INVESTMENT OUTLOOK

A PEAPACK PRIVATE PUBLICATION

THIRD QUARTER 2019: PATIENCE AND FORTITUDE

Patience and Fortitude conquer all things.
–Ralph Waldo Emerson

This summer, the New York Public Library announced that the two marble lion statues that flank the entrance of its magnificent Carrère & Hastings building would receive a much-needed restoration. The sculptures have stood guard there since 1911. But they are exposed to the elements, and to the eroding effects of urban pollution, and so they require repairs and cleaning every 10 years or so.

While many people—both New Yorkers and tourists—are familiar with these noble figures, less well known are their allegorical allusions. The lions represent the virtues of Patience and Fortitude.

Those virtues are appropriate for the protection of the Library's voluminous and invaluable collection. But those virtues are equally if not more appropriate as well for investors, and similarly worth a periodic renewal and restoration.

Investors needed substantial dollops of both patience and fortitude to withstand the barrage of challenges they encountered in the third quarter. Prominent among those challenges: a global economic slowdown, intensified trade disputes, an attack on Saudi Arabia's largest petroleum processing facility, the formal inception of impeachment investigations of the US President, a strike against the nation's largest automobile manufacturer, and a spike in overnight lending rates.

Against that backdrop, investment returns for the third quarter seem relatively—and surprisingly—modest. But these mostly modest figures mask dramatic intra-quarter volatility, which required investors to recommit to their investment strategy.

Asset Class	Index	3rd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	1.7%	20.6%
US Small-Mid Cap Stocks	Russell 2500	-1.3%	17.7%
International Developed Stocks	MSCI EAFE	-1.1%	12.8%
Emerging Markets Stocks	MSCI EM	-4.2%	5.9%
Real Estate Stocks	MSCI US Real Estate	7.7%	26.8%
Commodities	Bloomberg Commodity	-2.4%	1.4%
Bonds	Bloomberg Barclays US Aggregate	2.3%	8.5%
Cash	FTSE 3-month UST Bill	0.6%	1.8%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE/RUSSELL, MSCI, BLOOMBERG

Most asset classes rose or fell by low single digits. The stand-outs were real estate equities and bonds, benefiting from falling interest rates.

Lower interest rates also largely explain more robust year-to-date results, as they boosted domestic stocks and bonds and, most particularly, real estate stocks. Accommodative central banks around the world were also supportive of higher prices for international equities, albeit to a less robust extent.

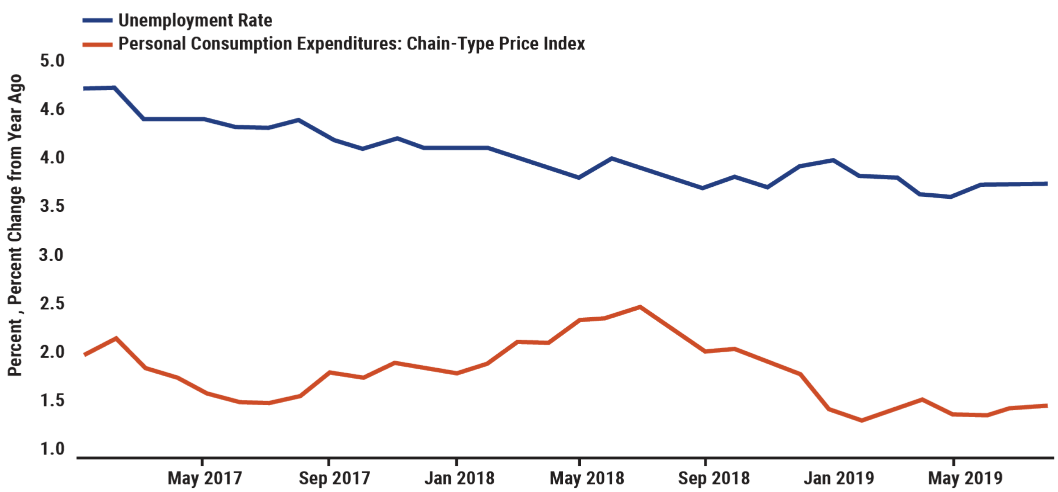
FOMC POLICY-MAKING: THE DEBT KING AND THE BONEHEADS

And now my life has changed in oh so many ways
My independence seems to vanish in the haze
But every now and then I feel so insecure
I know that I just need you like I've never done before
Won't you please, PLEASE help me?
–The Beatles

Faced with slowing global growth, increased economic uncertainty (stemming at least in part from escalating trade disputes), and an inverted yield curve, Fed Chair Jay Powell steered the Federal Open Market Committee (FOMC) to cut interest rates twice in the third quarter. Some market participants, however, believe the FOMC is woefully behind the curve, as market-determined interest rates are substantially lower than policy-determined rates.

Perhaps the loudest voice admonishing the Fed comes from the White House. President Trump has relentlessly assailed his Fed Chair for failing to aggressively lower interest rates "down to ZERO, or less." Of course, the self-proclaimed "Debt King" is a natural advocate for lower interest rates, as an erstwhile real estate developer. In the present, a zero interest rate policy would be supportive of a more robust economy—which of course would constitute a distinct advantage for a sitting president entering the 2020 election cycle. Thus does Mr. Trump eagerly beseech (berate?) the Fed "boneheads" for assistance. Chairman Powell, whose term extends longer than the President's, is focused on whether the Fed is meeting its dual mandate of full employment and price stability. With unemployment at 3.5% and inflation at 1.4%, the argument can be made that the Fed is sufficiently accommodative currently to achieve its statutory objectives.

Fed Successes: Low Unemployment, Low Inflation

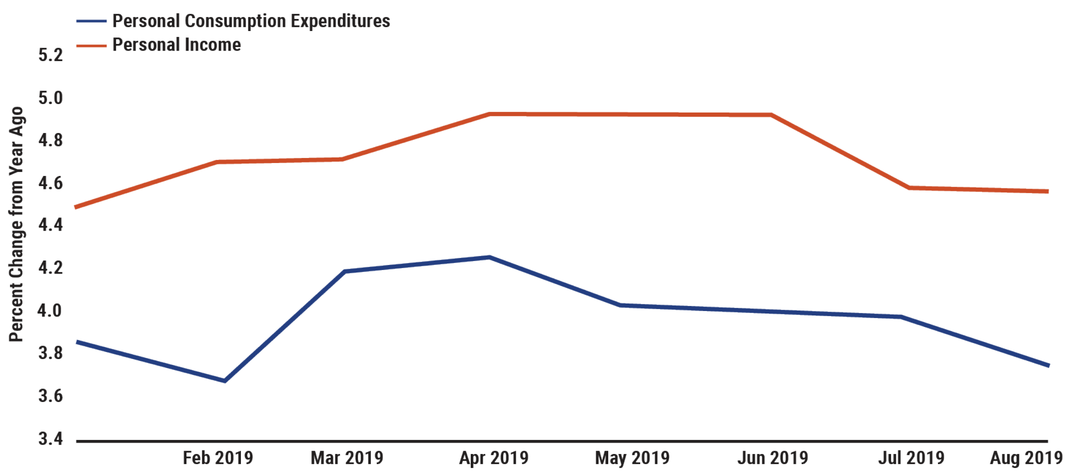


SOURCE: U.S. BUREAU OF ECONOMIC ANALYSIS, U.S. BUREAU OF LABOR STATISTICS

We are loath to wade into the maelstrom, but would offer a few observations about the state of the economy. After considerable hand-wringing this summer about a looming potential recession—with the inverted yield curve foreboding tough times ahead—more recent data are moderately more reassuring. In fact, the Citicorp Economic Surprise index rebounded sharply in September on better-than-expected economic reports.

The new and improved economic data center around three areas: housing markets, labor markets, and consumer financial health. On the housing front, the effects of interest rate reductions are starting to evidence themselves through increased home sales, new permits and construction activity: housing starts and building permits jumped to a 12-year high in August, and home resales rose to the highest level in 17 months. On the employment front, new unemployment claims and the unemployment rate are at 50-year lows, new jobs average over 150,00 for the past three months, and average hourly earnings are up 2.9% annualized. The Bureau of Labor Statistics' JOLTS report (Job Openings and Labor Turnover Survey) cites 7.1 million job openings. And, on the consumer front, personal income has risen by 4.6% over the past 12 months, and personal consumption is up 3.7%.

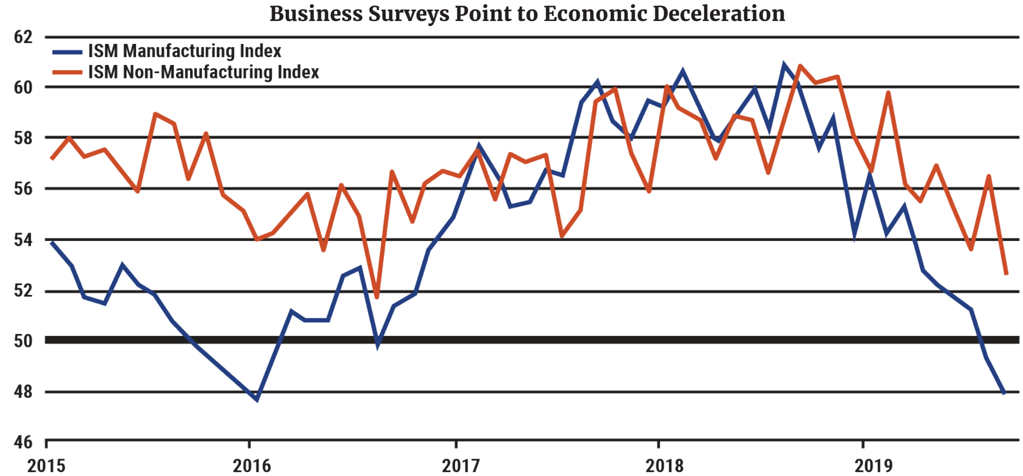
Personal Income and Consumer Spending Exhibit Strength



SOURCE: U.S. BUREAU OF ECONOMIC ANALYSIS

But it's not all roses and sunshine. Sluggish global growth, especially in manufacturing, has reached US shores. Measures of industrial production are deteriorating, and a measure of US factory activity (the ISM Manufacturing Survey) declined in September to its lowest level since 2009. Business investment spending has slowed, and the trade dispute with China has led to a drop in exports. The Atlanta Fed's estimate of third quarter GDP has been lowered to 1.8%, down from 2.0% in the second quarter and 3.1% in the first quarter. And corporate profits have yet to grow sufficiently to offset the effect of tax cuts, leading to a $1 trillion US government deficit for the first 11 months of fiscal 2019.

Business Surveys Point to Economic Deceleration



SOURCE: INSTITUTE FOR SUPPLY MANAGEMENT

An index with a score over 50 indicates that the industry is expanding, and a score below 50 shows a contraction.

TRADE: THE NEW "FAIR AND BALANCED"

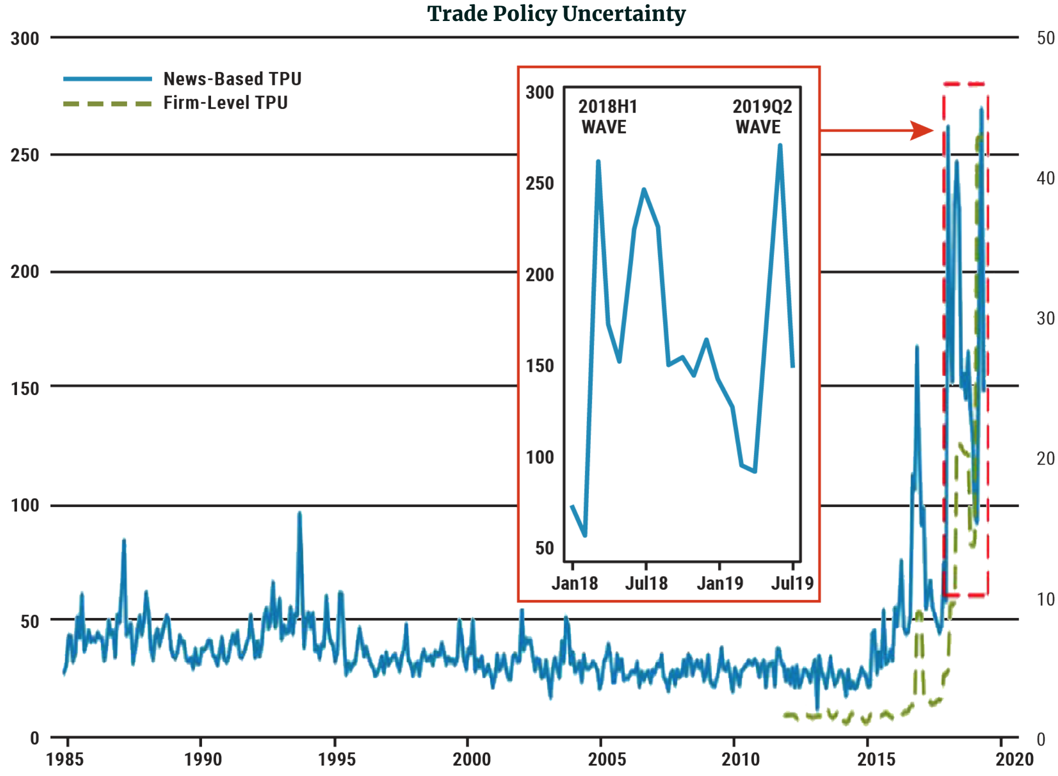
The future does not belong to globalists.
–Donald J. Trump

The elephant in the room is, of course, the trade war with China. In effect, the President wants the Fed to inoculate the economy against any negative effects from the imposition of tariffs as he prosecutes the trade disagreement with China.

The vicissitudes of the trade negotiations with China were on full display this summer, as both sides ratcheted up tariffs, China was labeled a currency manipulator, and negotiations were called off. It is impossible to predict how this dispute will resolve—there are some easy wins to be scored, and some nearly intractable and tantalizingly complex issues around intellectual property rights and technology transfer. There are reasons why the President would be motivated to reach an agreement ahead of next year's election, and reasons for him to hold firm. The same could be said for the Chinese.

From a world trade perspective, what we can say is that we are witnessing a change in the world order from a global, multilateral model to one that is nationalist, bilateral, mercantilist. Nearly all mainstream economists agree that restricting trade will have a depressive effect on global growth. But this is not a generalized theory—we are seeing it play out, now. In fact, Fed researchers found that an initial increase in trade-policy uncertainty in the first half of 2018 shaved around 0.8% from US and global economic output in the first half of 2019.

Trade Policy Uncertainty

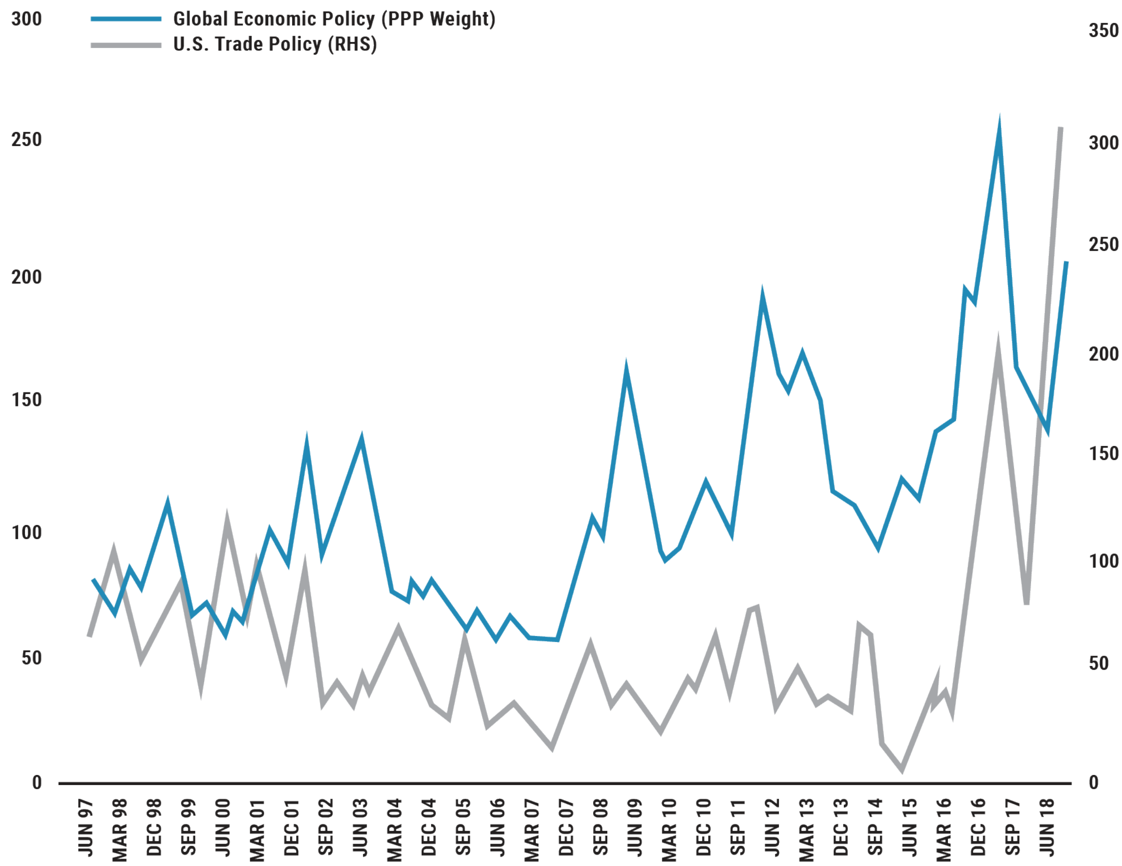


SOURCE: CALDARA, DARIO, MATTEO IACOVIELLO, PATRICK MOLLIGO, ANDREA PRESTIPINO, ANDREA RAFFO (2019), *THE ECONOMIC EFFECTS OF TRADE POLICY UNCERTAINTY.*

Left scale: News-based TPU (data through July 2019). At an index value of 100, 1 percent of news articles contain references to trade policy uncertainty. The articles are from seven major daily newspapers: *The Boston Globe, Chicago Tribune, The Guardian, Los Angeles Times, The New York Times, The Wall Street Journal,* and *The Washington Post.* **Right-scale:** Firm-level TPU index, average across firms (data through June 2019). **Inset:** News-based TPU from January 2018 through July 2019. Two waves of heightened trade policy uncertainty are labelled as 2018H1 and 2019Q2.

Furthermore, there is a commensurate increase in economic uncertainty stemming from the trade dispute. Fed researchers estimate that such uncertainty is reducing GDP—both in the US and globally—by 1%.

Global Economic Policy Uncertainty Index



SOURCE: ERNST & YOUNG GLOBAL LIMITED

As investors, we earnestly desire to see a resolution, or at least a truce, to the trade disputes that are restraining global growth. Trade agreements would have both direct economic effects and indirect effects on businesses and investors, from a confidence perspective. At the same time, it is incumbent on us to recognize that arriving at such agreements is arduous. The underlying issues are deep-rooted, and we must construct investment strategies that incorporate the possibility of sustained trade policy uncertainty.

BE LIKE THE FED: "ACT AS APPROPRIATE"

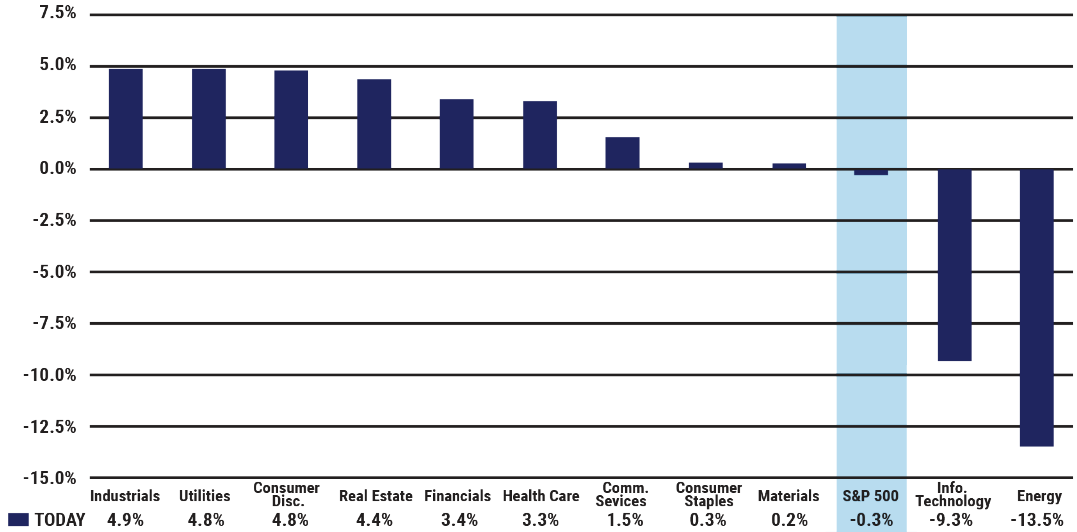
You cannot invest in retrospect.
–James Burnham

As noted above, markets have withstood a barrage of challenges over the course of the third quarter. That said, a number of companies in diverse industries—transportation (FedEx), steel (US Steel), energy (ExxonMobil), consumer staples (Clorox) and technology (Corning)—have warned investors that their earnings will fail to meet analysts' estimates. If corporate profits are the mother's milk of stock prices, then these profit misses should concern investors.

Markets do not appear to reflect any such concern. But is it resilience, or complacency? Are investors simply whistling past the graveyard? Or, are investors demonstrating patience and fortitude, like the Library's leonine likenesses?

Corporate profits have decelerated dramatically this year, following a big jump in 2018 that resulted from the Tax Cuts and Jobs Act. Expectations for the upcoming third quarter earnings season are especially lackluster, with an overall decline of -4.1% penciled in. While tepid earnings growth is expected for most sectors, significant earnings declines are anticipated for the information technology and energy sectors.

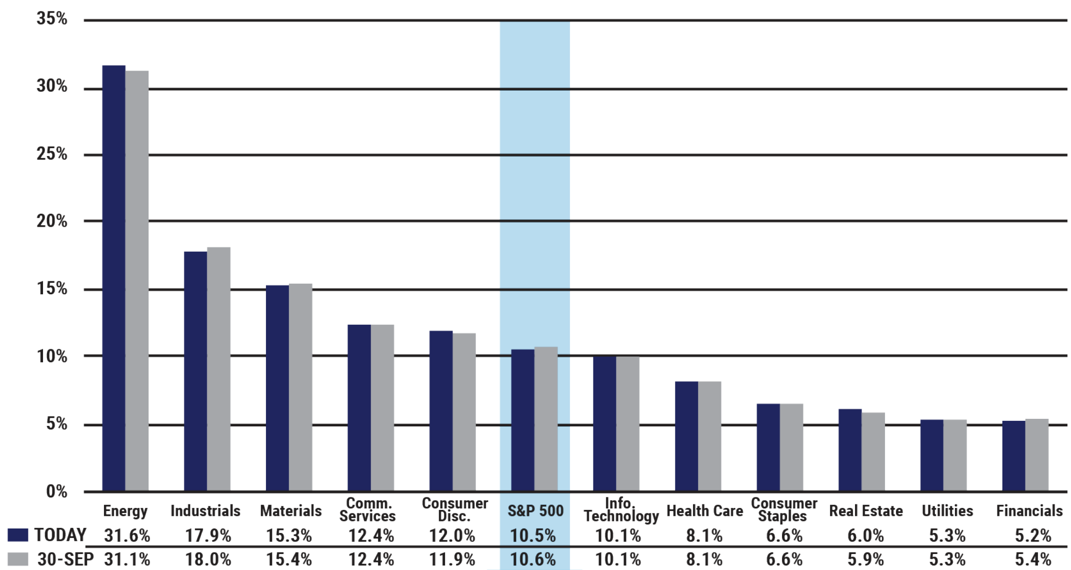
S&P 500 Estimated Earnings Growth: 3Q 2019



SOURCE: FACTSET

Earnings expectation for 2020 are more lofty—according to I/B/E/S, analysts anticipate 10.5% growth in corporate profits next year. While analysts forecast a dramatic earnings recovery in the energy sector, robust earnings growth is expected across most cyclical sectors. The S&P 500 trades at 16 times those estimated earnings—not that demanding in a low interest rate environment.

S&P 500 Earnings Growth: Calendar Year 2020



SOURCE: FACTSET

We cannot help but contemplate the potential for investor disappointment. Slower global growth, election year uncertainty, trade disputes, and heightened geopolitical conflicts are not a favorable backdrop for either economic reacceleration or a large jump in profits.

The outlook for interest rates is somewhat less cloudy. Challenges to growth both in the US and around the world virtually assure that global central banks will need to continue and extend their accommodative stances. Other things being equal—and they rarely are—lower interest rates support elevated equity and real estate valuations.

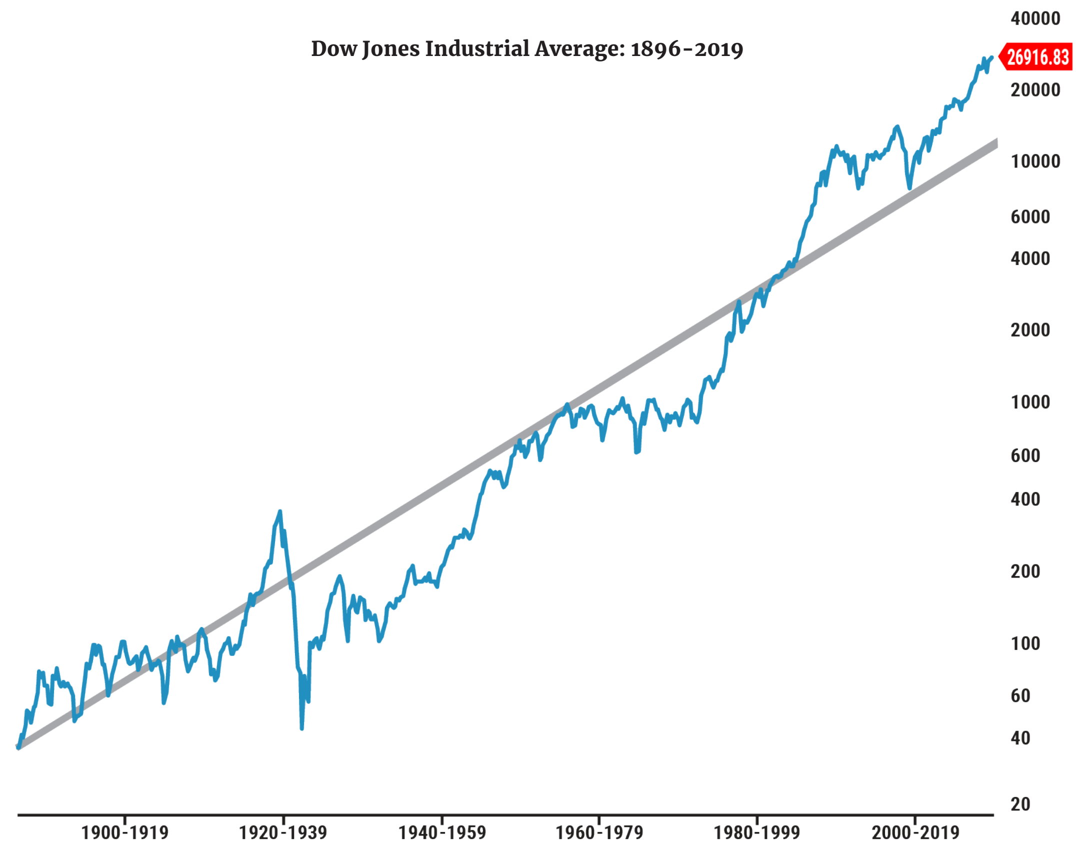
THE LONG TERM ADVANTAGE

It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent.
–Charlie Munger

It behooves anyone who is a steward of capital to determine investment goals and then to commit to a well-reasoned investment strategy. This isn't rocket science, but sometimes our senses—and our sensibility—are assaulted by data points and media reports and news stories that distract us from the prize. We may be tempted, through an excess of concern or an excess of enthusiasm, to abandon a sound and carefully conceived financial plan.

We anticipate further volatility in the weeks and months ahead, volatility that may tempt investors to abandon their investment strategies. But, as the chart of stock prices over time, below, makes clear, in the long run these swings in stock prices smooth out, and the long arc proceeds upward and to the right.

Financial markets, like the nation itself, have survived wars, impeachments, social upheaval, economic setbacks, and ideological divides. These and other obstacles have proven to be fleeting events. Over time, markets return to the trend line which denotes market appreciation over time.



SOURCE: BLOOMBERG

When the trustees of the New York Public Library erected its splendid Beaux-Arts structure to house its incomparable collection, it was with just such a long-term perspective. As fiduciaries of the city's intellectual capital, they recognized the need to protect and preserve valuable assets. And they chose symbols to guard these assets, the two lions representing Patience and Fortitude.

Investors would do well to adopt these guardians, as well. Patience and Fortitude. They're powerful protection for a well-crafted, long-term investment strategy. Be faithful to them, and they'll keep you, like Warren Buffett's side-kick, consistently not stupid.

PEAPACK PRIVATE

Wealth Management

500 HILLS DRIVE, SUITE 300, BEDMINSTER, NJ 07921
TEL (908) 234-0700 • WWW.PEAPACKPRIVATE.COM