The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets October 2019

From: *Philadelphia* Investment Management Group

OVERVIEW

- *The Upward Mobility of the Financial Cycle Seems to Continue to be Intact and Concern Over Any Major Correction in U.S. Markets Does Not Seem Warranted at This Time.*
- *Monetary Policy Appears to be Changing in Favor of Fiscal Policy. Spending and Taxing Decisions Appear to Now Have the Upper Hand in Guiding and Sustaining the World's Economies.*
- *The Administration's Insistence on Lower Rates Will Not Deter Foreign Money From Entering U.S. Markets Despite the European Central Bank's Resumption of Asset Purchases and Continued Negative Yield Conditions.*
- *Trade Negotiations Will Linger on With the Final Resolution Anyone's Guess in Substance and Timeframe.*

THE ECONOMY

The economy has long been a selling point for the Trump Administration, which inherited steadily declining employment numbers and seemingly non-existent inflation. The trend has continued under this Administration, and we are now in the midst of the longest run of economic growth. However, while our view is for continued forward progress, recent indicators suggest some cause for concern for what lies ahead. Bond yields have inverted, and business investment has slowed. Recent jobs and unemployment numbers continue to point to healthy—albeit easing—labor market expansion.

Conversely, there is a school that believes the economy is headed in the wrong direction. The ongoing dispute in the trade war with China has contributed to a growing sense of international uncertainty, and this may well be responsible for the slowdown in business investment, as companies with international supply chains have been left in the lurch. However, the adjustments necessary in the supply train to counter the loss of important product imports, primarily from China, seem to be quietly taking place. The move by U.S. manufacturers to go to other countries for supplies away from China does not seem to bother the Administration to any great degree. The overriding concern is with our enormous trade deficit with China, which is far and away front-page headlines.

What we do know is the economy is more dependent now, than ever before, on what happens with Brexit, Europe and trade policies with China. President Trump knows he needs the cooperation of Federal Reserve Chairman Powell in supporting the fragile U.S. economy in its confrontation with China by lowering the Fed's benchmark interest rate. In order for the Fed to maintain credibility as an independent Federal Reserve, Chairman Powell must put up as good a front as possible against White House pressure.

Of course, an additional uncertainty now is the impeachment process going on in the House. Our best guess is that the impeachment will be voted for in the House but, most likely, not agreed to in the Senate. While all of this should not have any great influence on the comments we have made so far in our commentary, it does, nevertheless, get front-page headlines and there is always a question mark as to the outcome.

FINANCIAL MARKETS

EQUITIES

Overall, for the third quarter, broad U.S. equity performance, as measured by the S&P 500, turned in a positive 1.70% return, as set forth in the table below, well ahead of the actual loss of 3.80% experienced by emerging markets. In addition, as evidenced by the index performances below, the quarter's gain in the market rested pretty much with the large capitalized companies. The NASDAQ index of multiple market cap companies, as well as the Russell 2000 index of smaller companies, did not fare anywhere near as well as the larger caps.

	Equity Returns*			
Index	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	1.70%	4.30%	13.65%	20.55%
Dow	1.83%	3.21%	11.81%	17.51%
NASDAQ	-0.09%	3.58%	16.49%	20.56%
Russell 2000	-2.40%	2.10%	14.58%	14.18%

*Total: price change + reinvested dividends

Again, as we expected, with two Fed rate reductions for the year through the third quarter, interest-sensitive areas, such as Real Estate, Utilities and Consumer Staples, were the best gainers, with Energy showing the biggest loss, as shown in the following table. Another interesting observation is that, finally, value stocks are taking the front seat away from growth. As investors become more cautious with the state of the economy, there is a natural shift to less expensive companies, measured by their market prices against specific financial ratios.

	S&P 500				
		Returns*			
Sector	**Weight**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
• Energy	4.5%	-6.30%	-2.83%	16.43%	6.00%
• Materials	2.7%	-0.12%	6.31%	10.30%	17.11%
• Industrials	9.3%	0.99%	3.57%	17.20%	22.58%
• Cons. Discretionary	10.1%	0.51%	5.28%	15.73%	22.46%
• Consumer Staples	7.6%	6.11%	3.72%	12.01%	23.28%
• Health Care	13.7%	-2.25%	1.38%	6.59%	5.64%
• Financials	12.9%	2.01%	8.00%	8.56%	19.60%
• Info Technology	21.9%	3.34%	6.06%	19.86%	31.37%
• Communication Svcs	10.4%	2.22%	4.49%	13.98%	21.74%
• Utilities	3.6%	9.33%	3.48%	10.84%	25.40%
• Real Estate	3.2%	7.71%	2.46%	17.53%	29.71%

09/30/19
*Price + income
Source: S&P Dow Jones

Further insight into the broad measures of stock performance is the very lopsided nature of the past quarter's equity performance. While we would like to see a broader acceleration of stock prices through many sectors and industries, that was not the case in the third quarter. We have always maintained a balanced portfolio of many of the S&P sectors with weights more in line than not with the S&P 500, our benchmark equity index. The greater or lesser emphasis we place with the sectors will be the result of our outlook for the equity markets.

FIXED INCOME

For the second consecutive meeting, Federal Reserve policymakers cut their benchmark rate one-quarter point to a target range of 1.75-2.00%. Will there be more cuts? The answer is "possibly," as the Administration would like to see the rate at "0" to counter any negative fallout from the trade issues and disruptive effects upon global growth and the current economic expansion.

The yield on the benchmark 10-year U.S. Treasury fell to near record lows in early September before recovering slightly to end the month at 1.67%, as reflected below, down from 2.01% at the end of the second quarter. At the end of 2018, the 10-year Treasury yield stood at a full percentage point above where it stood at quarter end. Short-term rates are also on a downward trajectory surpassing, at times, longer rates, creating an inverted yield curve.

Base Interest Rates

	U.S. Treasury Yields				
	Maturity				
Date	3 mo.	2 yr.	5 yr.	10 yr.	30 yr.
Dec 31, 2018	2.35%	2.49%	2.51%	2.68%	3.01%
Jun 30, 2019	2.09%	1.76%	1.77%	2.01%	2.53%
Sep 30, 2019	1.82%	1.62%	1.55%	1.67%	2.11%
Change:					
6/30-9/30/19	-0.27%	-0.14%	-0.22%	-0.34%	-0.42%
12/31-9/30/19	-0.53%	-0.87%	-0.96%	-1.01%	-0.90%

During the last three months, the U.S. Corporate/Government bond index returned 2.71%, for an impressive 9.83% year-to-date return, as shown in the following chart. In all areas, long bonds significantly outperformed the intermediate area for both the quarter and year to date. Credit spreads were relatively stable in the quarter with a surge in supply in September, and investors have continued to pour money into the investment grade market. As a result, corporate issuers capitalized on the opportunity to lock in historically low coupons, making September one of the most active months on record. The municipal market also had strong performance for the third quarter, with the Municipal index returning 1.62%, for a notable 7.06% for the year.

Fixed Income Returns

Index	3rd Qtr	2nd Qtr	1st Qtr	YTD
Corporate/Govt.	2.71%	3.55%	3.26%	9.83%
Int. Corporate/Govt.	1.39%	2.59%	2.35%	6.46%
Long Corporate/Govt.	6.56%	6.45%	6.17%	20.43%
U.S. Treasury	2.51%	3.06%	2.18%	7.95%
- Intermediate	1.15%	2.32%	1.57%	5.12%
- Long	7.49%	5.90%	4.59%	19.07%
Corporate	3.07%	4.35%	5.01%	12.94%
- Intermediate	1.81%	3.13%	3.80%	8.99%
- Long	5.75%	7.06%	7.85%	22.10%
- Quality				
- AAA	4.04%	4.86%	4.98%	14.53%
- AA	2.99%	3.53%	3.73%	10.60%
- A	2.92%	4.12%	4.59%	12.09%
- BBB	3.17%	4.66%	5.58%	14.00%
Municipal	1.62%	2.34%	2.95%	7.06%
- Intermediate	0.73%	1.59%	2.09%	4.47%
- Long	2.16%	2.80%	3.49%	8.69%

Source: ICE BofA Merrill Lynch

The ongoing concern in the present economic cycle is the desire on the part of institutions and individuals alike to reach for higher-yielding securities to maximize current income, as the yield on shorter, higher-quality paper falls below two percent. This will be setting these investors up for a fall if the economy does retreat. For some time now, our decision to invest in only investment grade bonds results from our risk concern with non-investment grade securities. Also, one simply does not get the "bang for the buck," in our opinion, by taking risk in lower quality and emerging market paper. Another strategy, as we outlined in our last market commentary, is to ladder maturities of bonds over a period of a few years.

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In conclusion, so much of our economic future rests with what's going on in the rest of the world. We are no longer solely in control of our own destiny. Yes, we are still the reserve currency of the world with over 80% of international trade being conducted in dollars, and we are still the safe haven investment in times of concern. But the strength of this country, which gives us this premium position in the world, is dependent on both a strong domestic and international business climate. On the domestic front, it is our belief that the realignment of our trade policy with China and the rest of the world will result in a betterment of our trade deficit. And the betterment of our trade numbers will help to reverse the outflow of dollars overseas. China, we all know, holds the largest amount of U.S. debt, some $1.3 trillion, followed by our trade deficit with Japan. These numbers need to improve. The U.S., we believe, is on the right path in becoming, once again, more self-sufficient.

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Philadelphia Investment Management Group
105 Clarke Avenue
Pocomoke City, MD 21851