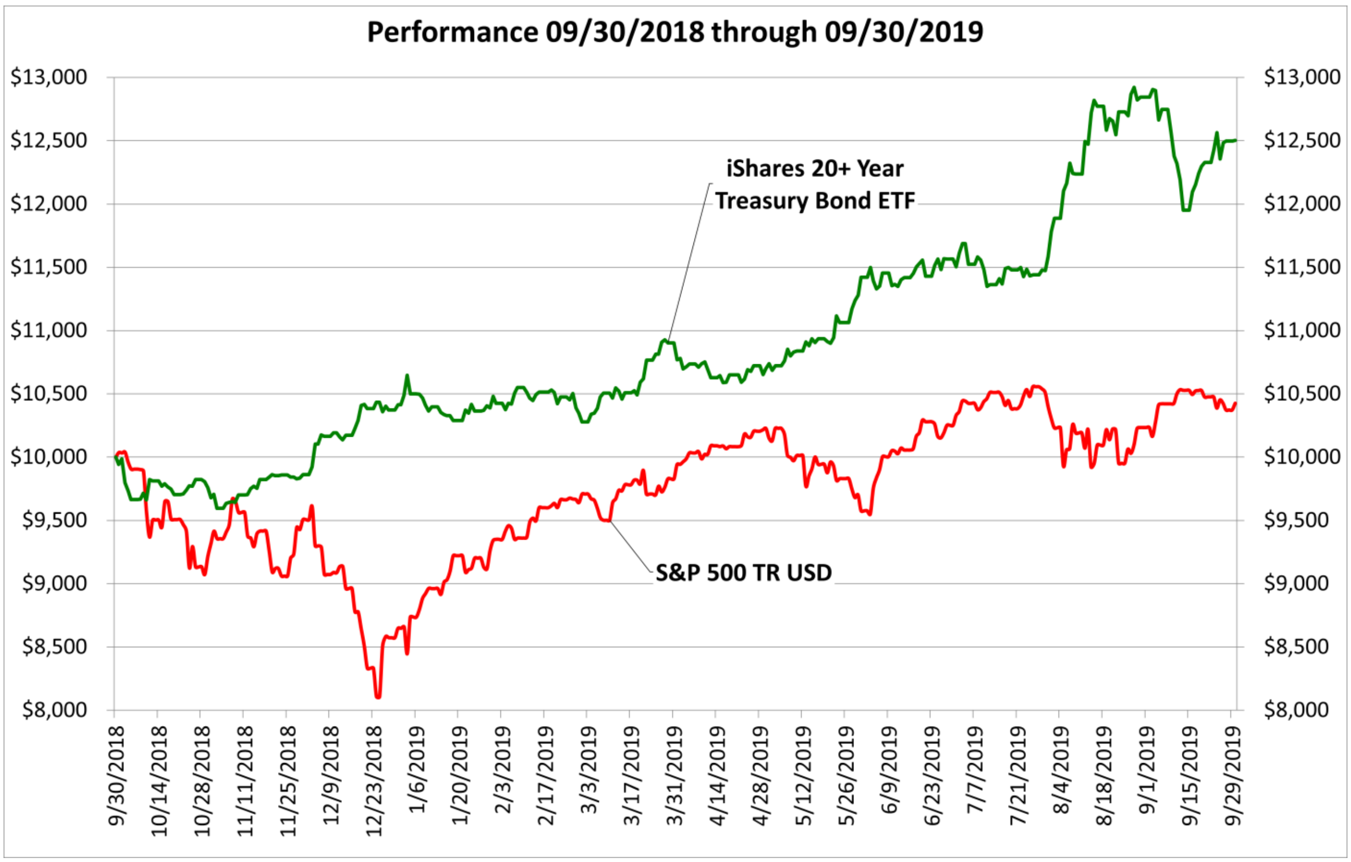
The Dance Continues – A Minuet of Stocks and Bonds

For the past year U.S. stocks and Treasury bonds danced to and fro like partners in a minuet. At times moving in sync, but more often in opposite directions. The chart below – which we have updated from last quarter's newsletter – shows the almost mirror image movement of stocks and bonds starting 12 months ago. In the fourth quarter of 2018, stocks (represented by the total return of the S&P 500) dropped nearly -20%. Meanwhile, long-term U.S. Treasury bonds (represented by the iShares 20+ Year ETF, ticker symbol: TLT) went up, demonstrating how negative correlation (one asset class moving up while another moves down) can provide protection for a portfolio when markets get volatile. TLT accelerated during the last two months of the third quarter when trade tensions escalated, posting a one-year return of +25% vs. +4.5% total return for the S&P 500.



Source: Morningstar, Waypoint Advisors.

Recession worries dominated the third quarter as "safer" assets outperformed their "riskier" counterparts. For example, small-cap growth companies which are often perceived as risky and are often the first affected as the economy begins to slow, were down -4.2%. Large growth companies were up +1.5% during the same period. Furthermore, while growth stocks have dominated this long bull market, value stocks, particularly small and mid-cap, showed improvement in the last three months, reminding us that high quality value stocks, particularly those paying high dividends, tend to do better in recessionary or slow growth periods. International stocks, burdened by the current trade war with China, declined with the developed countries index (MSCI-EAFE) down -1.0% and the emerging markets index (MSCI Emerging Markets) down -4.1%. Meanwhile a broad measure of U.S. bonds, Bloomberg Barclay's U.S. Aggregate Bond index, outperformed all major stock indices returning +2.3% for the quarter.

Next on the Play List – "Don't Let Me Down"[1]

Though the U.S. economy remains in a relatively healthy state bolstered by low interest rates, low inflation, and strong consumer spending, there are signs of potential problems to come. Global growth has slowed due to the trade war between the U.S. and China. Germany's economy, Europe's main economic engine, shrank last quarter and is forecasted to enter a recession with a decline in its GDP this quarter.

Uncertainty is often the early harbinger of recession. Trade restrictions and political tensions can make businesses cautious about investing in the future, causing them to cut back on capital spending and hold off on new hires. Signs of slowdowns in hiring often precede outright layoffs which further point to recession. These uncertainties likely explain why, in August, investors seeking a safe-haven drove the price of a 30-year Treasury bond up and its yield down to an all-time low of 1.903%.[2]

Uncertainty surrounding monetary policy has also fueled volatility in the markets. The Fed's unprecedented easing in the form of rate cuts and a planned increase of its balance sheet at a time when economic data is healthy, and unemployment is at a fifty-year low of 3.5%, goes against conventional wisdom. Investors wonder if the Fed sees more weakness than is evident in the numbers used to gauge the health of the economy. The Fed treading in uncharted waters with these actions may be exacerbating volatility in the markets.

"Money, It's a Gas"[3] or Will Spending Save Us in the Next Recession?

The current economic cycle has been largely fueled by consumer spending. Financial assets have also boomed while real wages have, until recently, been stubbornly stagnant. This has led to a widening disparity between those who have accumulated financial assets versus those who live primarily on their wages.

Why does this matter? Because an increase in consumer spending typically leads us out of recession. But what would happen if the consumer doesn't want to or can't spend more?

Consumer spending now represents 68% of the U.S. GDP[4]. As shown in the left two columns in the table below, the top 10% of income earners (yellow) make up 50.6% of the total dollars

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[1] The Beatles, released in 1969 as the B side of the single "Get Back."
[2] Tullet Prebon, U.S. 30 Year Treasury Bond (TMUBMUSD30Y), August 28, 2019, intra-day low.
[3] Pick Floyd, part of the lyrics from the song "Money" from their 1973 album, *The Dark Side of the Moon*.
[4] U.S. Bureau of Economic Analysis, Shares of gross domestic product: Personal consumption expenditures [DPCERE1Q156NBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DPCERE1Q156NBEA, October 10, 2019.

earned in the U.S., while the bottom 90% of income earners (blue) represents 49.4% of total income.

The far-right column shows that the top 10% of earners spend 69% of their income (after tax). The remaining 31% of money this group earns could either be spent at a later time or could be invested in other income producing assets. The bottom 90% spends 101% of their income – going slightly in debt to maintain their standard of living. But this group only represents 49.9% of total spending. Furthermore, this group does not have the capacity to increase spending without going deeper into debt. Many of these families are already over-extended with student loans, mortgages, and car loans. And many retirees today do not have sufficient assets to cover retirement costs.

Bolstering the economy in recession will likely fall on the shoulders of the top 10% of earners. While we know that this group has excess capacity, will they continue their enthusiasm for spending if the markets start tumbling and they see their financial assets declining?

U.S. Personal Income[5]		
Income Earners	**Distribution of Income**	**% Spending by Group**
Top 10% Group	50.6%	31% Unspent 69% Spent
Bottom 90% Group	49.4%	101% Spent

"Shake It Up"[6]– When Risks Appear or Opportunity Comes Knocking

Employing passive management by following the moves of other investors in index funds or ETFs may work well when the economy is booming, but what happens when the economy begins stumbling? Increased volatility in the markets, as we have been experiencing this year, can cause disarray. Investors following the herd, especially those who depend on distributions to supplement income, may find themselves on a bumpy, scary road with no obvious safe haven in sight. In times such as these, active management can be a superior choice.

Active management can take advantage of volatility by seizing the opportunity to invest in underpriced, high quality stocks, particularly those paying nice dividends that perform better during stressed economic conditions. Active management also can act pre-emptively when faced with higher risks by moving a portion of equities into treasuries or other negatively correlated securities that tend to move up when equities go down. Attention to diversification and active rebalancing can also help temper market volatility and protect portfolios from taking the full brunt of a financial downturn and protect investors from having to take withdrawals at low points in the market.

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[5] Source: J.P. Morgan Guide to the Markets, pg. 19, as of 9/30/2019. Bureau of Labor Statistics, "Income Inequality in the United States, 1913-1998" by Thomas Piketty and Emmanuel Saez, updated to 2017. Includes dividends and capital gains. Distribution is based on pre-tax income. Spending is based on post-tax income.

[6] The Cars, released as a single in 1981.

So, during times such as we are in now – when fear and uncertainty are beginning to disrupt the markets – we believe investors should take the prudent step of reevaluating the risks imbedded in their portfolios. Active managers will be able to take advantage of resulting price disparities by buying wisely, by searching for opportunities of negative correlation, and by reevaluating, rebalancing and maintaining appropriate levels of diversification. By employing these active management disciplines, investors are likely to lose less on the downside which leaves them with a higher base from which to catch up when the market reverses!