus estimates suggest S&P 500 profits in 2020 will increase 10% year-over-year, a figure we view as optimistic. We struggle to envision a scenario where corporate tax rates fall further from here. At best, we think the tax environment will be margin-neutral in the coming years. Although labor's share of national income is at its lowest level in forty years, we believe wage suppression has largely run its course in light of the current political climate and unemployment picture. With respect to pricing

the Great Financial Crisis (GFC) the world has remained awash in excess supply and as such, price inflation has been non-existent in nearly every sector save for healthcare and education. The principal source of optimism regarding profit margins that we can see is low interest rates, yet the benefits of cheaper money may be muted as corporations are increasingly signaling they are reducing share buyback activity (the biggest driver of stock price appreciation since the GFC) and sharply cutting capex budgets in an effort to shore up balance sheets in advance of a looming downturn.

Market cheerleaders will point to the historically low levels of unemployment and relatively high levels of consumer confidence to support the narrative that the economy is stronger than ever. These, however, are lagging, backward-looking indicators. Companies historically add new hires most aggressively towards the peak of the business cycle and generally do not begin layoffs until a recession is well underway. In fact, the last time the unemployment rate was below 3.5%, where it currently stands, was December 1969, and the next recession officially started in January 1970.

Many market prognosticators, eager to nail the doomsday call, are warning that lower interest rates against a backdrop of extraordinary levels of indebtedness will throw us into the fires of inflation, reminiscent of the climate in the 1970's. Others predict that the current environment, characterized by excess supply and aging demographics, will continue to drive us down towards the ice of deflation, as Japan experienced starting in the 1990's through today. From our perspective, neither scenario is inevitable and a conceivable path exists somewhere between the two. This, however, will not be achieved easily and will require fiscal and monetary policy to co-operate in such a way that generates non-inflationary growth. To us, this hypothetical "golden path" will depend upon a well-constructed fiscal spending program focused on infrastructure - a concept both sides of the political aisle can presumably get behind given the complete lack of concern around deficits in Washington.

If and when a spending package is approved, confidence could quickly improve, yet the real effects would lag as appropriated funds must trickle down from the federal level to the state and local level, and await permits, zoning, labor contracts, and so on before deployment. As an example, by 2012 a mere 30% of the funds earmarked in the American Recovery and Reinvestment Act of 2009 had been used. Other forms of fiscal stimulus proposed by candidates on the left, including basic income, student loan forgiveness, or a guaranteed jobs program, could provide a more immediate boost to inflation expectations by putting cash directly into the hands of households.

As much as we wince at the thought of incorporating political forecasts into the management of our portfolios, we must point out that the current times are unique and seem eerily reminiscent of the early 1930's when populist movements on the left and right grew significantly in strength. At the heart of the

movements today is a growing awareness of the rise of income inequality since the early 1980's, and the belief that the economy and our political system has been geared to solely benefit owners of capital.

We hesitate to speculate on how the political landscape will evolve, but we do suspect we are entering a period where the pendulum will increasingly shift back towards labor and away from capital in the form of some combination of protectionism and higher taxes. The President's trade war has severely disrupted global supply chains and business confidence, and as we approach the 2020 election we expect candidates on either side will continue to promote labor-friendly policies that may cast a shadow over markets and valuations for some time.

In the end, our investment strategy rests on the dependability of cycles as the dominant factor in asset allocation and security selection. We've made it clear for some time that we believe we're in a stage where fundamentals, psychology, and returns are in decline, but we're far from eternal pessimists. Inevitably we'll approach a point when sentiment has bottomed, fear is at a peak, and the most attractive buying opportunities will emerge.

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