Au AURUM
WEALTH MANAGEMENT
A SKODA MINOTTI FIRM

## Strategy Newsletter – 3rd Quarter 2019

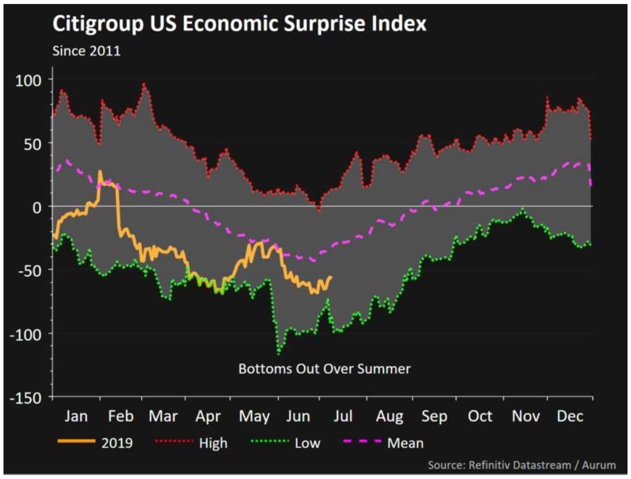
- Is the downturn in U.S. economic data a calendar year phenomenon or a bigger issue?
- Small caps lagged the rally up and are cheap compared to the last 15 years.
- Fixed income markets are not waiting on the Fed to price in lower interest rates.
- Housing still trending up as lower mortgage rates provides a boost for buyers.

## Economy

Recent pockets of manufacturing data and other business surveys came in below estimates. The big question is whether this is a structural shift in the economy or just a seasonal blip?

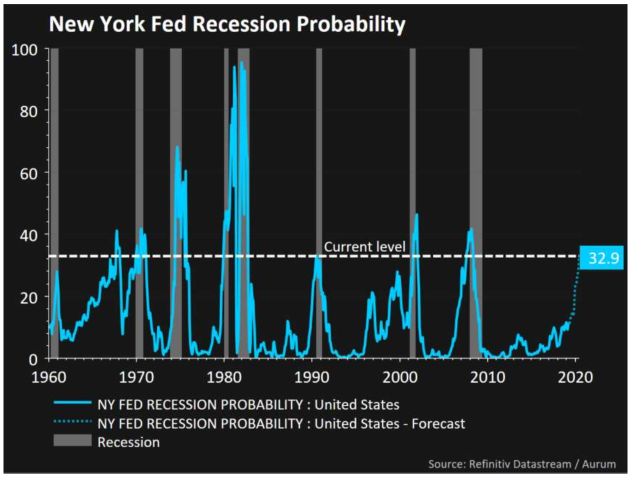
Over the last decade, economic data consistently came in lower than expectations, especially during the second quarter. The Citigroup Economic Surprise Index oscillates between -100 to 100, depending on if aggregate data is lagging or beating estimates. Eventually economists lower the bar enough that data has a chance to be above expectations in the second half of the year.

In the orange line below, one can see that the data in 2019 has been below the average of the last ten years.




Part of this has to do with the weather, as the harsh winter months have seen consistent disappointments into spring. The second half of 2019 and the shift in expectations will be important.

There are signals pointing to recession in 2020. The New York Federal Reserve's Recession indicator is flashing. It is based on the U.S. yield curve spread between the 3-month Treasury bill and the 10-year bond. It now shows a 33% chance of recession in the next 12 months. In 8 of the 9 previous times it reached this level, recession followed. There was one time when the signal did not work, which was in 1967. Some market participants believe the bond market may be acting irrationally and triggering this signal.




After fading out to the background for awhile, the trade war became front and center during the second quarter. Banter against China, Mexico, and many others upended markets and corporate planning. Will the tariffs be increased in the future or will there be a deal? This risk is known but the long-term impact is still unclear.

## Equity

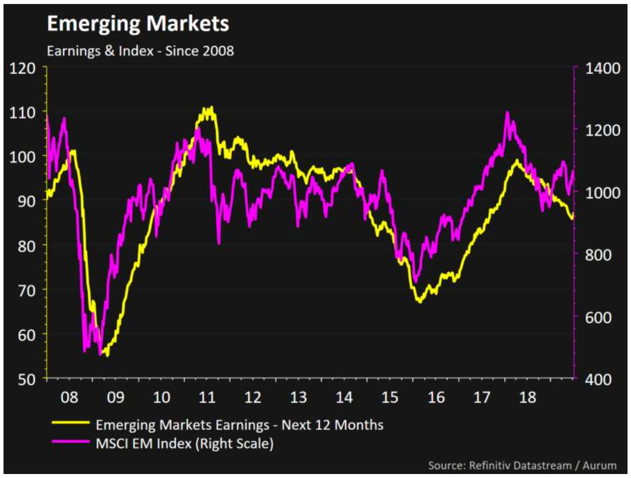
Despite the headlines of the trade war being back on, equities turned in a positive quarter across the globe. U.S. stocks led the way, followed by Europe, with Japan and Emerging Markets trailing.

| US Equity | 2Q 2019 |
|---|---|
| **Large Cap Stock** | |
| S&P 500 | 4.3% |
| **Small & Mid Cap Stock** | |
| S&P 400 Mid Cap | 3.1% |
| S&P 600 Small Cap | 1.9% |
| **All Cap Style Indices** | |
| S&P 1500 Value | 3.8% |
| S&P 1500 Growth | 4.4% |
| **International Equity** | **2Q 2019** |
| MSCI EAFE | 4.0% |
| MSCI EAFE Value | 1.9% |
| MSCI EAFE Growth | 6.0% |
| MSCI Europe | 4.9% |
| MSCI Japan | 1.0% |
| MSCI Emerging Markets | 0.7% |

Since the trough in stock prices on Christmas, large caps traced a nearly straight line up (outside of the correction in May). On the other hand, small caps peaked out in February and trended sideways since. Small caps are also over 10% below the peak reached in September 2018, while large caps went on to make new price highs.


Small caps currently trade at a slight discount on a forward price to earnings ratio basis. This contrasts with the last 15 years in which small caps averaged a premium of 3.8.

Expected earnings for emerging markets hit a fresh low in June but may be turning the corner. With many people in the administration feeling that the U.S. dollar needs to be weaker, this could be the catalyst to see earnings turn higher in emerging markets. A weaker dollar allows emerging markets currencies to move higher, which is a major part of the risk of owning foreign securities.




Portfolios remain near equal weight for equities in the Aurum Asset Allocation Frameworks.

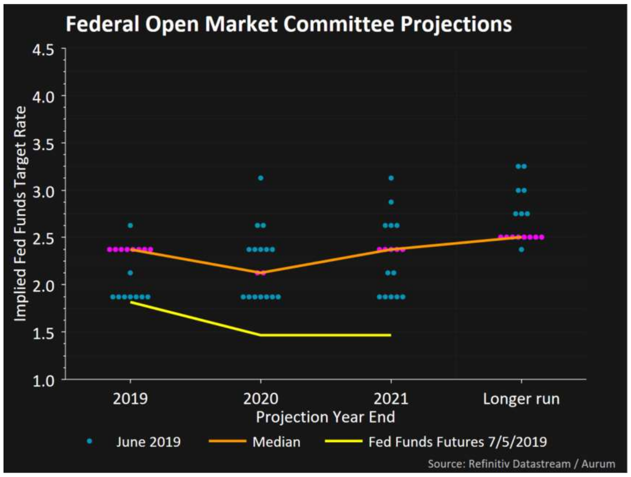
## Fixed Income

The 10-year yield fell from 2.69% to 2.41% in the first. In the second quarter, it continued the decline falling to 2.00% to end the quarter. This boosted bond prices across the board. The longer duration of investment grade corporate bonds led it to be the top performer, just ahead of TIPS (Treasury Inflation Protected Securities).

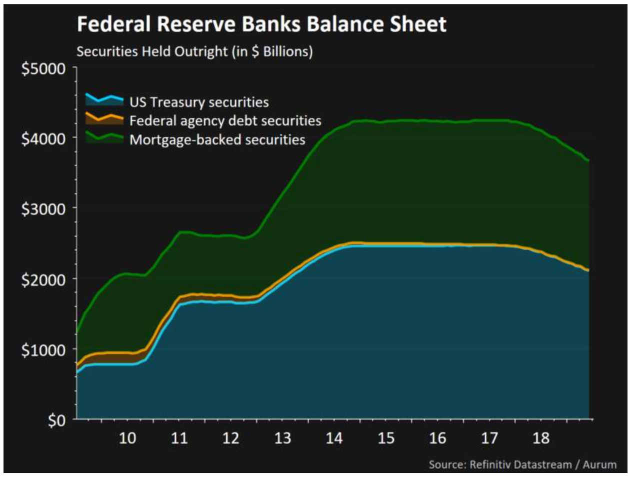
| Fixed Income | 2Q 2019 |
|---|---|
| Barclays U.S. Aggregate Bond | 2.9% |
| Barclays Corporate Inv. Grade | 4.6% |
| Barclays High Yield Bond | 2.9% |
| Barclays Global ex. U.S. Tres. | 4.3% |
| Barclays Municipal Bond | 2.3% |
| Barclays TIPS | 4.3% |

Behind the movement in bond prices was something no one saw coming twelve months ago. The Fed changed its tune, signaling a willingness to cut interest rates. The reasons behind the cuts? Inflation data coming in below the target of 2%. In addition, the trade war affecting business confidence and creating uncertainty in global growth has been a part of the discussion.

As seen below, the futures markets (yellow line) has a much lower path for interest rates than the latest projections by the Fed (orange line).




In addition to cutting interest rates, the Fed is widely expected to stop the shrinking of the balance sheet. As seen below, the balance sheet ballooned to over $4 trillion from 2008 to 2014. During 2018, the Fed allowed many of its securities to mature without reinvesting proceeds. Most forecasters expect the reinvestment to begin again.




While this does not seem to have a real impact on the economy, it does affect expectations of inflation and investor sentiment. Most view the reinvestment as a positive trend.

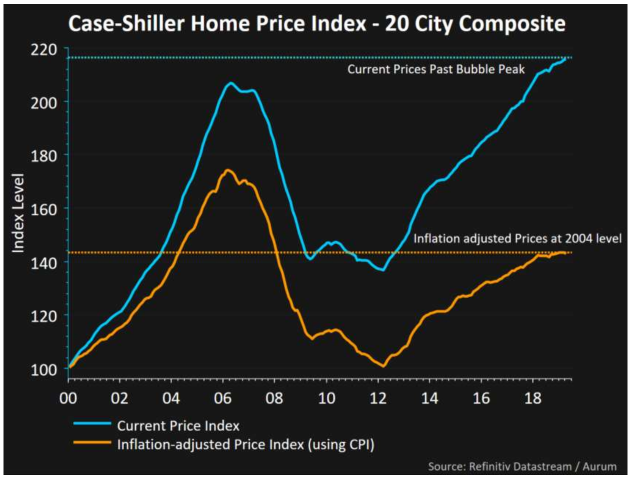
The Aurum Asset Allocation Frameworks continue to maintain exposure to bonds. We see value in a low duration global bond strategy along with gaining interest rate exposure from mortgages, municipals, and TIPS.

## Real Estate

REITs and private real estate turned in a second consecutive quarter of positive performance.

| Real Estate | 2Q 2019 |
|---|---|
| Wilshire U.S. REIT | 1.6% |
| Wilshire Int'l REIT | 1.4% |

After interest rates rose throughout 2018, the housing market began showing signs of slowing. This is not surprising as home prices were up relentlessly since the bottom in 2012, creating affordability problems. With the decline in mortgage rates in the first half of the year, housing has seemed to have found its footing.

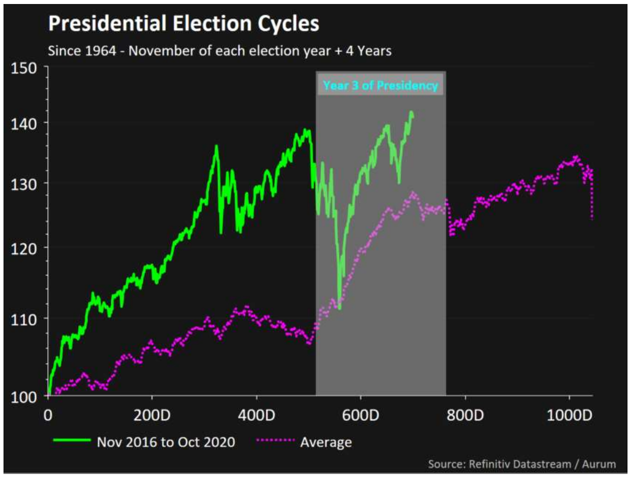



The amount of inventory available for sale is low compared to the long-term. It has risen over the past year for the first time since 2014.

One of our active real estate managers is a fan of subsectors of the housing market, which include single family rental REITs and mobile home communities. REITs remain at equal weight within the asset allocation frameworks.

## Conclusion

Since 1964, the third year of the Presidential cycle has typically been a good one for equity markets. We certainly saw a swoon in the first two months of the third year (November to December 2018). Since then, the playbook of trying to stimulate the economy has been followed by the administration in power (with talks of lower interest rates and a little discussion on an infrastructure plan). If the averages track like normal, then the next few months may not see as much upside. It will come down to earnings, the Fed, and the trade war as the major narratives surrounding markets, and of course any surprises to the system.




## Aurum Asset Allocation Frameworks

| | Income | | Conservative | | Balanced | | Moderate | | Growth | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Asset Class** | Strategic | Tactical | Strategic | Tactical | Strategic | Tactical | Strategic | Tactical | Strategic | Tactical |
| **Equity** | **20%** | **19%** | **35%** | **33%** | **50%** | **48%** | **65%** | **63%** | **80%** | **78%** |
| U.S. Large Cap | 10% | 8% | 17% | 16% | 24% | 24% | 31% | 31% | 38% | 38% |
| U.S. Small-Mid Cap | 2% | 3% | 4% | 4% | 6% | 6% | 8% | 8% | 10% | 9% |
| International Equity | 6% | 6% | 11% | 9% | 15% | 12% | 20% | 16% | 24% | 22% |
| Emerging Markets Equity | 2% | 3% | 4% | 4% | 5% | 6% | 7% | 8% | 8% | 10% |
| **Fixed Income** | **77%** | **78%** | **62%** | **64%** | **47%** | **49%** | **32%** | **34%** | **17%** | **19%** |
| US Fixed Income | 69% | 70% | 56% | 58% | 42% | 44% | 29% | 31% | 15% | 17% |
| Global Bonds | 8% | 8% | 6% | 6% | 5% | 5% | 3% | 3% | 2% | 2% |
| **Real Estate / REITs** | **3%** | **3%** | **3%** | **3%** | **3%** | **3%** | **3%** | **3%** | **3%** | **3%** |

The risk designations are relative only to the five Strategic Allocation targets and do not represent comparisons with any other investment or risk of the overall strategies.

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