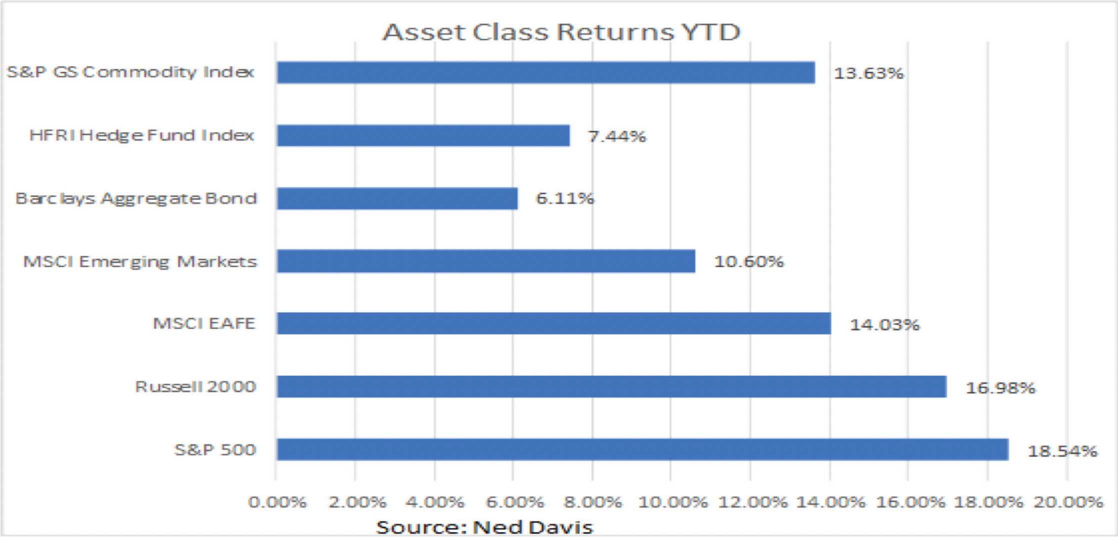
Market & Economic Review

Third Quarter 2019

Q2 2019 Review

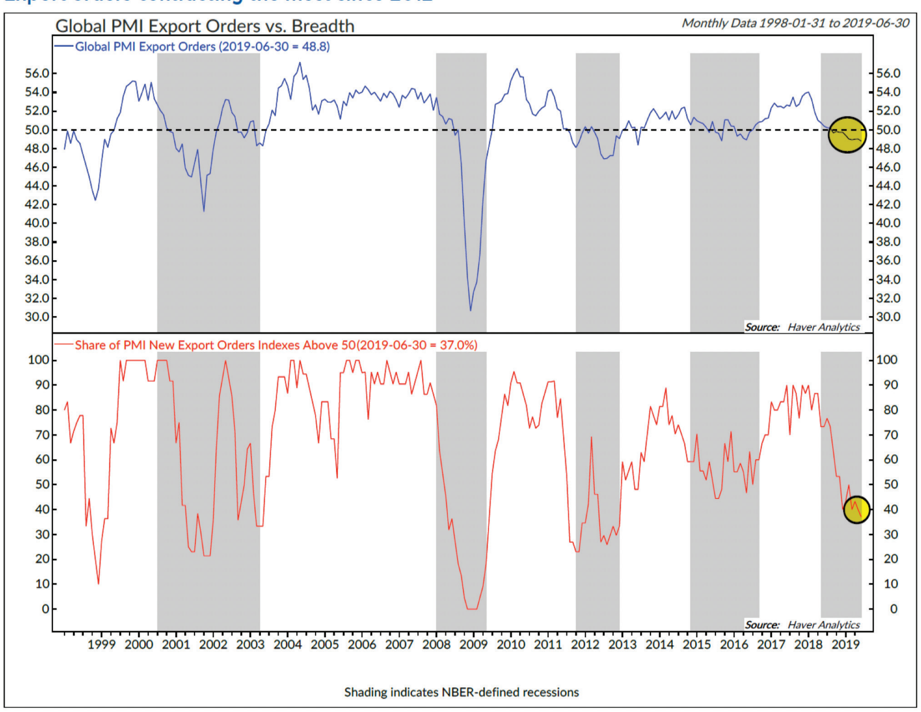
There was significant change in monetary policy expectations at the end of the quarter. Expectations up until June were for the Federal Reserve to remain on hold regarding further rate cuts. Global economic indicators showed a slowdown due to tariff policies affecting trade. Manufacturing PMI outside of the U.S. began to contract, and export orders slowed. This trade uncertainty affected U.S. business decisions as well as international trade. At the end of June, markets priced in a higher than 90% chance that the Fed will cut rates. The consensus is now for a 25 basis points cut in July and another 25 basis points cut in September. Despite the slowdown, asset valuations continue to move higher. U.S. equity performance continued to widen the gap relative to international equities. The S&P 500 is up 17.4% at the half-way point of the year, which is the best first half since 1997. With the increase in economic uncertainty, gold was the best performing major asset class during the quarter with an increase of 9.7%. Long-term U.S. treasuries were up around 6% as the yield on the 10-year U.S Treasury bond fell from 2.4% to 2% during the quarter.



Economic Outlook

The global economy continues to slow with indicators showing a mild global contraction. At the same time, the U.S. continues to grow but at a slower pace. We expect to see U.S. GDP growth around 1.5% - 2% going forward. The uncertainty around global trade and the possibility of more tariffs have made international and U.S. businesses less likely to commit to expanding. In the U.S., we have seen small business dealing with the effects of uncertainty by reducing their capital expenditures. According to the National Federation of Independent Businesses (NFIB), the number of small businesses who have made capital expenditures in the past six months is at its lowest level in four years. Inflation is expected to remain under control as the global economic slowdown and innovative technology continue to exert disinflationary forces on U.S. goods and services.

Export orders contracting the most since 2012



U.S. economic indicators remain in growth territory, unemployment is at historic lows, and asset valuations are at historical highs. Why is the Fed looking to cut rates going forward? With the U.S. growing at the low end of historical GDP growth, any type of slowdown outside the U.S. could be enough to push us into a recession. The impact of the tax cuts has worn off and the tightening of monetary policy has made its way into the system. The Fed is concerned that at such low interest rates, they will have less tools available if a recession were to occur.

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The Fed is likely looking at a series of cuts to head off any momentum in weakness. Historically we saw this in 1995 and 1998. In both periods, the global economy was having issues while the U.S. remained relatively strong. Global growth came back in both cases; and after 1998, we saw the major run up in equity valuations prior to the 2001 recession. There is a very good chance that we see a similar pattern. The Fed cuts once or twice in 2019 and things begin to stabilize. With President Trump up for re-election, it is more likely that a trade deal gets done in 2020. The downside, which we put at around a 25% probability, is that there is true weakness and the Fed will have to follow Japan and Europe into Negative Interest Rate Policy (NIRP). Under this scenario, the Federal Reserve would likely have to take the Fed Funds Rate below zero to provide enough stimulus to keep the U.S. economy out of a significant recession. This policy has been in effect in both Japan and Europe since 2012 and 2015. The results have been tepid economic growth, low unemployment, and a significant increase in government debt. While we view this scenario as having a low probability, it is now starting to be considered a possibility and is not priced into U.S. interest rate markets.

Equities

In the second quarter, equity markets continued the trend of U.S. growth stocks outperforming value stocks. The strongest sectors for the year continue to be technology and consumer discretionary, while financials were the strongest sector this quarter. In an environment where growth is scarce, companies with higher growth potential continue to be bid higher relative to companies that depend on high levels of economic growth. Companies that depend on high levels of growth tend to be value stocks. We are well aware of the historical performance of value relative to growth, and the tendency for there to be a mean reversion when growth valuations get to relative extremes. The reversion tends to happen after a significant market selloff or when GDP is growing at a stronger rate. The current environment of low interest rates and economic growth has been conducive to growth stocks outperforming. We don't take a binary view of being exclusively value or growth all of the time. In the current environment, we have tended to be positioned with managers who are investing in companies that are growing, but with a valuation discipline.

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Source: Blackrock

With increasing innovation we have seen the gap between large and small companies widening. Large companies are able to leverage technology to keep labor costs down while increasing margins. More of the winnings are going to fewer and larger firms. In a June 2019 report, Blackrock presented a chart showing earnings growth, which historically has been faster in small caps, now growing faster in the largest companies over the past decade. As we indicated in our last newsletter, small caps have also been squeezed by innovative private companies with substantial venture backing staying private longer. We continue to favor larger cap U.S. stocks while looking for better growth opportunities in private equity and venture capital.

Fixed Income

The 10-year U.S. Treasury bond has anticipated weakness as its yield declined by 40 basis points during the quarter. We remain in the “lower for longer” camp with increasing risk to the downside regarding interest rates. If the Fed cuts twice this year, we are likely to see a small increase in the spread between 10-year and 2-year U.S. Treasury bonds. Relative to other countries, the 10-Year Treasury at a 2% yield is still attractive. Germany and Japan have 10-Year Government Bond yields that are slightly negative.

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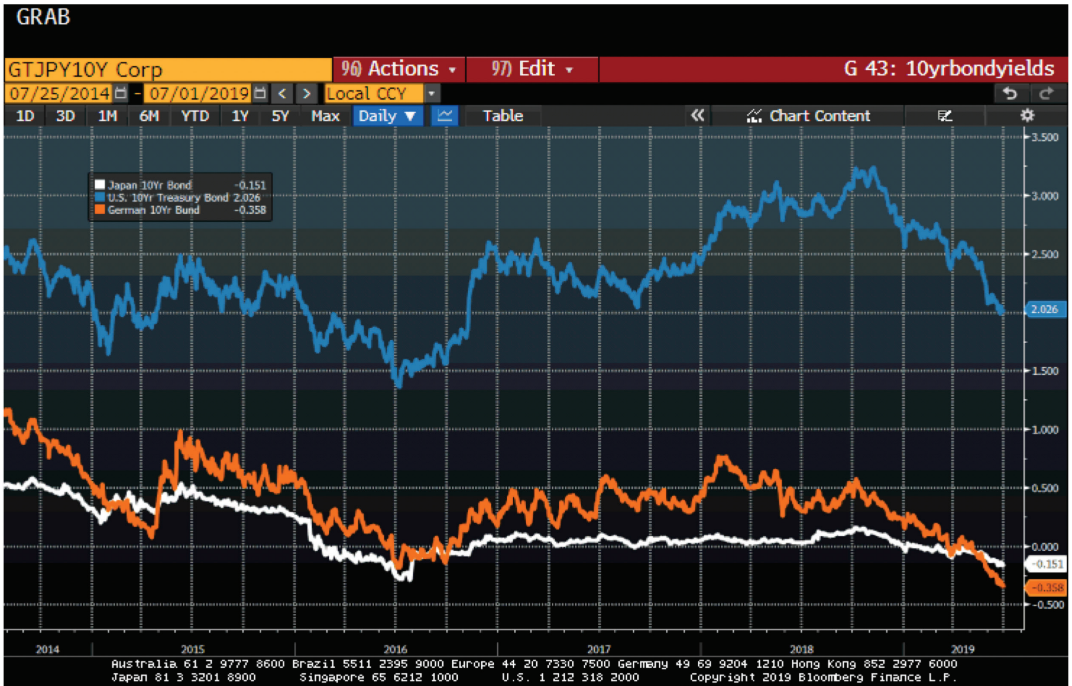

Source: Bloomberg

High yield debt, especially in Europe, continues to be less appealing regarding portfolio construction. Apparently, a small percentage of high yield debt in Europe is trading at negative rates. We see better equity hedges in quality corporate and municipal bonds. We have gradually pushed out our average duration in bond exposure towards 5 years. Our position on rates remains the same as it has been the previous couple of quarters. Strong demographic trends, disinflationary pressures, and the massive recovery from the Great Recession are likely to keep interest rates low for the foreseeable future.

Current Positioning

- **Equity:** Favor Large Cap and U.S.
  - Favor Quality and GARP (Growth At a Reasonable Price) managers
- **Fixed Income:** Quality bonds with average duration around 5 years
- **Alternatives:** Environment for Hedge Funds is improving and we are slowly adding exposure
  - Private Equity exposure is increasing with focus on small-mid buyout funds and co-investments with small to mid-size funds

The Family Office at Synovus

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