Bank of New Hampshire
WEALTH MANAGEMENT

Private Banking

Quarterly Review
October 2019
Focus Shifts to the Labor Market

Market/Economic Update

Elections are many times won and lost based on jobs and how satisfied voters are with the economic climate. It will come as no surprise that this is also true for bull markets as the pace of job creation is one of the most important determinants that investors look at to identify shifting economic trends. The reason for this is that labor has a ripple effect across the economy because it reflects not only overall demand, but also is a key driver for both consumer spending and housing activity. The lows in both jobless claims and the unemployment rate in recent months have been a bulwark for the market along with company stock buybacks and increased foreign buying. Though these key structural factors continue to be in place, there has been increasing concern in recent weeks about the pace of future activity and whether it will begin to negatively impact the job market data which is so well correlated with the onset of recessions.

The reasons for concern are the erosion in manufacturing activity and the inversion of the yield curve would suggest that the risk of recession has risen in the last few months. The Institute of Supply Management (ISM) Purchasing Managers Index reading for September at 47.8 was well below analyst expectations and indicates slowing activity. While manufacturing overseas has been contracting for several months at this point, this is the first sign that we are now importing that weakness here in the U.S. economy. Credit activity, such an important component for economic growth, is also likely to slow as banks become less aggressive in making new loans when the yield curve is flat because margins are tighter. These two factors have been harbingers of slowdowns in prior business cycles and are indicative of heightened risks as we head into next year.

The long term market trend remains bullish for the moment, but we are maintaining an awareness of the role that effective risk management plays in managing portfolios in the later stages of a business cycle. This will be especially true should employment trends begin to reverse. Asset allocation strategy is neutral within the various investment objectives which reflects some profit taking that we have done on the stock side over the last twelve months, though not yet defensive as there is no catalyst for a sustained sell-off to this point. Security selection also becomes important in the later stages of a bull cycle as we tend to focus more on quality in terms of balance sheet strength and the ability to generate free cash flow. These steps create a margin of safety in portfolios which doesn't eliminate the possibility of near term declines in value, but rather provides investors with a measure of insulation that will foster the achievement of long term client objectives.

—Charlie Mathews, CFA

Equity Markets

The S&P 500 year to date through the close of the third quarter has returned +20.55%, while the Dow Jones Industrial is up +17.51%. The Nasdaq closed the quarter with a year to date return of +21.56%. Market volatility continued in the third quarter as the S&P 500 moved to a new high in late July, which has since been followed by much churning between 2,800 and 3,000, a level that has now become key resistance for the bullish trend. In other markets, the Russell 2000 Small Cap Index is up +14.15% year to date, but down just over -2.00% for the quarter, international stocks lagged a bit with the EAFE Index up +13.39% year to date and the MSCI Emerging Markets up a more modest +6.14%, with both international indices losing ground during the quarter. After a strong start to 2019, the third quarter returns were muted at best which would indicate some profit-taking amid trade policy concerns.

As the FOMC cut rates for the first time in several years in July and then again in September, we have begun to consider the possibility of the yield curve steepening next year in response to a series of rate cuts. This may shift investor focus for 2020 to the interest sensitive financial sector as well as smaller stocks which have traditionally done better in that environment. Until then, we expect markets will be volatile with the trade war and political uncertainty as the major headline grabbers. This choppiness causes us to favor higher quality, blue chip stocks as corporate earnings estimates, which at the end of the day are the best measure of economic health, may be subject to some revision amidst the uncertainty.

—Robert Magan, CFA

Credit Markets

Last fall, not many financial professionals expected that we'd be staring at a 1.67% yield on the ten-year today. A year ago, the ten-year yield was 3.06%, and the Federal Reserve was raising their short-term interest rate, a gesture normally reserved to dampen a hot economy. However, the U.S. economy was already experiencing lackluster growth, and a more reasonable explanation is that the Fed raised the rate to reload its quiver to provide flexibility should the economy start to falter which some of the data is beginning to support. You may recall that the Fed had cut its way to a zero rate after the 2007 financial crisis and has been raising rates periodically during the expansion to ramp up its ammunition for rate cuts it might need should the economy show signs of slowing down. The last Fed increase in December 2018 may not have been necessary given the low level of inflation, as the central bank has now found the need to lower its overnight rate twice in the third quarter from 2.5% to 2.0%.

As the Fed cut its short term lending rate, intermediate and longer rates followed suit with yields still inverted throughout much of the curve. Investors across the globe have moved money into the U.S. Treasury market, pushing yields much lower than many expected as uncertainty over U.S./China trade, tensions in the Middle East, and slowing economies in the Eurozone have created the possibility of recession in the months ahead. With over 30% of global debt now negative yielding, the U.S. has become the market of choice for fixed income investors as there is yield to be had and relative stability.

Credit Markets continued

Profit taking in equities has also been a factor in strong bond performance this year. The Bloomberg Barclays Aggregate Index was up +2.3% for the quarter and +8.7% for the last nine months, well above average annual returns of +2.4% and +3.8% for the last five and ten year periods respectively. Longer duration bonds fared well as the long end of the curve flattened more with each Fed rate cut. Economic concerns also led investors out of lower quality junk bonds which have a higher level of default as companies experience decreased revenues and tighter cash flows during periods of economic stress. The shift into higher quality assets reflects an environment where inflation is largely non-existent and concerns about demand are likely to persist. As we are now operating in a lower rate environment (depicted in the chart below), we will continue to search for selective opportunities to enhance yield without sacrificing credit quality and liquidity which are important cornerstones of portfolio construction as uncertainty is likely to rise heading into an election year.

—Dona Murray