Peak Asset MANAGEMENT

3RD QUARTER 2019 UPDATE

October 11, 2019

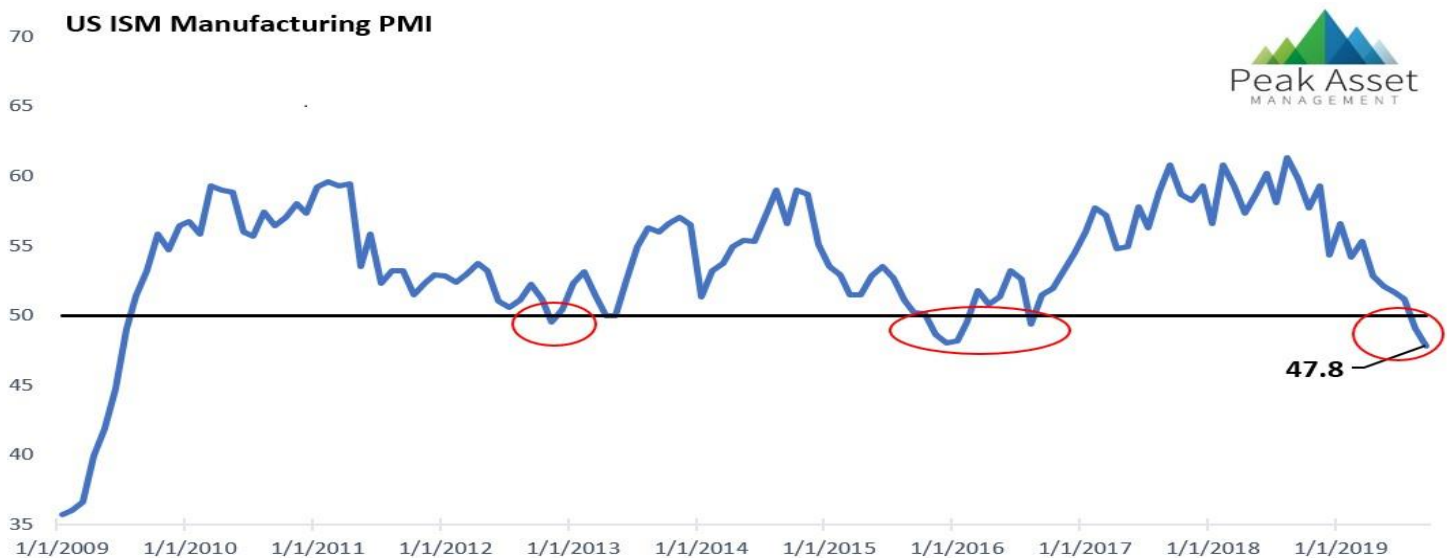
Investors clearly could do much better if they knew what lies ahead. But they can't. Few people can accurately predict what the future holds in store for the economy and markets, and fewer still know enough about these things to out-think and thus out-invest the general consensus of investors whose views are incorporated into – 'discounted by' – the market prices of securities. But we know economies and markets follow an up-and-down pattern called a cycle and, importantly, knowing where we currently stand with regard to the economic cycle and the market cycle can give us a better idea of what lies ahead. This is a process through which investors can get the odds on their side.

Howard Marks, Co-founder of Oaktree Capital Management
and author of *Mastering the Market Cycle*

The longest business cycle expansion in U.S. history continues. From its inception at the nadir of the great recession, the length of the expansion has reached 10 ¼ years and counting. A record in duration, however, does not necessarily imply a record pace of growth. The average rate of growth through July 2019 was a historically moderate 2.3% annualized.[1] Slow and steady has won the race -- score one for the Turtle![2]

At least in part, the record duration of the expansion can be explained by smaller cycles operating beneath the surface, allowing the economy to effectively moderate itself without either overheating or falling into a recession. There are 3 distinct cycles illustrated in the chart of the ISM Manufacturing Purchasing Managers Index (PMI) below. While manufacturing has shrunk as a percentage of the U.S. economy over time, it remains a proxy for the more cyclical forces. In the chart, a reading above 50 indicates manufacturing is expanding and a reading below 50 indicates that manufacturing is contracting. At the bottom of each these smaller cycles, the Manufacturing PMI has fallen into contraction territory.

Monetary stimulus, both by the U.S. Federal Reserve (the Fed) and other global central banks, is well underway. If we could create some positive catalysts (some clarity on global trade, a solution to Boeing's 737 Max failures and a timely settlement between GM and its workers would be a great start), a new manufacturing cycle could help extend our economic expansion further into record territory.



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[1] *On a rolling 4 quarter basis, the growth in GDP in this expansion has ranged from a low of 0.95% in the 4 quarters ending March 2011 to a high of 4% in the 4 quarters ending March 2015.*

[2] *The slowest growth rate in a previous US economic expansion that I could find was during the transition out of World War II, from Oct 1945 to Nov 1948, with average annual growth rate of 1.5%. The following expansion, from Oct. 1949 – July 1953, ran at a 6.9% average annual growth rate, the fastest in the post WW II era.*

Turning to the financial markets, U.S. stocks, as represented by the S&P 500 in the chart below, have basically been going sideways since hitting an all-time high in January 2018 (with a nice whoosh down in the 4th quarter of last year and a nice whoosh back up in the first 4 months of 2019). The closing price of the S&P 500 on September 30, 2019 was about 3.6% above the high from January 2018 (note: the price level does not include dividends). Based on the slowing economic cycle discussed on the previous page, the stock market, while remaining near all-time highs, does not yet have the conviction necessary to surge ahead of the economy. It is also not collapsing in fear of a recession.

Meanwhile, in bond land, as I referenced earlier in relation to monetary stimulus, the Fed cut its federal funds overnight lending rate by ¼ of 1% two times in the 3rd quarter. The financial markets are pricing in another cut later this month that would take the rate back down to a 1.5% -1.75% range. The yield on the 10-year U.S. Treasury note, which ended the 3rd quarter with an interest rate of 1.65%, has also moved lower and is back near the smaller cycle lows of 2012 and 2016.

The divergence between stock prices and the interest rate on the 10-year U.S. Treasury note that I wrote about in our 1st quarter letter has grown even larger. Either stocks near their highs are right or interest rates near their lows are right. Either the economy is going to start accelerating upward or it is going to roll over. A real-world inflection point is drawing ever closer (still!). Howard Marks, whose quote opened this letter, would likely counsel that increasing your investment risk in either stocks or bonds at this point in the various cycles is not putting the odds in your favor. And Peak would agree. Now is a time for prudence and patience.

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We appreciate your business and we continue to work hard to earn the trust that you have placed in us. Please let us know if you have a friend or family member that could use our assistance.

John McCorvie, CFA

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