CURBSTONE FINANCIAL
MANAGEMENT CORPORATION

From the Curb

Letter to Clients
Quarter Ending September 30, 2019

Markets in the third quarter of 2019 looked surprisingly similar to the second quarter as U.S.-China trade war uncertainty and a lack of clarity on future interest-rate policy caused a sharp increase in volatility. Despite the turmoil, the S&P 500 remained resilient and ultimately recouped mid-quarter losses to finish not far from the new all-time highs established in late July.

The third quarter started strong as news of a "trade truce" between the U.S. and China combined with better-than-expected second-quarter corporate earnings to propel the S&P 500 to new all-time highs. Also helping the markets' rally was a 25 basis-point cut in the Fed Funds Rate on July 31st, the first since 2008.

But that strong start to the quarter was quickly undone in early August thanks to increased tariffs between the U.S. and China, uncertainty over future Fed policy, and concerning signals from the bond market regarding economic growth and inflation.

The U.S.-China trade truce that was agreed to in late June didn't last much more than a month as President Trump announced new 10% tariffs on $300 billion worth of Chinese imports on August 1st. Then, later in the month, China retaliated by levying various new tariffs on $75 billion worth of U.S. imports, and President Trump immediately responded by increasing existing tariffs on all $550 billion of Chinese imports. The tariff tit-for-tat weighed on markets throughout the month.

Concurrently, stocks were pressured by uncertainty surrounding U.S. monetary policy. Although the Fed cut interest rates in July, it did not definitively signal that more rate cuts were coming. This lack of clear guidance and growing worries over future economic growth added to the volatility.

Finally, a closely watched part of the U.S. Treasury yield curve, the "10s-2s spread," inverted, which happens when the yields on shorter-term notes exceeded those of longer-term notes. This signal, last seen in 2007, has historically preceded a recession by an average of 18 months. Although not a perfect indicator, the inversion led to a deterioration in investor sentiment which further dampened enthusiasm for risk assets.

September opened with a perceived improvement in U.S.-China trade relations as President Trump authorized a short delay on the implementation of some of the recently announced tariff increases. Both the U.S. and China agreed to face-to-face meetings in October in another attempt to end the 18-plus-month trade war. Additionally, the Federal Reserve cut interest rates for a second time on September 18th and clearly signaled more willingness for future cuts, if conditions warranted further action. Lastly, after a brief period of being inverted, the yield curve normalized in early September in part due to better-than-expected U.S. economic data and subsequently easing concerns of a future recession.

In sum, the volatility we witnessed in the third quarter, which remains historically typical, was not surprising due to the numerous macroeconomic uncertainties facing this market and the economy.

The quarter was also a reminder that volatility does not automatically mean poor performance as stocks provided another quarter of positive returns.

The increase in volatility we saw in May, and again most recently in August, is an important reminder that while markets remain broadly resilient, risks to investment portfolios and the economy need to be carefully monitored. There are still multiple unknowns currently facing investors as we begin the final three months of 2019.

First, the ongoing U.S.-China trade war is clearly an important influence on the markets. And while there has been rising optimism for some sort of temporary resolution, the fact remains that the U.S. and China still have substantial tariffs in place on imports, with more potentially coming in December. Those tariffs continue to be a headwind on global economic growth, presenting a risk to markets that we will continue to watch closely.

Turning to the economy, the outlook remains uncertain. Currently, U.S. economic growth is solid and the envy of the world's developed economies. The accommodative policy stance taken by the Federal Reserve will continue to support domestic growth. However, Fed rate cuts don't bring guarantees of sustained periods of economic growth. The US consumer still represents approximately two-thirds of GDP and consumer confidence is a key factor in sustaining a stable economy. We remain vigilant in detecting any potential future economic slowdown. Several of the indicators we are tracking include an inverted yield curve, tight credit, unemployment and hourly wage growth.

Finally, two domestic and geopolitical dramas require close observation over the coming months. Domestically, the impeachment inquiry of President Trump has the potential to weigh on investor sentiment, while internationally U.S.-Iran tensions are as high as they've been in years. Any conflict between the U.S. and Iran will almost certainly be a negative for stocks.

We understand that markets always face uncertainties and we are committed to monitoring these situations and their potential impact on the markets and your portfolio. We know that volatility, regardless of cause, can be unnerving, even if it is historically normal. Our years of experience in all types of markets have taught us that successful investing happens over extended periods of time. Therefore, it is critical to stay invested, remain patient and stick to a plan.

Enclosed are your third quarter reports. Please let us know if you have any questions and know that our entire team is dedicated to helping you achieve your financial goals.