AARON WEALTH OCTOBER 2019

MARKET COMMENTARY

General Observations

History shows that the Dow Jones Industrial Average and the S&P 500 index usually generate their largest quarterly gains in the final three months of each year. According to Refinitiv, in the October-December quarter, these indices rise on average 2.8% and 2.5%, respectively, and have advanced more in the fourth quarter than in any other interval, advancing 66% and 73% of the time.

That having been said, as year-end 2019 approaches, the expiration of lockup agreements on technology companies and other equity initial public offerings could exert technical selling pressure on the stock prices of selected companies. And investors may recall how one year ago, investor fears of rising interest rates and a slowing global economy led to a 14% decline for the S&P 500 index in the fourth quarter of 2018, its worst performance in seven years.

Through October 18 on a year-to-date price return basis, the Dow Industrials were +14.8% and the S&P 500 was +19.1%, with the two top-performing S&P sectors being technology, +30.5%, and real estate, +28.4%, and the two bottom-performing S&P sectors healthcare, +6.0%, and energy, -0.8%.

U.S. Treasury 10-year yields closed at 1.75% on October 18, up from 1.46% on September 4, and the (thus far) all-time closing low of 1.32% set in July 2016. (The all-time record close for the S&P 500, 3025.86, was set on Friday, July 26, 2019.)

The following two charts underscore the wisdom of keeping in mind the length of time since the last recession:

RECESSIONS BY DECADE

...WILL THIS DECADE BE THE FIRST WITH NONE?

DECADE	#	STARTING YEARS OF RECESSIONS			
1850	1	1857			
1860	3	1860	1865	1869	
1870	1	1873			
1880	2	1882	1887		
1890	4	1890	1893	1895	1899
1900	2	1902	1907		
1910	3	1910	1913	1918	
1920	4	1920	1923	1926	1929
1930	1	1937			
1940	2	1945	1948		
1950	2	1953	1957		
1960	2	1960	1969		
1970	1	1973			
1980	2	1980	1981		
1990	1	1990			
2000	2	2001	2007		
2010	0				

For the decade beginning in 2010, there have been zero recessions thus far, making it stand alone among the past 17 decades of American history.

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And as shown below, with an *official* bear market defined as a *minimum* 20% decline in the Dow Jones Industrial Average, a bear market has not yet occurred in the decade beginning January 1, 2010 (but came close during the September 20 – December 24, 2018 equity market selloff):

Equity Bear Market Episodes

Decade Beginning	Bear Markets	DJIA Decline
1900	3	46%, 49%, 27%
1910	3	24%, 40%, 47%
1920	1	89%
1930	3	23%, 49%, 41%
1940	1	24%
1950	"Near Miss"	19% (22% for S&P 500)
1960	3	27%, 26%, 36%
1970	2	45%, 27%
1980	2	24%, 36%
1990	1	21%
2000	2	38%, 53%
2010	"Near Miss"	18.8% (19.7% for S&P 500)

Following the September 14 drone and missile attacks on Saudi Arabian oil facilities, Brent sweet light crude, the global benchmark of Atlantic basin oil prices, rose 15% in Brent's largest-ever one-day gain. In subsequent weeks, this marker has since slipped back to close at $59.42 a barrel (with the per-barrel West Texas Intermediate oil price at $53.78) — below the levels industry analysts maintain are needed for Saudi Arabia and other large producing countries to support their economies.

Oil prices have declined more than 22.2% in the past 12 months and reflect softening demand in the face of continued output from the U.S. and other key producers. On September 11, for the third time in four months, the Organization of the Petroleum Exporting Countries (OPEC) lowered its forecast for 2019 global oil demand growth to 1.02 million barrels per day. Similarly, reports of growing stockpiles of crude in developed nations led the International Energy Agency (IEA) also to lower its projections of 2019 global oil usage.

Partly reflecting substantially diminished competition from ultralow (and even negative) interest rates in many developed economies around the world, as well as the possibility of massive fiscal stimulus and continued money printing to stave off the next recession, as of October 18 on a year-to-date basis, gold at $1,488.20 per troy ounce was +16.4%, gold mining shares were +28.6%, junior gold mining shares were +23.4%, silver was +14.1%, and silver shares were +12.3%.

Influences on Asset Prices

Trade and Tariff Disputes: U.S. and Chinese officials met in Washington on Thursday, October 10 for trade talks, with the United States holding off on the increased tariffs scheduled to begin on October 15, and China agreeing to purchase more agricultural products. After a rally the next day, asset prices eased off again as financial market participants came to the realization that the trade deal was rather limited in scope and numerous additional issues remained, including intellectual property protections and the fact that the U.S. has yet to cancel its intentions to impose additional tariffs in December.

Tensions and the major underlying sources of trade and economic frictions remain elevated and both sides' interests are still far apart in the United States-China relationship, including China's subsidization of state-owned industries, cyber theft issues, predatory regulation against American companies, forced technology transfers, and intellectual property protection for data flows and computer source codes.

China's concerns include, among other issues, possible restrictions on U.S. capital flows into China; the U. S. blacklisting of a number of Chinese technology companies over alleged human rights violations; State Department visa restrictions on selected Chinese officials; and U.S.

restrictions on the ability of Chinese telecommunications companies to sell products in the United States. In 2018, U.S. companies generated $544 billion in annual revenue in China, representing over three times the total of U.S. exports to China.

While the intermediate and long-term elements of the relationship between the United States and China are likely to remain a work in progress for quite some time, on a short-term basis investors can continue to expect the trade and tariffs discussions to generate back-and-forth swings in financial asset prices, with upside moves driven by outbreaks of cooperation and downside moves driven by episodes of disputatiousness.

Quarterly Earnings Results and Outlook: Facing expectations of three consecutive quarters of lower profits, the third quarter 2019 earnings reporting season began in earnest in mid-October, with strong results and constructive profit forecasts from banks and healthcare companies surprising to the upside, reducing concerns of an impending recession, and generating expectations that the -4.7% expected profit decline could actually turn out to be overly pessimistic when final results are tallied.

As of October 18, analysts' year-over-year S&P 500 earnings estimates as compiled by FactSet and Refinitiv called for +1.5% in 4Q19 (with full year 2019 earnings expected to grow +0.7%); +4.8% in 1Q20; and +5.2% in 2Q20 (with full year 2020 earnings expected to grow +10.4%). Interest rates, energy prices, the status of the tariffs and trade discussions, and retail sales will be among the chief determinants of whether these growth rates and 12-month forward earnings per share estimates are realistic and can be achieved, or whether they will be subject to further downward revision.

Monetary Policy and Interest Rates: At its September 17-18 policy meeting, three fed governors voted against the 25 basis point interest rate cut that was approved; the presidents of the Boston Fed and the Kansas City Fed wanted no interest rate reduction, and the head of the St. Louis Fed wanted a larger cut. In the press conference following the FOMC meeting, Fed Chair Jerome Powell suggested that continued weakening in the economic data could turn the "mid-cycle [monetary policy] adjustment" into a full-fledged easing cycle.

Emphasizing that such measures have been undertaken purely to keep money markets and the repurchase agreements system functioning smoothly — and not specifically aimed at stimulating the economy — since mid-September, the Fed has also been boosting reserves and purchasing $60 billion of U.S. Treasury bills per month to reduce liquidity pressures in the U.S. money markets.

As of October 21, the CME fed funds futures pricing reflected a 88.3% probability of a total of three 2019 interest rate cuts (the first occurred on July 31, and the second, on September 18; three in total would imply one more interest rate reduction at either the October 29-30 meeting or the December 10-11 meeting).

Synchronized Slowing in GDP Growth: In its mid-October World Economic Outlook, the International Monetary Fund has projected global GDP growth of +3.0% for 2019 as a whole, down 0.2 percentage points from its July forecast and sharply below the +3.6% registered in 2018. For 2020, the IMF projects +3.4% global GDP growth.

For the United States, the IMF projects +2.4% GDP growth in 2019, down from +2.9% in 2018, with a further slowdown to an estimated +2.1% U.S. GDP growth in 2020. For Europe, the IMF projects +1.2% GDP growth in 2019 after +1.9% in 2018, and only a slight recovery to +1.4% in 2020. China's GDP is projected to decline from +6.6% in 2018 to +6.1% in 2019, followed by +5.8% in 2020 (if such a growth rate occurs, it would be the slowest GDP growth since 1990).

With readings below 50 indicating contraction, the September ISM manufacturing PMI (Purchasing Managers Index) fell for a sixth consecutive month to 47.8, the lowest outcome since June 2009, a significant downside surprise, and continuing a downward trend that started in September 2018, when computed using a six-month moving average. And as might be expected given the stronger dollar up to that point and uncertainties associated with the tariff and trade disputes, the September ISM manufacturing export orders subindex was even weaker at 41.0, the weakest reading since the 35.0 that was plumbed during the 2008-2009 recession.

At 52.6, the September ISM Non-Manufacturing index surprised to the downside, suggesting that the unfolding slowdown is not limited to the manufacturing sector. Of particular concern was the 50.2 reading of the employment component, hinting at some developing degree of weakness in the labor market.

Although the Dow Transportation Index of trucking, railroad, airline, and package delivery companies is +14.6% year to date, over the past 12 months, it has gained only +0.7%. The widely followed Cass Freight Index, a monthly measure of rail, trucking and airfreight volume, dropped 3% in August from a year earlier, its ninth consecutive month of year-over-year declines, with the associated Cass commentary moving from "warning of a potential slowdown" to "signaling an economic contraction."

The timing and depth of any recession are likely to be largely determined by the health of the jobs market (including wage growth, average hourly earnings, hours worked, labor force participation, and unemployment rates): productivity growth; consumer sentiment; retail sales; trade tensions; corporate investment; and not least, real activity outside the U.S. in developed and emerging economies.

A number of economists and Fed prediction models gauge the odds of a U.S. recession in the next six months at approximately 30%, and in the next 12 months at roughly 50%. Aside from attempting to predict when a recession might begin, of equal if not greater importance to consider are the likely depth, extent, and fallout of any such economic retrenchment, especially given elevated asset prices; waning faith in the efficacy of central banks' actions; high levels of non-financial corporate indebtedness; and the difficulties that policymakers have had

(1) in stimulating growth using conventional (and unconventional) monetary policies, as well as

(2) in persuading political leaders to undertake the heavy lifting of fiscal stimulus and effective economic reform.

Election Year Dynamics: With the pressing Syria situation and smoldering impeachment proceedings in the House of Representatives, and polls registering meaningful support for significant tax increases on the fortunes of America's richest individual taxpayers as a means of reducing wide wealth inequalities, Democratic Party presidential candidates Elizabeth Warren and Bernie Sanders have proposed the following measures, with the proceeds used to fund new social programs including tuition-free college, universal child care, and Medicare for all:

• Senator Warren would impose a 2 percent tax on households with a net worth above $50 million and a 3 percent tax on households with a net worth above $1 billion.

• Senator Sanders proposes a 1 percent tax on net worth from $32 million to $50 million for married couples, rising to 8 percent on net worth above $10 billion.

Opposition to such plans has centered on the unknown effects on financial asset prices, possible negative consequences for philanthropic giving, and difficulties in valuing many forms of individual wealth — such as privately-held companies, art, and other tangible assets.

Regardless of their political leanings, investors need to pay attention to the implications for sectoral and broad-based asset prices of potentially higher individual and corporate taxation, new policy proposals, and increased regulatory actions that are almost certain to be floated — during the debates, the primaries, and the runup to the national election — directed toward companies in, among others, the following sectors: social media and e-commerce; pharmaceuticals, biotechnology, and life sciences; energy; automobiles; banking and financial services; and electric utilities.

Brexit: With the United Kingdom facing an October 31 deadline to withdraw from the European Union, virtually continuous negotiations have centered on mutually acceptable checks and controls relating to the flows of goods and people between Northern Ireland, Ireland, the U.K., and the European Union.

Ever since the June 23, 2016 vote (by 51.9% of participating voters) Brexit's effects on asset prices have tended to manifest themselves through swings in investor sentiment affecting the British pound and euro, and to a lesser degree, through British and European equity and fixed income securities prices. For our stance to become more positive on European equities, we need to see authentic signs of economic growth in Germany, improved profitability in the banking and financial sector, and definitive actions embracing fiscal stimulus and structural reform.

Portfolio Positioning

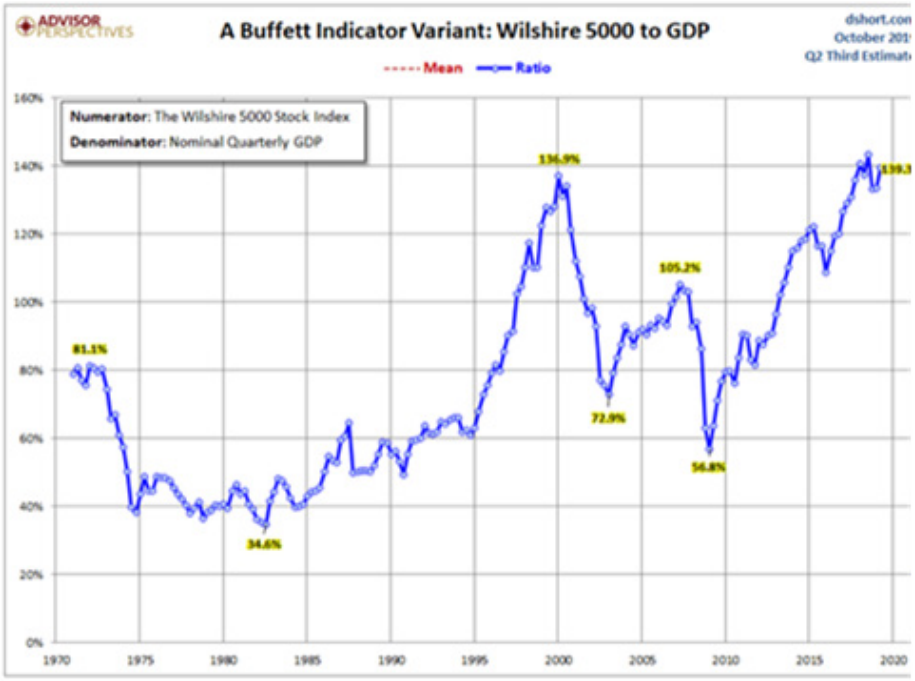
Fundamental Considerations: In the five economic recessions that have occurred over the past four decades, sustained weakness in

the manufacturing Purchasing Manager Indices has tended to favor our current recommended positioning: defensive portfolio allocations emphasizing cash; shorter-duration and/or floating-rate fixed income securities; and stable equity sectors with ample dividend coverage (including utilities, financials, and consumer staples) while underweighting more highly-valued sectors such as lowest-quality and longer-duration bonds, technology stocks, and consumer discretionary companies.

With very few friends and representing multi-decade low levels of total U.S. equity market capitalization, high-quality energy stocks possessing balance sheet strength and solid dividend coverage may offer opportunity to contrarian-minded investors willing to view such exposure almost as bond substitutes.

Valuation Considerations: The chart below sets forth one measure of the total U.S. Equity Market Capitalization-to-Gross Domestic Product ratio, popularized by Warren Buffett in a 2001 Fortune magazine interview in which he called this indicator his preferred "single best measure of where valuations stand at any given moment."

Recognizing that valuation measures also include ratios of price to earnings, price to sales, price to book value, and other metrics, and keeping in mind that most valuations are by no means cheap — and are in fact somewhat on the expensive side — we recommend that heightened caution and special attentiveness should be necessary elements of investment thinking right now.



In the taxable and tax-exempt credit markets, we counsel vigilance and an emphasis on the higher quality portions of both the high-grade and the high-yield sectors. Important valuation indicators to monitor include:

(1) the S&P Global Ratings U.S. distress ratio, representing the proportion of junk bonds that yield more than 1000 basis points (10 percentage points) above Treasuries, which rose to 9.4% in August from 6% in July;

(2) investor flows into and out of mutual funds and exchange traded funds that buy high-yield bonds and leveraged loans compared to mutual funds and exchange traded funds focused on investment-grade corporate bonds; and

(3) the yield spread of very low-rated bonds (with triple-C ratings by S&P) compared to best-quality junk bonds (with double-B ratings by S&P). Somewhat cautionary signals have been sent by the fact that, as of mid-October, the worst-rated corporate bonds have witnessed a rise in the yield spread above U.S. Treasuries to 10.7 percentage points, from 7.0 percentage points one year ago, whereas the yield spreads on the best-quality junk bonds have effectively not budged at all, registering 2.3 percentage points in mid-October, the very same spread as a year earlier.

With 2018 S&P 500 earnings of $161 per share (up 22% over 2017), some preliminary yearend 2020 price targets for the S&P 500 are:

(1) at the Bear Case low-end, 2457 based on 2021 Earnings of $166 and a PE multiple at 14.8 times;

(2) at the Bull Case High-end, 3382 based on 2021 Earnings of $190 and a PE multiple at 17.8 times; and

(3) in the Base Case, 2901 based on 2021 Earnings of $178 and a PE multiple at 16.3 times (not higher, because of possible feeble revenue growth, declining profit margins, and ongoing trade tensions).

Our call continues to maintain that U.S. equities are likely for the foreseeable future to experience cyclically corrective, bearish episodes that likely will be followed by cyclical rallies in an up-and-down pattern.

U.S. equities should continue trading in a multiyear range featuring low returns and increased volatility, with the high end of the range for the S&P 500 Index in the neighborhood of 3000-3300 and the low end of the range for the S&P 500 in the neighborhood of 2300-2500.

The resumption of the secular bull market for U.S. equities should likely only take place when financial market participants feel expectations of a clearer, more enduring, and more sanguine intermediate-term outlook for the economy, the political environment, and corporate profits. When such conditions ensue, stock market highs are likely to be sparked and maintained by investor enthusiasm over narratives and corporate optimism associated with Artificial Intelligence, Machine Learning, 5G cellular network technology, 3-D printing, the Internet of Things, biotechnology breakthroughs, battery and energy inventions, robotics, quantum computing, and other scientific advances.

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