Global Economic Review

Eagle Eye

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BARILOTTI WEALTH STRATEGIES, LLC IS PLEASED TO PRESENT ECONOMIC AND MARKET INSIGHTS FROM THE MULTI-ASSET SOLUTIONS' PORTFOLIO MANAGERS.

"Rule No.1: Never lose money. Rule No.2: Never forget rule No.1." - Warren Buffett

A time for caution? It's been three months since our last quarterly letter, in which our counsel to readers was to adopt a more defensive stance than we have argued has been appropriate for most of the past decade. From then to now, risk assets have moved fitfully sideways, neither validating nor invalidating our advice. Incoming economic and market data have not eased our concerns, and we remain of the opinion that protecting capital should take precedence over the pursuit of maximum return in the current environment.

The factors sustaining current growth remain generally intact. In July households, the primary driver of economic activity, were hale and hearty. That remains mostly true today, although surveys of consumer confidence appear to have plateaued (at best). Within the surveys, perceptions of job availability fell marginally, and spending moderated. Since July, an important pillar of support, monetary policy, has continued down a path of greater accommodation – though these impacts are often delayed.

While current growth remains generally intact, indicators of future weakness may be growing stronger. Some are typical of any late cycle environment: worker shortages, rising labor costs, elevated leverage, and rich valuations in financial markets. However, other unnerving features of the current expansion are unique to this cycle. Specifically, we are concerned with the inflection in decades-long trade policy and its knock-on effects.

The trade war is taking its toll. We see this not only in higher final prices and reduced demand (direct impact), but also in waning business confidence, faltering business investment, and fading hiring intentions. The longer these strains persist, the more likely they are to eventually infect the service sector and potentially push the economy toward a downturn. A truce between the U.S. and China may provide temporary relief, but only a fundamental shift in policy marked by a rollback of existing tariffs can foster a reacceleration in growth.

The upside opportunity for risky assets is limited while the downside appears relatively substantial and growing. A prudent course of action is to pull back moderately on risk exposure. For us that means reducing equity exposure at the periphery and upgrading the quality of our bond holdings.

ON THE RADAR SCREEN

1. Household spending drives the U.S. economy despite global manufacturing weakness. Any sign of weakness in labor market conditions or consumer confidence would lead us to become more cautious.

2. Trade tensions remain top of mind. A truce between the U.S. and China will be temporarily helpful, but the path to faster growth will not be clear until existing tariffs are rolled back, and uncertainty lifted.

3. Business sentiment has been the victim of trade hostilities, discouraging capital expenditures and dampening hiring plans. Changes to CEO temperament provides a useful read on the direction of economic growth a few quarters out.

4. Global central banks, including the Fed, are using accommodative monetary policy to push back on slowing growth. We monitor the demand for credit among consumers and businesses to determine its effectiveness.

5. A variety of exogenous geopolitical risks remain including Brexit, a Japanese consumption tax, and increased conflict in the Middle East.

Insights from Multi-Asset Solutions' Portfolio Managers

Continued from previous page

"When the facts are at odds with your theory, it's time to think again." - Mark Gilbert, Bloomberg News. "When the facts are at odds with your theory, it's time to think again." - Mark Gilbert, Bloomberg News. In the past quarter monetary conditions have shifted meaningfully. Twice the Federal Open Market Committee (FOMC) has elected to cut short-term interest rates. Additionally, quantitative tightening has been turned off and talks of quantitative easing has been resuscitated. Such action is hardly surprising: it is duty of the Federal Reserve (Fed) to maintain both full employment and price stability. With economic growth showing clear signs of weakening, some monetary stimulus is a reasonable response. But we can't help but to wonder how effective it will really be, coming as it does near the zero bound. Are businesses and households reluctant to borrow because rates of a few months ago were too high? Will going all the way back to zero or even into negative territory fire up the credit creation engine? History is not particularly encouraging. Two decades of zero interest rates in Japan have yet to yield the nominal growth promised all those years ago. And Germany today is on the cusp of a technical recession even as its entire curve is submerged below zero (i.e. "investors" pay the German government for the privilege of lending them money). With these examples in mind, we are unimpressed by the argument that lower rates and a flood of liquidity are the magic elixir the US economy needs to get back on track. Absent repair of trade policy and/or a meaningful fiscal injection, we're likely to remain stuck in the quagmire in which we now find ourselves.

"The market is about as efficient as a cloth diaper" – Jared Dillian. A recent interview Michael Burry, Investor made famous in the book/movie "The Big Short", reminded us of a theme we have revisited several times over the past few years. In the interview conducted by Bloomberg, we heard yet again about the avalanche of cash pouring into passive investment strategies. Burry, a contrarian who generated unimaginable profits by correctly anticipating the subprime mortgage meltdown that spawned the great financial crisis, has positioned his hedge fund across a series of small cap value stocks. His contention is that the massive migration of capital into index funds over the past decade has badly corrupted price discovery and grossly inflated pricing of large cap growth stocks while almost entirely overlooking many small cap value names deserving a higher market capitalization than has been assigned them. We have considerable sympathy with that view. It's unclear just what the catalyst will be that causes those flows to reverse, but eventually they will for there is no trend in finance of which we are aware that runs in only one direction. And when it does, a substantial transfer of wealth from passive to active investors is possible. The golden age of indexing is mostly behind us.

About Risk

All investments are subject to market risk, including possible loss of principal. Stocks and bonds can decline due to adverse issuer, market, regulatory, or economic developments. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline. A bond’s prices are inversely affected by interest rates. The price will go up when interest rates fall and go down as interest rates rise.

MLPs and other natural resources sector companies are subject to certain risks, including, but not limited to fluctuations in the prices of commodities; the highly cyclical nature of the natural resources sector may adversely affect the earnings or operating cash flows of the issuers in which the Fund will invest; a significant decrease in the production of energy commodities would reduce the revenue, operating income, and operating cash flows of MLPs and other natural resources sector companies and, therefore, their ability to make distributions or pay dividends.

Past performance is no guarantee of future results. An investment cannot be made in an index

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