Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

QUARTERLY NEWSLETTER

2019: THIRD QUARTER **123RD EDITION**

"If we were in Europe, we would ask: How long can interest rates stay negative? Think about this. Not only are you lending your money to governments, but you're paying them interest for the privilege of doing so."

~ Mohamed El-Erian

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CAPITAL MARKETS SCOREBOARD

Equities					
Indices	**3Q19 Total Return (%)**	**2019 Total Return (%)**	**Index Characteristics**		
Domestic			**NTM P/E**	**P/B**	**Div. Yld. (%)**
S&P 500	1.7	20.6	16.9	3.4	1.9
DJIA	1.8	17.5	16.0	3.9	2.2
NASDAQ	0.2	21.5	22.2	4.4	1.0
Russell 1000 Growth	1.5	23.3	21.3	8.2	1.2
Russell 1000 Value	1.4	17.8	14.1	2.0	2.5
Russell 2000	-2.4	14.2	21.4	2.0	1.5
International*					
MSCI EAFE	-1.0	13.3	13.8	1.6	3.2
MSCI Emerging Markets	-4.1	6.2	12.0	1.6	2.5
MSCI United Kingdom	-2.5	10.2	12.4	1.7	4.1
MSCI France	-1.6	16.9	14.2	1.7	3.2
MSCI Germany	-4.0	10.7	13.0	1.5	3.1
MSCI Japan	3.3	11.5	13.2	1.3	2.4

Fixed Income		
Indices**	**3Q19 Total Return (%)**	**2019 Total Return (%)**
Domestic		
U.S. Corp - Gov (1-3 Years)	0.7	3.4
U.S. Corp - Gov (3-5 Years)	1.2	6.1
U.S. Corp - Gov (10+ Years)	6.6	20.4
U.S. Treasuries Master	2.5	7.9
U.S. Corporates Master	3.1	12.9
U.S. Municipals Master	1.6	7.1
U.S. High Yield Master	1.3	11.5
International*		
Developed Markets Sov Bond	0.9	6.1

Commodities		
Resource	**3Q19 Total Return (%)**	**2019 Total Return (%)**
Precious Metals		
Gold	4.0	14.7
Silver	13.4	11.6
Industrial Metals		
Copper	-5.2	-2.4
Aluminum	-3.9	-8.9
Energy		
Brent Crude Oil	-12.2	17.2
WTI Crude Oil	-7.0	19.9
Natural Gas	1.0	-20.7

Key Rates				
Rates	**9/30/2019**	**6/30/2019**	**12/31/2018**	**9/30/2018**
U.S. Target Fed Funds Rate	2.00	2.50	2.50	2.25
2-Year U.S. Treasury	1.63	1.75	2.48	2.81
10-Year U.S. Treasury	1.68	2.00	2.69	3.05
30-Year U.S. Treasury	2.12	2.52	3.02	3.19
10-Year German Bund	-0.58	-0.31	0.24	0.47
10-Year Japanese Bond	-0.23	-0.16	-0.01	0.12
30-Year Fixed Mortgage	3.61	3.80	4.64	4.63

Currencies				
Indices/ Exchange Rates	**9/30/2019**	**6/30/2019**	**12/31/2018**	**9/30/2018**
ICE U.S. Dollar Index	99.38	96.13	96.17	95.13
USD per EUR	1.09	1.14	1.14	1.16
USD per GBP	1.23	1.27	1.27	1.30
JPY per USD	108.08	107.74	109.72	113.59
CAD per USD	1.32	1.31	1.37	1.29

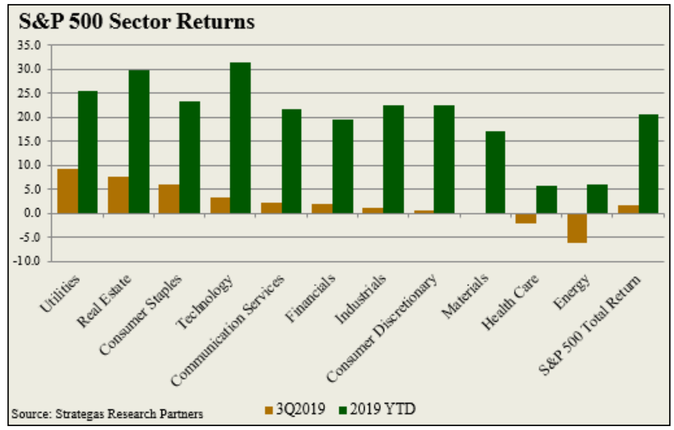
*Returns denominated in U.S. dollars

**ICE Bank of America Merrill Lynch (BofA-ML) indices

EQUITIES

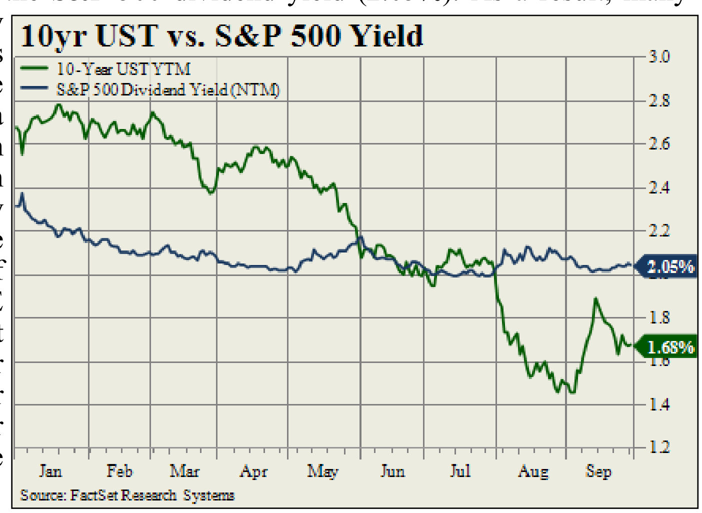
- The Standard & Poor's 500 (S&P 500) index ended September at 2,976.74, generating a positive total return (price appreciation plus dividends) of 1.7% for the third quarter. The index set an all-time closing high of 3,025.86 on July 26 before selling off sharply, nearly reaching correction territory (a decline of 10%) by the first week of August. Recession fears persisted as the 10-year U.S. Treasury (UST) yield fell below the 2-year UST yield (yield curve "inversion"), causing an 800-point daily selloff in the Dow Jones Industrial Average (DJIA) on August 14 – its fourth-largest daily price drop on record. Stocks rallied, however, and volatility remained subdued from its August spike through the end of the quarter.

- Within the S&P 500, Utilities and Real Estate Sectors led the way (up 9.3% and 7.7% for the quarter respectively) while Energy Sector stocks lagged (down 6.3%). Market breadth has declined – fewer companies have participated in recent rallies, with the number of companies posting new highs near the end of the third quarter nearly two-thirds lower than as the second quarter closed. International indices once again lagged domestic stocks for the quarter. The MSCI Europe, Australasia, and Far East (EAFE) Index declined 1.0% on a total return basis, and the MSCI Emerging Markets Index fell further at -4.1%.



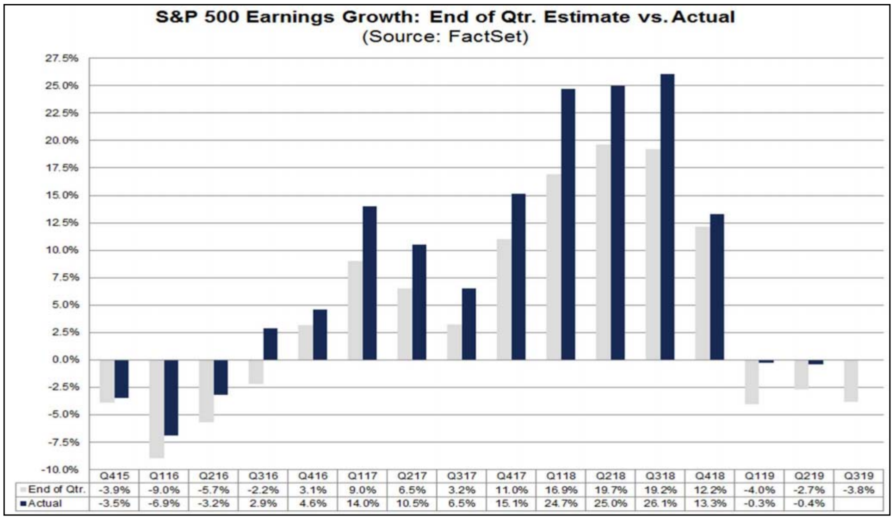
- For only the second time since the last quarter of 2016, value stocks outperformed growth stocks for the quarter. Still, the valuation discrepancy between the two styles remains near its highest level since March 2006 as a lack of available growth has driven up the premium investors are willing to pay for it. The S&P 500 Growth Index and S&P 500 Value Index closed the quarter at forward price-to-earnings (P/E) ratios of 20.6x and 13.8x next twelve months (NTM) earnings respectively. Despite the affinity for growth, initial public offerings (IPOs) continued their trend of disappointment. Ride-sharing companies Lyft and Uber posted dismal initial offerings in March and May respectively, and have traded abysmally since. The poor debuts caused WeWork to withdraw its highly-publicized IPO filing in the third quarter.

- Investors have also been willing to pay a premium for high dividend payers as the 10-year UST yield (1.68% at the close of the quarter) fell below the S&P 500 dividend yield (2.05%). As a result, many investors have taken on more volatility by increasingly favoring equities rather than bonds for portfolio yield. Valuations in some historically-stable sectors have been bid up as a result. Utilities stocks, for example, long seen as a stable income-producing component of an equity portfolio, closed the quarter at a nearly 20% valuation premium to the S&P 500 on the aggregate versus a historical discount of roughly 8%. The Utilities Sector reached a P/E of more than 20x forward earnings for the first time on record in the last week of September versus a historical average for the sector closer to 14.3x. Valuations of Real Estate Sector stocks have also been bid up as investors strive to replace lackluster bond yields.

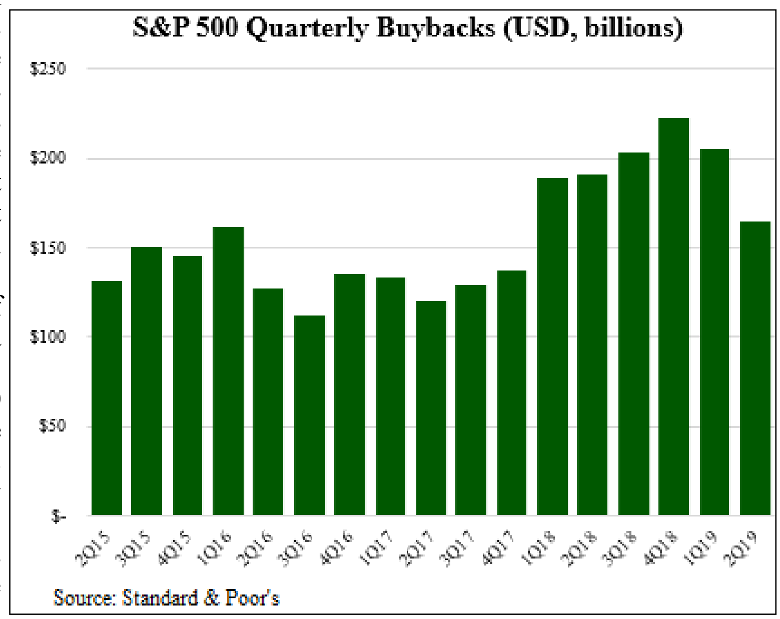


EQUITIES

- Earnings growth has historically been a primary driver of stock price appreciation. S&P 500 companies posted earnings declines in the first and second quarters (-0.3% and -0.4% respectively), officially marking an "earnings recession." Despite an estimated 2.8% growth in revenues, expectations call for a third consecutive earnings decline. Earnings growth is projected at -4.1% for the quarter as corporate margins continue to erode (-1.3% estimated margin growth for Q3). International headwinds such as slowing global growth and tariffs have also hampered corporate profitability. Within the -4.1% projected S&P 500 third-quarter earnings growth, companies with less than half of their revenue obtained outside of U.S. borders are predicted to post collective revenue and earnings growth of 4.6% and -0.1% respectively while those with more than half of their revenue earned abroad expected to report revenue and earnings growth of -1.9% and -11.2% respectively for the quarter.



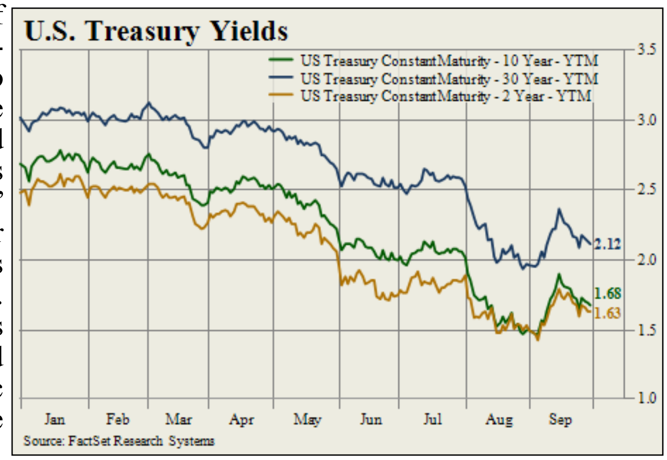
- While net earnings have fallen in total, large-scale share buybacks continue to boost earnings per share (EPS) by reducing the ratio's denominator. These share buybacks have been noted as one of the current bull market's largest supporters and have been the subject of much consternation in political arenas. After a record-setting 2018 total and a strong first quarter of 2019, buybacks slowed on both a year-over-year (Y/Y) and quarter-over-quarter (Q/Q) basis to $160 million for the second quarter. The trajectory of buybacks bears watching as a sustained decline may bode threatening for stock prices. However, the recent decline has returned buybacks to a more normalized level after the Tax Cuts and Jobs Act of 2017 led to the historic spike in 2018. Further, investors globally now hold over $3.7 trillion in money market fund balances available for investment, which should serve to bolster equity prices as interest rates remain at low levels.



FIXED INCOME

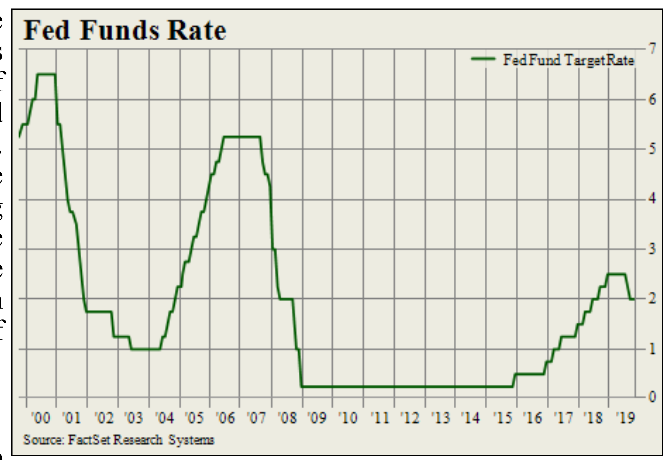
- Fixed income markets generally provided strong returns in the third quarter as interest rates continued to decrease. USTs in aggregate provided a total return of 2.5% as measured by BofA-ML indices. This brought their year-to-date return to 7.9%. Investment-grade corporate bonds provided a return of 3.1% for the quarter and 12.9% through the first nine months of the year. High-yield (junk) bonds slightly underperformed due to less sensitivity to interest rates and provided a 1.3% return for the quarter and 11.5% total return for the year.

- The bond market continued to display a pessimistic message regarding growth expectations, with rates falling across the yield curve (the spectrum of UST yields across varying maturities). The 10-year UST yield plummeted from 2.00% to 1.46% before rising to 1.68% to close the quarter. A widely-followed segment of the yield curve is the relationship between 2-year USTs and 10-year USTs. This relationship "inverted" with the 10-year USTs yielding less than 2-year USTs briefly in August. This was notable as this inversion often precedes recessions historically. Additionally, 30-year USTs briefly yielded less than 2% for the first time ever, a signal that bond investors in aggregate do not believe economic growth or inflation will notably increase in the foreseeable future.



Source: FactSet Research Systems

- The Federal Reserve (Fed) cut the fed funds rate twice in the third quarter, indicating concerns over economic growth and a lack of concern of increased inflation. This brought the target fed funds range from 2.25%-2.50% to 1.75%-2.00%. Both cuts were widely expected and were reflected by the forward rates markets heading into the decisions. These markets are anticipating more moves by the Fed and are pricing in more than a 70% chance of an additional cut in October and a 44% chance of two more cuts in 2019.

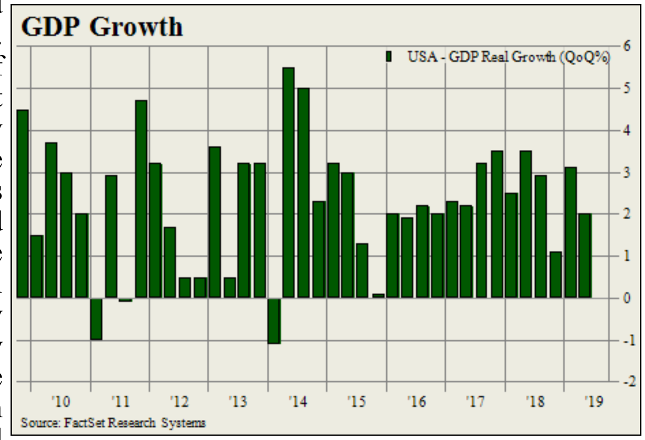


Source: FactSet Research Systems

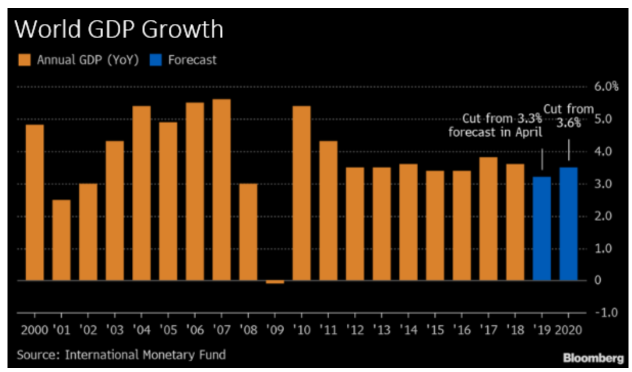
- The Fed acts as a lender of last resort to help stabilize financial markets and institutions in times of crisis. In September, the Fed decided to step in and inject capital into the repo (short for repurchase agreement) market. The repo market serves as the "plumbing" of the financial system by distributing cash to where it is needed via collateralized short-term borrowing. In a short time period, a great deal of cash was needed to pay corporate taxes and absorb large issuances of Treasury securities, leading repo rates to spike as high as an annualized 10%. Many banks were either unable or unwilling to step in and fully take advantage of these rates (by lending the amount of cash demanded by the market) due to post-financial crisis liquidity and excess reserve regulations. Because of this confluence of events and the ultimate stability of the banks in question, the spike in rates was mostly interpreted as a transitory liquidity crunch and not a sign of the greater financial instability usually present when the Fed intervenes.

ECONOMICS

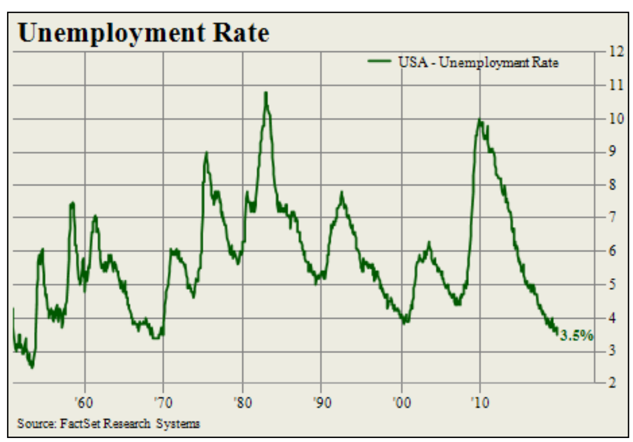
- The third and final estimate of second quarter gross domestic product (GDP), which measures real annualized growth in the U.S. economy, was 2.0%, down from 3.1% for the first quarter. The consumer was primarily responsible for this growth as household spending was up 4.6% in the second quarter. Negative contributions from business fixed investment and exports brought GDP down. Consumer confidence remains high because of low unemployment, wage growth, and the first growth of inflation-adjusted median family income in 20 years; a 6.8% increase since January 2017 to $65,084. The savings rate has been running 7.5%-8.0% in 2019 and household balance sheets are in good shape. However, the consumer is not immune to evolving geopolitical uncertainties. Consumer confidence fell sharply to end the quarter, and consumer spending only increased 0.14% in August versus average monthly increases of 0.49% in the first seven months of 2019. As a result, consensus third quarter GDP estimates have been downgraded to below 2%.



- Due to a slowing global economy this year, the International Monetary Fund (IMF) reduced its estimate of global economic growth to 3.2% for 2019. This is down from 3.6% in 2018 and 3.8% in 2017. Slowing global growth, tariffs, and geopolitical uncertainties are having a profound effect on world trade. The World Trade Organization estimates world trade will increase 2.5% in 2019, down from 5.5% in 2017. World trade involves mostly goods, so the slowing of the global economy and trade activity is impacting global manufacturing. It is now contracting and is more pronounced in countries with larger manufacturing bases such as Germany, Japan, South Korea, and China. Manufacturing has declined for two consecutive months in the U.S. for the first time since 2016. It is important for this sector to recover so there is no spillover effect to the service sector of the U.S. economy. Growth of manufacturing and the service sector both peaked last November, although the latter is still growing moderately. While the IMF also reduced global growth expectations for 2020, it is forecasting growth to pick up to 3.5% for the year.



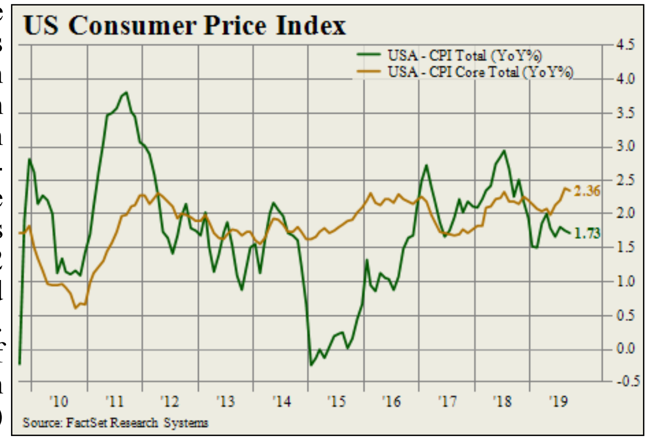
- The September jobs report provided a mixed message on employment. The unemployment rate of 3.5% was the lowest in 50 years and is at a multi-decade low for all groups based on education and ethnicity. 136,000 jobs were added, and job growth reports for the prior two months were revised up by 45,000. Employment gains are slowing, however. For the first nine months of the year, 161,000 jobs were added per month verses an average of 223,000 in 2018. This may be reflective of a tight labor market but could also be indicative of a slowdown in U.S. economic growth.



ECONOMICS

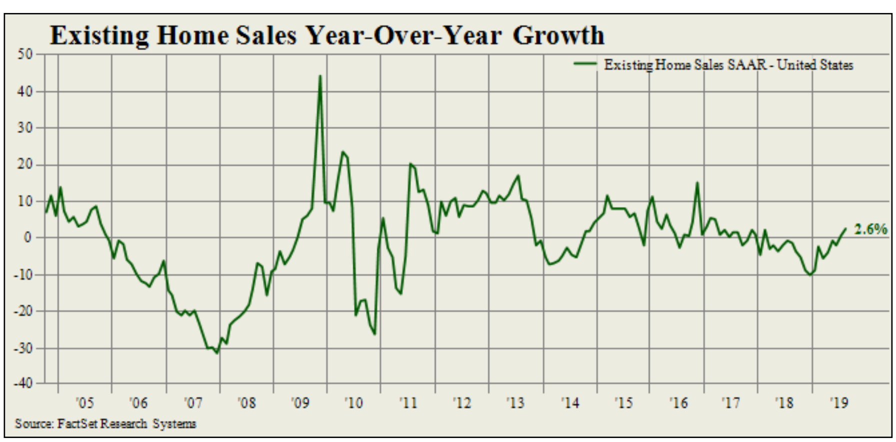
There is evidence to support both cases. Average hourly earnings were flat but increased 2.9% on a Y/Y basis. This was down from 3.2% the prior month and a post-recession peak of 3.4% in February. The employment rate in September for prime-age workers, ages 25-54, was 80.1%, equal to the peak in 2007, indicating a tighter labor market. The share of all Americans working or looking for work held steady at 63.2%.

- Inflation has increased but still falls short of the Fed's 2.00% target. The Labor Department's Consumer Price Index (CPI) increased 1.7% in September from a year earlier. Core CPI, which excludes food and energy, increased 2.4% Y/Y in August and September. These were the largest 12-month gains since 2008. The Commerce Department's Personal Consumption Expenditures Price Index (PCEPI) was up 1.4% for the 12 months ending in August. The Fed's preferred inflation measure, the Core PCEPI, was up 1.8%. The CPI and PCEPI have alternate weightings of goods and services and calculate substitution effects differently. The Producer Price Index (PPI) increased 1.4% and Core PPI increased 2.0% for the 12-month period ending in September.



- The federal government's fiscal deficit was $1.07 trillion for the first 11 months of the fiscal year, up 18.8%. Receipts were up 3% but outlays increased 8%. The deficit is running at 4.5% of GDP, and will exceed $1 trillion for the fiscal year ending in September for the first time since 2012. Government debt increases with the deficit and now stands at 78% of GDP. The trade deficit increased by $28.2 billion year-to-date through July, up 8.2%. Exports decreased by $3.4 billion and imports increased by $24.9 billion. Goods comprise over 100% of the trade deficit while the U.S. maintains a trade surplus in services. For example, the total trade deficit was $54.0 billion in July, but the goods deficit was $72.5 billion. The strong dollar also has not helped exports as it hit a two-year high recently.

- The housing market has also perked up. Existing home sales increased 0.6% in July and 2.6% in August on a Y/Y basis, the first Y/Y increases in 17 months. New home sales occurred at a seasonally-adjusted annual rate of 713,000 in August. The housing market has been helped by lower mortgage rates and moderating price increases. The 30-year fixed mortgage rate is now below 4%, down from over 5% last November. The S&P/Case-Shiller National Home Price Index increased 3.2% Y/Y in July, lower than price increases of 6.0% in the prior year. Home prices have increased for 91 consecutive months. There is a 4.2-month supply of homes on the market but a much smaller supply of moderately priced homes. Some segments of the housing market have almost doubled in price since 2012 according to the National Association of Realtors.



A Race to the Bottom

The Fed lowered short-term interest rates, the fed funds rate, by 0.25% at the end of July, the first rate cut since 2008. This was done in part because of slowing global growth (particularly in Europe), the fading impact of tax cuts and fiscal stimulus in the U.S., manufacturing weakness, the longer-term inflation outlook, and trade tensions with China. Fed Chairman Powell called it a “mid-cycle adjustment” and said it was not unreasonable to expect a modest series of tweaks to “sustain the expansion.” It was considered an insurance policy to protect future economic growth. The question is whether this is a one-off cut or the beginning of a series of cuts.

The key to determining future interest rate policy will be economic growth in the U.S. and globally as well as inflationary expectations. The latter remain subdued. The Fed will likely have to react to what other central banks are doing; Australia, New Zealand, India, Thailand, and other countries have already cut short-term interest rates. The European Central Bank and the Bank of Japan have also signaled they are ready to cut rates. Interest rates are trending lower around the globe and central banks will undoubtedly react to others’ actions.

The primary concerns facing central bankers are a downturn in global manufacturing, in large part due to declining export orders, and uncertainty caused by global trade tensions. While manufacturing comprises only 11% of GDP, it plays an outsized role in the business cycle. For example, during the 2007-2009 recession, about two-thirds of the total decline in U.S. GDP was attributed to reduced household spending on durable goods and business investment in new capital equipment even though together they accounted for less than 15% of total GDP. Manufacturing is a much larger part of the economies of China, Japan, and the Eurozone, especially Germany. Manufacturing is contracting in more than 60% of countries worldwide, including China, Japan, and Germany, and is growing in the U.S. at its slowest pace since 2009.

The other big issue facing central bankers and global economies is trade tensions between China and the U.S. and the uncertainty of how other countries will react. For decades, global trade was the main driver of global growth – on average it grew annually at 2%-3% more than global GDP. This year for the first time in decades, global trade is growing slower than global GDP, which itself is nothing to write home about at an estimated 3.2% for 2019 (2.6% for developed countries). This is the first sign of deglobalization.

The trade talks between the U.S. and China have seen mixed results to date. The U.S. had previously imposed tariffs on $250 billion of Chinese imports. In August 2019, an additional $300 billion in tariffs were announced for September 1 but then partially delayed until December 15. Since the trade war with China started, Chinese exports to the U.S. have fallen by nearly 13% and U.S. exports to China are down nearly 17%. Since China has more exports to the U.S. than vice versa, it may be reviving an old tactic – devaluing its currency. China sets a daily yuan anchor and lets it fluctuate daily by +/- 2%. After President Trump’s threats of tariffs on an additional $300 billion of imports, China let the yuan break the symbolic “7” level for the first time since 2008. The yuan depreciated from 6.69 per U.S. dollar to 7.06 recently, a devaluation of 5.5% since June 2019. The U.S. immediately labeled China a currency manipulator but it is up to the International Monetary Fund to decide if China is truly manipulating their currency.

The devalued currency would help China offset some of the increased tariffs costs, but there are downsides; for one, import prices rise. Also, China has almost a trillion dollars of dollar-denominated debt, mostly corporate, which becomes more expensive to repay with a weaker yuan, and a weaker currency encourages capital flight. When the yuan was devalued in 2015, it cost China almost $1 trillion of foreign-exchange reserves and it had to impose controls on capital outflows. It appears China is digging in for a protracted trade fight and to possibly wait out the Trump presidency.

The trade war may be evolving into a currency war. The Trump administration professes to like a strong dollar but accuses other countries, especially the Eurozone, of intentionally weakening their currencies. But this is a symmetrical process; if the U.S. dollar is strong, other currencies are weaker and vice versa. Any time a country lowers its central bank interest rate, it will be accused of doing so to weaken its currency and give its exports a competitive edge in the global economy. This is referred to as competitive currency devaluation, but central bankers would not admit to such. When the Fed cut rates in July, there was little to no discussion about doing so to help U.S. exports. Unfortunately, with a slowing global economy, more central bank interest rate cuts will likely be forthcoming, creating more trade tensions. Uncertainty bolsters demand for safe havens such as the U.S. dollar, Japanese yen, Swiss franc, and gold. This will make the dollar stronger as it has the yen and gold.

A risk now is central banks get caught in an adverse feedback loop. As the global economy slows, central banks cut interest rates to address slower domestic growth and low inflation. If the trade tensions escalate, this increases risk and uncertainty causing global growth and trade to decline further, promoting more central bank interest rate cuts. Once in the loop, it becomes difficult to disengage. Central banks cannot fall out of sync with other central banks, so they chase each other down, setting off a spiral of currency devaluations. A global recession would exacerbate the race to the bottom.

The bottom used to be zero, but now it is negative. There is now roughly $17 trillion of government and corporate bonds with negative yields, mostly in Japan and Europe, up from $6.04 trillion in October 2018. Switzerland has a 50-year bond with a negative yield, and several Eurozone countries have bonds with negative yields out to 30 years' maturity. Buying these bonds and holding to maturity guarantees a loss. Not many investors will hold the bond to maturity; if the bond one year later has a more negative yield, it can be sold for a profit. In Denmark and Germany, it is possible to get a 10-year mortgage with a negative yield, meaning the bank pays you money to borrow for 10 years. The European Central Bank, the Bank of Japan, the Swiss Bank, and several other central banks have already imposed negative interest rates and signaled they may be heading more negative. Where it all stops depends upon global economic growth and inflation. A global recession would escalate the downward spiral of interest rates.

If other countries cut interest rates, the Fed will be under tremendous pressure to stay in sync. Our interest rates, short-term and long-term, remain some of the highest in the developed world. Cutting short-term interest rates may not be enough to weaken the dollar if other countries are also cutting. The U.S. could intervene directly in the currency markets to weaken the dollar as it has done on at least six occasions in the last 50 years. It would be hard to do so on its own given the role of the dollar as the world's reserve currency so the Fed would have to do so in concert with other big central banks. Even though the U.S. dollar is near a multi-decade high on a trade-weighted basis, convincing other central banks that it is overvalued would be a challenge.

Where this all ends, nobody knows. The 10-year Treasury yield has already fallen by nearly 50% since last fall. Unthinkable a decade ago, negative interest rates in the U.S. are not beyond the realm of possibility in today's environment. Negative interest rates are good for borrowers but terrible for savers and the banking system. Who would not like to be paid to take out a mortgage? The biggest challenge with a race to the bottom in interest rates is that while somebody may get there first, this competition may very well have no winner. History shows currency wars certainly increase the probability of a global recession.