Investment Commentary: 9/2019

Stocks struggled in August as rising trade tensions between the U.S. and China weighed on market sentiment. Weak global economic data and the inversion of the 10-year and 2-year Treasury yield curve added to concerns. Hope for a de-escalation in trade tensions at the end of the month helped the S&P 500 recover some of its losses, but it still finished down 1.6% for the month. A strong U.S. dollar, negative interest rates and geopolitical concerns pushed foreign markets lower, led by emerging market stocks down 4.9%. **Increasing volatility and negative stock markets led investors to seek out safe havens**, pushing global yields lower and bringing the market value of negative yielding debt to over $16 trillion. The flight to quality and negative yields around the world drove strong returns for U.S. bond markets. Core U.S. bonds finished the month up 2.6%, while other defensive sectors like real estate, utilities and consumer staples had strong returns as well.

"Overall, it seems as if the U.S. economy is slowing but not stalling…"

Recent ecnonomic data showed signs of slowing and suggested the U.S. economy is not immune to global trade tensions. The manufacturing part of the economy remains the weak spot as shown by the drop in the August Manfacturing PMI to 49.9, the lowest reading since September 2009. While consumer confidence declined during the month, actual domestic demand has remained relatively resilient. **So far the strength of the labor market and rising wages are outweighing trade and recession concerns.** Overall, it seems as if the U.S. economy is slowing but not stalling, and it's likely the Fed will soon cut rates at the September meeting. With central banks around the world adopting a loose monetary policy, it seems probable the U.S. will avoid a recession. This potentially could creating a positive environment for financial assets, assuming trade mishaps or other geopolitical mishaps can be avoided.

In this month's commentary we discuss several stock market cycles that are reaching extreme levels and the potential catalysts that may cause these trends to reverse.

Watching for Catalysts

It is no secret that the stock market often runs in cycles. These cycles can be driven by a particular characteristic of the stock market or an investment style, and occasionally the cycles will go to extremes. The challenge is, of course, it's hard to predict how long cycles will last or how extreme they may get before they change. **A few cycles we've been watching are approaching extreme levels: the underperformance of dividend paying stocks; the outperformance of growth stocks relative to value; and the outperformance of US stocks relative to foreign stocks.** We highlight each of these cycles and discuss a few catalysts that could lead to their reversal.

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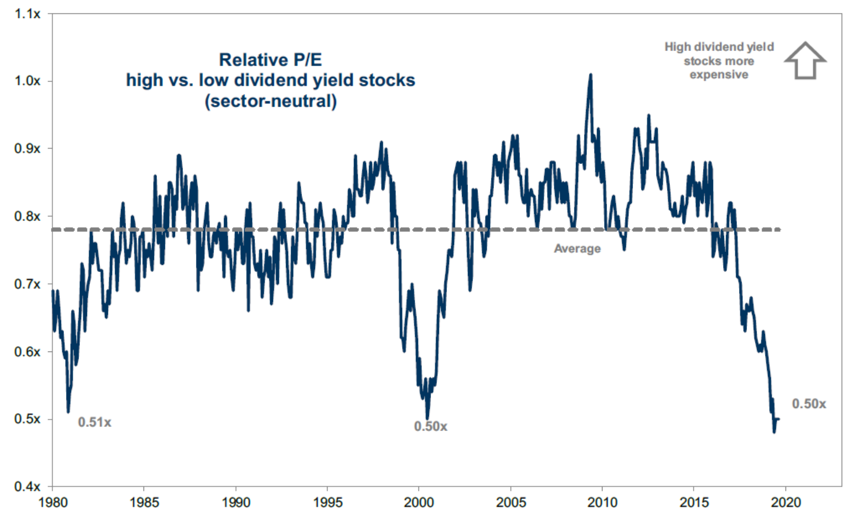
Dividend paying stocks: the chart (right) shows the valuation gap between high and low dividend stocks recently reached the widest level it has been in the last 40 years. In addition to low expectations for future dividend growth, this discount reflects a generally wide valuation dispersion across the US equity market, and investor preference for expensive growth stocks.

The valuation gap between high and low dividend yield stocks is nearly the widest ever



Source: Compustat, Goldman Sachs Global Investment Research

Growth vs. value: the chart below illustrates the vast outperformance of growth stocks relative to value stocks since the financial crisis of 2008. It also highlights how the US stock market in the past twenty years has been dominated by three distinct cycles which culminated in market peaks. At the 2000 peak, it was growth stocks that drove the market to outrageous values. At the 2007 peak, it was value stocks. It's starting to look like we may be forming another peak in growth stocks.

U.S. large cap equities: Value minus growth

As of 30 June 2019
SOURCE: Bloomberg
Refer to appendix for index, outlook and risk information.

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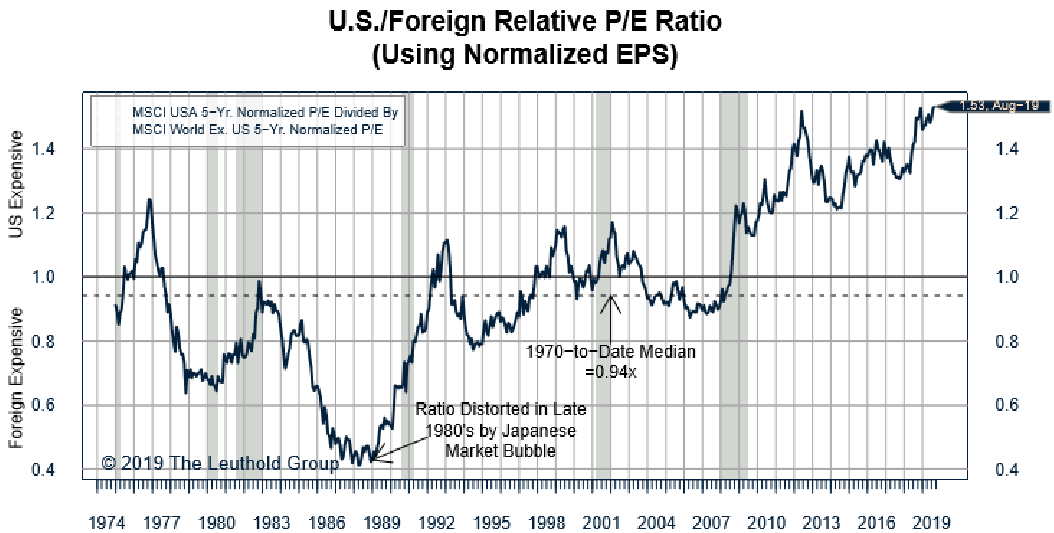
US vs. Foreign stocks: Since the 2008 financial crisis, the performance of US stocks has vastly outperformed foreign stocks. The chart below highlights the relative valuation of US stocks to foreign stocks is trading near its highest level over the past 40 years.



What stands out, is the cycle of extreme relative performance of the different investment styles highlighted in each chart. **With confidence we can state all of the above trends will reverse and we are likely to see significant outperformance of dividend paying stocks, value stocks and foreign stocks. We just can't tell you exactly when that reversal will take place.** However, we can look at history to see what have been the catalysts for previous cycles to reverse. **Here are some of the potential catalysts that history suggests could lead to a reversal of the current trends:** a mid-cycle economic slowdown; a recession or financial crisis; a significant change in direction of interest rates, currencies, and/or inflation; regulatory changes; political crisis or war.

We can't know what or when the next catalyst will arrive, but with confidence we can say it is an excellent time to overweight dividend paying, value and foreign stocks in your investment strategies. **Note- as we are writing this commentary we are in the midst of a significant rotation out of growth momentum stocks into value stocks. We don't know how long this rotation will last, however making changes in your portfolio to emphasize value, dividends and foreign stocks, should significantly improve both absolute and relative portfolio returns over the next three to five years.**

- AWM Investments (September 2019)