JURIKA · MILLS & KEIFER
Private Wealth Management

Quarterly Investment Commentary

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Hurricane Donald:

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Hurricane season may be over in the Atlantic, but is in full force in Washington, London and other political capitals.

A lot of the questions and concerns that we are hearing from clients lately relate to the current stormy political situation and its potential impact on markets and their portfolios.

Politics is always a consideration in investment strategy but is normally more of a sideline conversational topic, like talking about sports, than the central focus of discussion.

These are not normal times, at least politically. Certainly, we have seen partisan division, scandal, corruption, social unrest and even impeachment proceedings in the past, but the current level of it all seems unprecedented.

Part of the reason is that partisan division within the House of Representatives and Senate is more extreme than in past decades. There are fewer centrists who can find common ground and pass legislation. Another reason is that everything is magnified through the lens of traditional news stations and social media. There is a maelstrom of opinion and spin: up is presented as down, black as white, night as day. The amount of distortion, distraction and dishonesty is not only troubling, it is outright exhausting.

It is therefore no wonder that investors want to board up their portfolios in the face of the gathering political storm.

Historically, it has not been good practice to mix politics and investing. Economics and markets have tended to drive political outcomes more than the other way around. If the economy and employment are strong, incumbent presidents and parties tend to hold power. If the economy and markets are declining and unemployment is rising, incumbents tend to lose power. Moreover, markets tend to have a way of doing the opposite of whatever most people expect them to do. The consensus opinion prior to the 2016 election was that if Trump won, markets would crash. They did, for about eight hours, before moving sharply higher for the next fourteen months.

We still believe that from an investment standpoint, it is good practice to ignore most of the political news and noise and focus on economic fundamentals and long-term client objectives.

However, while the economy does tend to drive political cycles, politics and governance can have an impact on the economy and markets, for better and for worse. This is particularly relevant with respect to trade, tax, fiscal and regulatory policy. It is also relevant with respect to how well the government engenders a sense of institutional stability and rule of law.

One of the biggest areas of concern for investors, company managements and consumers has been trade policy and the Trump administration's volatile and vacillating approach to reaching a trade deal with China. One day there are reports of progress and the next day we awaken to tweets of new tariffs. Much of this is bargaining bluster, but it is having a real and detrimental impact not just on the U.S. economy, but around the world. It has put a damper on global economic growth and resulted in higher prices for U.S. businesses and consumers who end up paying the tariffs. This seems counterproductive as it undermines many of the economic benefits of the 2017 tax cuts while causing Federal budget deficits to soar.

Another area of concern is the growing lack of predictability and faith in what rules apply. The world economy runs on confidence. Company managements, investors, and consumers need to have faith in the integrity of government institutions, and confidence that the rules that apply to their actions today will apply tomorrow as well. If these rules keep changing from day to day, it is only natural to hunker down, reduce risk and wait to see what happens. This collective hunkering down results in slower economic growth: less investment, less hiring and less consumption.

Can't you hear the whistles blowin'?

We are not clever enough to predict how the current impeachment inquiry will play out. We doubt any of the political experts know either. In all likelihood, the House will vote to impeach the president. How the Senate acts, will depend largely on public opinion. Current expectations are that Senate Republicans will defend the president and claim there is nothing to see here. If however, additional evidence of wrong-doing comes into the light of day, and public opinion against the president builds among their constituents, they could turn on Trump very quickly as they did with Nixon.

A key swing factor in this - besides the actual merit of the case to be made against the president - is the economy; one of the only areas where the president gets favorable ratings. If the economy is weakening and markets are declining, support for the president will also likely decline.

This is where economics and politics become unusually intertwined in this case. At the very least we expect greater volatility in the markets in the coming few months as political and economic events play out.

Although global economic growth is slowing, it is still positive. Some of the slowing is doubtless the result of all of the trade and political uncertainty described above and could be temporary. In the U.S., the manufacturing sector, which is more reliant on trade, has been particularly affected. The services sector, which represents close to 70% of the U.S. economy, is still growing, albeit at a slower rate.

Elsewhere in the world we see more significant patterns of economic slowing or contraction. Some of this slowing is because of regional challenges, but a lot has to do with trade. The rest of the world is more reliant on global trade than the U.S. and, however bad the trade war is for the U.S., it is worse for almost everyone else.

In Europe, there is the additional prospect of Brexit which, regardless of how things play out in Washington, could create additional headwinds for European economies.

Recessions do not typically occur without a major economic imbalance or bubble, Central Banks raising interest rates, or a shock from left field. We do not currently see any major imbalances, except perhaps in government bonds, which are selling at historically low or even negative interest rates throughout much of the developed world. Meanwhile, central banks around the world are actively lowering interest rates to support economic growth.

The political situation could be that external shock that pushes the economy over the edge into recession, but this is not our current central thesis. We think the most likely scenario is that some kind of trade deal or truce is reached with China, Trump is not fully impeached, and economic conditions plod along and even start to improve. We could also see moves in Europe and China to boost fiscal spending and stimulate economic growth.

If this is how things play out, stocks should rebound and move higher, supported in part by very low interest rates and a lack of better investments. For a long-term investor, the S&P 500 index has a higher dividend yield (1.9%) than a 10-year Treasury Bond (1.5%) and so on a relative basis looks like a bargain. The stock index pays you more to hold it and could easily double in value in 10 years. The Treasury bond pays you less and will never be worth more than the $1,000 that you paid for it. Which would you rather own for the long term?

If, on the other hand, no trade agreement is reached, and/or the political storm escalates, consumers and businesses will likely continue to move to the sidelines. Then, we could easily end up in a self-inflicted recession that spills around the globe. This path is not in anyone's best interest and flies in the face of reason and common sense, but both seem to be in short supply in government these days. Politicians have a knack for taking extreme positions - largely to get attention - that back them into corners from which there is no easy exit, or Brexit, or border wall.

In Hartford, Hereford and Hampshire, Hurricanes Hardly ever Happen...

With respect to Brexit, we think the most probable and hopeful scenario is that the October 31st deadline gets postponed and the issue ultimately gets put back to the English people in the form of a new referendum vote (specifically on Brexit) rather than a new election. Like a trade war with China, it is not in anyone's best interest for the U.K. to leave the European Union, especially in a sudden way, but in a high stakes game of political chicken, mistakes and hurricanes, can happen.

Quarter Review:

The third quarter started out on a positive note for global stocks only to run into a new set of trade-related worries in August, followed by renewed optimism in September. U.S. stocks finished the quarter up about 2%, while international stocks lost a percent and emerging market stocks lost about 4%. Bonds rallied in step with a swift decline in interest rates. The benchmark Bloomberg Aggregate Bond index gained 2.3%. Gold also rallied 9% during the quarter.

Investment Strategy and Conclusions:

Although we typically do not counsel mixing politics and investing, we think that the current situation warrants an extra measure of caution. Valuation levels for stocks are full but not extreme. Stocks could easily move higher if the near-term storm clouds abate and economic activity picks up.

But there is a real risk that the political and economic situation gets worse before it gets better and the market is not currently priced to reflect this. In our view, the current symmetry of potential reward to potential risk is skewed to the downside. Over the longer term, with historically low interest rates, stocks offer compelling value relative to bonds.

We therefore continue to maintain a slightly more cautious allocation to stocks relative to our long-term target models, offset with a defensive cushion of gold and bond holdings. This cushion can be re-deployed into stocks and other risk assets should we experience a significant downturn in stock prices and valuation levels and/or our fundamental economic outlook improves.

As always, we welcome your comments, questions and referrals.

Jurika, Mills & Keifer
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Private Wealth Management

Based in the San Francisco Bay Area, Jurika, Mills & Keifer provides wealth management, planning and advisory services to a limited number of individual, families and foundations.

We combine a forward-looking view of the world with a deep understanding of our client's needs and aspirations to build and preserve wealth and financial well-being over time.

Over the years, we have built a reputation for independent thinking, sound judgement, and a high level of individualized advice and service.

We welcome the opportunity to discuss your financial priorities and goals and how we can help you achieve them.

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