Sterling Advisors

REVIEW & OUTLOOK – 3Q2019

This Review & Outlook includes commentary on Sterling Advisors' three investment Strategies: Large Cap Value, Large Cap Core and Intermediate Fixed Income. As a valued client, we want you to be aware of and updated on all investment options available from Sterling Advisors.

Closing Prices 9/30/2019	
DJIA	26,916.83
S&P 500 Index	2,976.74
Barclays Intermediate U.S. Govt.	2,227.62
Russell 1000 Value	1,263.10
Russell 1000 Growth	1,605.39
NASDAQ	7,999.33
U.S. Treasury Bond	
Current Yield 10-year Bond	1.664%
Current Yield 30-year Bond	2.1105%

Source: Bloomberg

The Market Environment

U.S. equities treaded water in the third quarter, digesting robust year-to-date gains and remaining within striking distance of historic highs. The current economic expansion, dating back to the end of the financial crisis, stands at 41 consecutive quarters of positive economic growth. Interest rate volatility, escalating trade tensions and an increased focus on the 2020 presidential election top the list of factors influencing investor sentiment as we move into Q4. Large Cap U.S. stocks, represented by the S&P 500 Index, posted a modest advance of 1.68% in the third quarter. Bonds saw unusual volatility, but finished with gains, evidenced by the Bloomberg Barclay's Aggregate Bond Index's 2.27% return.

Perhaps the most notable development was the Federal Reserve's decision to cut interest rates by .25% at the July and September meetings. These were the first reductions in more than a decade, representing an acknowledgment by Chair Jerome Powell that the economy required stimulus to maintain its growth trajectory. Bond yields plunged, with the yield-curve inverting for a brief period this summer, sending a clear message policy changes were needed to stave off a recession. Powell referred to these rate reductions as a "mid-cycle adjustment," and the vote to act was not unanimous, leading us to believe consternation over monetary policy will linger.

The U.S. economy continues to expand, albeit at a more moderate pace than the last several years. Unemployment is at a half-century low, wage growth is sluggishly advancing, consumers are spending, the U.S. dollar is strong and asset prices have been stable. Cyclical areas of the economy that are purely domestic, such as housing, have seen an uptick lately, with strong new housing starts and household formation data. On the other hand, some multinational industrial, retail and technology companies have reported rising inventories and lack of visibility due to global trade and tariff constraints. In fact, substantial additional tariffs on Chinese imports are set to be implemented on Dec. 15th. These tariffs will be comprehensive in nature, therefore more onerous on companies beholden to China as part of their supply chain. A trade and tariff resolution, or lack thereof, is likely to have an increasing impact on those corporations tethered to global trade, as costs become harder to mitigate without materially impacting earnings per share.

Turning to the internals of the financial markets in Q3, large cap stocks continued to outperform small caps, growth and value equities traded blows registering similar returns, and volatility was most notable in the bond market, as yields plummeted with unusually high levels of daily volatility. One negative development has been the poor performance of a slew of new issues. From ride-sharing companies, to in-home connected exercise bikes, to the cancelled listing of co-working giant WeWork, IPO buyers have suffered as shares were bid up to elevated levels prior to being offered to the public. Historically, this pattern is a hallmark of a business cycle in its later stages, and negative sentiment has recently spread to other hyper growth, cash-burning companies, highlighting investors' renewed attention to profitability.

Large Cap Value Strategy

Value stocks posted modest gains in the third quarter indicated by the positive 1.26% performance of the Russell 1000 Value Index. We continue to maintain a cash position of 5-10% based on macro risks and to provide the ability to act quickly when opportunities present themselves, which is often the case in volatile markets. As a whole, value stock and growth stock had similar returns in the third quarter. This is a departure from the more recent trend of growth besting value.

Our team of portfolio managers made six new purchases in Q3, acting on our macro views coupled with the output of our fundamental screening process. Diversification remains top of mind, with new holdings representing the following areas – internet security, insurance, defense contracting payroll services, banking, and retail/grocery.

Smaller market sectors known to be defensive in nature, such as Real Estate, Consumer Staples and Utilities rose sharply, greatly outperforming more cyclical pro-growth sectors. Real Estate performed well since we are in the environment of very low interest rates. The Healthcare sector suffered in response to lingering drug pricing pressure, opioid litigation and uncertainty over political policy. Other areas that contributed to market returns in the quarter included Industrials with exposure to aerospace and defense, and Healthcare with the sub-sectors of medical devices and managed care leading the way. Energy and Materials are generally cyclical in nature, and although we view the Strategy's holdings as fundamentally strong, the market's preference for defensive characteristics and counter-cyclical traits were the overwhelming factors in the third quarter.

Large Cap Core Strategy

Markets were rotational in the third quarter as the overall capital markets finished up modestly. From an investment standpoint, large capitalization stocks were positive and fared better than their smaller capitalization peers, which finished negative during the quarter. Utilities, real estate and consumer staple sectors performed the best during the quarter. The market is rewarding stocks with predictable and growing earnings growth, factors our investment team looks for when evaluating companies. Also, U.S. companies that have had minimal foreign exposure, especially to the ongoing trade battle with China, have benefited. Our exposure to foreign markets, in general, has been limited for the last several years.

The Federal Reserve has stopped hiking interest rates at the 2.5% level, which represents the ceiling for this tightening cycle started a few years ago. During this past quarter investors witnessed the Federal Reserve cut interest rates twice with the current Federal Funds rate residing at 2%. There's more evidence of central banks being pushed into easing monetary policy with negative yields in some parts of the world. A generational change in Federal Reserve thinking coupled with declining inflation expectations, for now, should allow the Fed to catch up to market expectations by cutting interest rates more. This should improve liquidity and point to an intermediate term reacceleration of growth in the future. The difficult question is, how long this vulnerable period of earnings and stock prices will last, as we wait for the next leg of future economic growth.

During the last several months gold has surged, bond yields have fallen and the trade war with China has no particular end in sight. Any trade war that ensues won't cost lives, but livelihoods. The world seems to be splintering politically and economically. The United Kingdom is still trying to figure out how to leave the European Union. Italy might be next to leave the European Union. Tensions in Hong Kong, renewed tensions with India and Pakistan and the never-ending saga with Iran all weigh on investors as they monitor investments. The ability to separate geopolitical risk from economic and trade risk has become more challenging when evaluating companies.

The U.S. economy has returned to a "muddle thru" trajectory. The solid labor market and household finances are underpinning consumer confidence. Consumer spending is helping keep the odds of a recession at bay for now. Strong consumer spending has helped power the economy forward, with economic damage from the trade wars mostly confined to the manufacturing and agriculture sectors. With central banks lowering their benchmark rates to spur lending activity, this should hopefully increase inflation expectations, and in turn, push intermediate and longer yields higher. What happens if the opposite occurs? Falling prices lead consumers to believe prices will continue to be lower in the future, therefore postponing current purchases. Lower current demand can lead to a retraction of labor. As a result, companies and consumers may spend less, which may lead to an increase in financial difficulties for families and businesses. It's important the U.S. does not find itself in this vicious cycle.

Most of the equity market's return this year has come from multiple expansion, which rebounded from late 2018 when investors experienced multiple contraction in stock valuations. Is it possible that there will be no major market decline? Can stocks continue to levitate for longer if central banks keep pumping trillions of dollars into the financial system and the extra liquidity finds its way to the U.S. markets? We ask ourselves, is it better to react to market conditions as they happen or try to anticipate the next move? The market has already moved forward from the fears at the end of last year. But has the rebound been too quick? We continue to focus on high quality companies that offer a rising dividend, buybacks from non-leveraged balance sheets and predictable earnings. Preservation of capital remains paramount.

Outlook

As our investment team shapes or outlook for the balance of 2019 and beyond, changing global macroeconomic conditions and the U.S. economy's aging business cycle are top of mind. Interest rates have seen wild swings in 2019 along with investor sentiment, yet equity markets remain near all-time highs, at similar levels to where they were 18 months ago. Economic indicators here in the U.S. are showing some signs of deterioration, yet purely domestic industries continue to perform reasonably well. What is the message in all of this? We feel now is a time for investors to be vigilant and discerning in what they own. Paying attention to corporate debt levels, not reaching for yield, and paying an appropriate price for companies with reliable earnings are all good practices that investors tend to abandon at the end of bull markets. With these risks in mind, we're cautiously optimistic that U.S. equity markets can move higher between now and year-end. All things considered, markets have absorbed a plethora of macroeconomic uncertainty and refused to give up this year's healthy gains. There may be a message in this resilient price action, that markets are poised to move higher and climb the "wall of worry" with any hint of positive news. Of course, this news would likely be in the form of trade and tariff alleviation – which is not something one can predict with any degree of certainty. Additionally, we expect greater volatility in the year ahead as the presidential election draws nearer. This is also likely to cause swift sector rotation as investors draw conclusions from poll numbers, debates, and even tweets as to what each candidates' success or lack thereof may mean to future earnings of specific industries.

Bulls Say:

- Low interest rates and supportive Fed help GDP growth economic indicators deteriorating
- Positive wealth-effect from strong equity markets IPO failures signal a market top
- Unemployement at 50-year low with wages ticking higher of slowdown or recession
- U.S. economy stands out globally and will attract capital high level of Baa rated bonds

Bears Say:

- Increasing number of leading
- Record IPO issuance/ high-profile
- Flat yield curve is a reliable indicator
- Corporate debt overhang, record

Our outlook can be broadly defined as one of cautious optimism, giving the benefit of the doubt to the upward trend and continuation of the current economic expansion. Risks have risen in recent months, warranting a more conservative investment stance that allows our clients to participate in the majority of a further market advance while remaining committed to capital preservation. As a result, adding risk to equity or fixed-income portfolios does not seem timely to us, and we're watching economic data carefully for any material change in trend. The message of financial markets in the third quarter was one of asset class rotation and digesting the gains of the first half of the year. Expectations of interest rate hikes have been shelved indefinitely, making dividend-paying stocks and investment grade bonds attractive places to invest for total-return, especially given what appears to be a mature business cycle. We'll continue to adjust our outlook using our disciplined approach, and implement changes as needed on your behalf.

Sources: Bloomberg and FactSet

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Dow Jones Industrial Average: The most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. **NASDAQ Composite Index:** Measures all NASDAQ domestic and international based common type stocks listed on The Nasdaq Stock Market. The NASDAQ Composite is calculated under a market capitalization weighted methodology index. **Standard and Poor's 500 Index:** Capitalization-weighted index of 500 stocks, including the reinvestment of dividends and other distributions, designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Russell 1000 Value** Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.