Markets Resilient Again in the Third Quarter

Markets in the third quarter of 2019 looked surprisingly similar to the second quarter as more U.S.-China trade war uncertainty and a lack of clarity on future interest rate policy caused a sharp increase in volatility in the middle of the quarter, but the S&P 500 remained resilient and ultimately recouped those losses to finish the quarter 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, which was announced at the G20 meeting in late June, combined with better-than-expected second-quarter corporate earnings to propel the S&P 500 to new all-time highs in July. **Also helping markets rally was anticipation of the first interest rate cut by the Federal Reserve since 2008, which became reality on July 31st when the FOMC cut the Fed Funds Rate by 25 basis points.**

But that strong start to the quarter was quickly undone in early August thanks to increased tariffs between the U.S. and China (the trade truce was short-lived), 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, citing a failure by the Chinese to fulfill promises to increase purchases of U.S. agricultural products. **Then, in late August, 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 August.**

Also pressuring stocks in August was uncertainty regarding U.S. monetary policy. As mentioned, the Fed cut interest rates by 25 basis points on July 31st, but they did not definitively signal more rate cuts were coming, and disappointment from that lack of clear guidance, combined with growing worries over future economic growth, added to the volatility in August.

Finally, a closely watched part of the U.S. Treasury yield curve, the "10s-2s spread," inverted (meaning that yields on shorter-term notes exceeded those of longer-term notes) for the first time since 2007. This signal has historically preceded a recession by an average of 18 months, although admittedly, it's not a perfect indicator. **Regardless, seeing this signal for the first time in over a decade led to a deterioration in investor sentiment and added to the August volatility.**

Despite this trifecta of headwinds, markets again showed impressive resilience in the final month of the quarter, just as they did in the second quarter of 2019.

Early in September, there was 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, and both the U.S. and China agreed to face-to-face meetings in October in another attempt to end the now 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.
Finally, 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.

Due to the improving market fundamentals listed above, the S&P 500 rebounded solidly in September and came close to matching July's all-time highs, although the initiation of an impeachment investigation by the House of Representatives on President Trump caused a modest pullback late in the month.

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. But the third quarter was also a reminder that volatility does not automatically mean poor performance. Resilient corporate earnings, stable U.S. economic growth and an accommodative Federal Reserve combined with rising optimism towards U.S.-China trade to offset the volatility and deliver another quarter of positive returns.

Third-Quarter Performance Review – Defensive Sectors Outperform

Major index returns were somewhat mixed in the third quarter as three of the four major indices, the S&P 500, Nasdaq 100 and Dow Jones Industrial Average, finished the quarter with positive returns, while the Russell 2000 saw negative returns. That mixed performance largely reflected the deterioration in U.S.-China trade relations and rising concerns about global economic growth.

By market capitalization, large caps once again outperformed small caps, which is a continuation of the trend witnessed in the second quarter. Large-cap outperformance was partially due to investors reacting to rising future recession fears, as large caps are historically less sensitive to a slowing economy. From an investment style standpoint, growth outperformed value due to strength in consumer sectors, industrials and large-cap tech.

On a sector level, eight of the 11 S&P 500 Index sectors finished the third quarter with positive returns. But in a departure from the first two quarters of 2019, traditional defensive stock sectors with high dividend yields (like utilities and REITS) handily outperformed. Falling Treasury yields and concerns about future economic growth fueled the outperformance of these higher-yielding sectors.

Sector laggards, meanwhile, were the same as the second quarter. The energy sector experienced negative returns again thanks to further declines in the price of oil and the healthcare sector was pressured by continued political risks via increasing calls for the expansion of government healthcare programs, dubbed "Medicare for all," and consistent, yet so far unsuccessful efforts by the government to lower the cost of prescription drugs.

US Equity Indexes	Q3 Return	YTD Return
S&P 500	1.70%	20.55%
DJ Industrial Average	1.83%	17.51%
NASDAQ 100	1.29%	23.42%
S&P MidCap 400	-0.09%	17.87%
Russell 2000	-2.40%	14.18%

Source: YCharts

Looking internationally, foreign markets saw negative returns in the third quarter thanks primarily to coMarkets in the third quarter of 2019 looked surprisingly similar to the second quarter as more U.S.-China trade war uncertainty and a lack of clarity on future interest rate policy caused a sharp increase in volatility in the middle of the quarter, but the S&P 500 remained resilient and ultimately recouped those losses to finish the quarter not far from the new all-time highs established in late July.
Also pressuring stocks in August was uncertainty regarding U.S. monetary policy. As mentioned, the Fed cut interest rates by 25 basis points on July 31st, but they did not definitively signal more rate cuts were coming, and disappointment from that lack of clear guidance, combined with growing worries over future economic growth, added to the volatility in August.
Finally, a closely watched part of the U.S. Treasury yield curve, the "10s-2s spread," inverted (meaning that yields on shorter-term notes exceeded those of longer-term notes) for the first time since 2007. This signal has historically preceded a recession by an average of 18 months, although admittedly, it's not a perfect indicator.
Regardless, seeing this signal for the first time in over a decade led to a deterioration in investor sentiment and added to the August volatility.
Despite this trifecta of headwinds, markets again showed impressive resilience in the final month of the quarter, just as they did in the second quarter of 2019.
Foreign developed markets declined but relatively outperformed emerging markets due to the European Central Bank cutting interest rates and restarting its quantitative easing (QE) program for the first time since September of 2018. Emerging markets, meanwhile, saw moderate declines thanks to concerns about global economic growth, combined with pressures from a stronger U.S. dollar.

International Equity Indexes	Q3 Return	YTD Return
MSCI EAFE TR USD (Foreign Developed)	-1.00%	13.35%
MSCI EM TR USD (Emerging Markets)	-4.10%	6.23%
MSCI ACWI Ex USA TR USD (Foreign Dev & EM)	-1.70%	12.06%

Source: YCharts

Switching to fixed income markets, bonds were broadly higher in the third quarter, as we'd expect given global rate cuts, rising concerns about future economic growth, and still subdued inflation readings. The leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) experienced solidly higher returns for the fourth straight quarter.

Looking deeper into the fixed income markets, longer-duration bonds once again outperformed those with shorter durations which is a continuation of what we observed in the first half of 2019 and reflective of a market that is responding to the recent rate cuts and threats of potentially slowing economic growth.

Corporate bonds saw solidly positive returns in the third quarter, although investment-grade bonds handily outperformed high-yield bonds, and that move to higher-quality corporate debt also underscored concerns about future economic growth and corporate earnings.

US Bond Indexes	Q3 Return	YTD Return
BBgBarc US Agg Bond	2.27%	8.52%
BBgBarc US T-Bill 1-3 Mon	0.54%	1.76%
ICE US T-Bond 7-10 Year	2.72%	9.85%
BBgBarc US MBS (Mortgage-backed)	1.37%	5.60%
BBgBarc Municipal	1.58%	6.75%
BBgBarc US Corporate Invest Grade	3.05%	13.20%
BBgBarc US Corporate High Yield	1.33%	11.41%

Source: YCharts

Fourth-Quarter Market Outlook

Once again, the S&P 500 successfully weathered an increase in volatility this past quarter, as positive current economic fundamentals, interest rate cuts, better-than-expected corporate earnings and renewed hope for resolution on U.S.-China trade helped the S&P 500 maintain strong year-to-date gains.

However, 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 the most 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, and slowing global growth is 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. And, accommodative policy by the Federal Reserve will continue to support that growth. However, Fed rate cuts don't bring guarantees of sustained periods of economic growth, and the ongoing U.S.-China trade war paired with the reappearance of some concerning indicators, such as an inverted yield curve, mean we must remain vigilant in detecting any potential future economic slowdown.

Finally, both domestic and geopolitical dramas require close watching 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, and any conflict between the U.S. and Iran will almost certainly be a negative for stocks, broadly speaking.

Bottom line, U.S. markets were resilient in the third quarter and the performance of most markets year to date remains impressive. However, our experience has taught us that while markets may be resilient, risks still need to be monitored closely, and so we will continue to do so as we have all year. What happens next with the U.S.-China trade war (will there be a trade truce?), Federal Reserve policy (will the Fed cut rates again in 2019?), and future economic growth (does the yield curve invert again?) will likely determine whether markets maintain, and potentially add to, year-to-date gains—or whether

we see similar bouts of volatility like we did in May and August of this year.

We understand that markets always face uncertainties at the start of a new quarter, and we are committed to monitoring these situations and their impact on the markets and your portfolio. Positively, current corporate and economic fundamentals remain solid, and it is those factors that determine the longer-term path of markets, not the latest political drama or salvo in the U.S.-China trade war.

At *Acorn Wealth Advisors*, LLC we understand that volatility, regardless of the cause, can be unnerving, even if it is historically typical. That's why we remain committed to helping you navigate this ever-changing market environment, with a focused eye on ensuring we continue to make progress on achieving your long-term investment goals.

Our years of experience in all types of markets (calm and volatile) have taught us that successful investing remains a marathon, not a sprint.

Therefore, it remains critical to stay invested, remain patient, and stick to a plan. That's why we've worked diligently with you to establish a personal allocation target based on your financial position, risk tolerance, and investment time horizon.

The strong market performance notwithstanding, we remain vigilant towards risks to portfolios and the economy, and we thank you for your ongoing confidence and trust. Rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

Acorn Wealth Advisors, LLC
Financial Peace of Mind