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Capital Markets Review and Outlook

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October 2019

Economy and Outlook

The first month of the final quarter for 2019 was book-ended by two notable events. October began with a significant de-escalation of the trade war between the United States and China. Top trade officials from the two countries met for the first time since July, and the talks in October led to the possibility of a "Phase One" trade agreement between the two countries. October also ended with the Federal Reserve cutting interest rates by 25 bp for the third time this year, but with an indication the Fed was now on hold with regards to further rate cuts. The latest rate reduction lowered the federal funds rate to a target range of 1.5% to 1.75%. Despite continued weakness in the manufacturing sector globally, which was precipitated to a large degree by the protracted U.S./China trade war, the U.S. economy has held up remarkably well considering the longevity of the current economic expansion. For the second and third quarters of 2019, real GDP grew at an average annualized rate of 2%, which the Federal Reserve considers as trend growth for the U.S. economy. While business spending has fallen for the past two consecutive quarters after almost two years of strong gains, this decline has been more than offset by the strength in consumer spending and housing. The solid U.S. employment picture with an unemployment rate near 50-year lows, annual wage gains of 3%, and upbeat consumer confidence measures continue to underpin consumer spending which accounts for two-thirds of U.S. economic growth. The housing market has also been a positive contributor to the economy. The sharp decline in interest rates this year has led to a significant drop in mortgage rates with the average rate for a 30-year home mortgage dropping recently to 3.75% from almost 5% just a year ago. As a result, residential investment increased at a 5.1% annual rate in the third quarter of this year after six straight quarters of declines. Despite the age of the current economic expansion, the longest on record, inflation remains benign and below the Federal Reserve's 2% target. This has enabled the central bank to undertake three interest rate cuts this year in response to the economic uncertainties created by the trade war and the global economic slowdown. The Fed's Chairman Powell has noted the problems posed by persistently low inflation.

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The chart on this page shows that even inflation expectations 5 years out have been declining below the Fed's target. There is, therefore, a high bar for the Federal Reserve to consider raising interest rates in the foreseeable future.

In addition to the accommodative monetary policies by the major central banks, interest rate cuts have also been undertaken by a wide range of other central banks around the world. Low interest rates, low inflation and improvements in the trade war rhetoric should provide a positive backdrop for the financial markets. Risks, of course, remain due to factors such as the impeachment hearings in Washington, the up-coming U.S. presidential elections, and the geopolitical implications of the on-going unrest in Hong Kong as well as the more recent unrest in the Middle East.

Equity Markets

The positive developments on the monetary policy and trade war fronts in October provided a renewed boost for the equity markets. The broad domestic equity market represented by the Russell 3000 index gained +2.2% for the month which brought its return for the year to a strong +22.7%.

In terms of capitalization, October marked the second consecutive month that Small Cap outperformed Large Cap. While the outperformance for the month was +50 bp, on a year-to-date basis, Small Cap underperformed Large Cap by -590 bp. Historically, the underperformance of Small Cap has continued for a prolonged period – for the past 10 years (ending 10/31/19), Small Cap has underperformed Large Cap by an annualized -140 bp per year. From a style perspective, there was a reversal of Value's outperformance over Growth seen in September. For the month of October, Value underperformed Growth by -130 bp bringing the year-to-date underperformance to -700 bp. Similar to the long-term underperformance of Small Cap, the underperformance of Value has also persisted over the long-term. For the past 10 years, Value has underperformed Growth by an annualized -340 bp per year. The buoyant tone in the equity markets was reflected in sector performance. For the second consecutive month, Cyclicals outperformed

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Defensives. Technology and Financials were top performers for the month with returns of +3.9% and +2.4% respectively, while Consumer Staples (-0.1%) and Utilities (-0.8%) lagged. Health Care with the best sector return of +5.1% was an outlier amongst Defensives. This sector continues to be buffeted by the contrasting and changing proposals for healthcare reform from the contenders for the Democratic presidential nomination.

The positive developments in the U.S./China trade war together with interest rate cuts by central banks, and a weaker U.S. dollar bolstered international equity markets which outperformed U.S. markets for the second consecutive month. The MSCI Developed Markets equity index increased +3.6% in October bringing its year-to-date return to +16.9%. The Emerging Markets index rose a strong +4.2% for the month. Investors viewed the political and economic problems in specific countries such as Argentina, Chile, Turkey and South Africa as idiosyncratic with a low risk of spilling over into the broader markets. For the first 10 months of 2019, the Emerging Markets index had a return of +10.4%.

<u>Fixed Income Markets</u>

Despite the rally in equity markets, short to intermediate term Treasury yields declined as the Fed cut interest rates for the third time this year. Yields on 2-year Treasury securities dropped by 11 bp to 1.52%, while 5-year yields declined by 4 bp to 1.51%. Longer maturity yields rose modestly with the 10-year yield rising by 1 bp to 1.69%, and the 30-year Treasury bond ending the month at 2.17%, 5 bp higher than the previous month. The Fed's actions were viewed as a positive for the economy, and the Treasury yield curve steepened for the second consecutive month with the 2-year/10-year Treasury yield differential increasing sharply by +12 bp.

The constructive tone in risk markets was also reflected in the corporate bond market as spreads tightened for the second consecutive month. The spread on the Bloomberg Barclays Investment Grade Credit index narrowed by 4 bp to end the month at +105 bp generating +55 bp of outperformance over duration-matched Treasuries. The corporate credit curve as well as the quality curve both flattened in October as investors increased exposures to longer maturity and lower quality corporate bonds. Long maturity corporates outperformed short and intermediate-term issues by an average of +56 bp, while the BBB-rated sector outperformed the Single-A sector by +19 bp. The theme of better performance for going down in credit quality did not apply to the High Yield sector. While the overall Barclays High Yield sector generated a return of +0.28% for

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October, lower quality sectors underperformed higher-rated sectors. The BB-rated sector had an excess return of +57 bp, but the corresponding excess returns for the Single-B and CAA sectors were -20 and -47 bp respectively. On a total return basis, the distressed sector within High Yield had a negative return of -1.5% for the month. Year-to-date, the overall High Yield sector posted a strong return of +11.7%. In developed markets outside the U.S., yields rose modestly on an improving global economic backdrop and as monetary policies remained accommodative. However, despite the rise in yields, the non-dollar government bond market posted a positive return of +0.8% in October as the U.S. dollar declined sharply with the weighted dollar index down over -2% for the month. Year-to-date, the non-dollar government bond market had a return of +6.3%.

			Returns as of 10/31/19 (In %)			
		Month	YTD	1 Year	3 Years	5 Years
Russell 3000®	US AllCap Equity	2.2	22.7	13.5	14.5	10.3
Russell 1000®	US Large Cap Equity	2.1	23.1	14.2	14.7	10.5
Russell 1000® Growth	US Large Cap Growth	2.8	26.8	17.1	18.9	13.4
Russell 1000® Value	US Large Cap Value	1.4	19.5	11.2	10.5	7.6
Russell Midcap®	US Mid Cap Equity	1.1	23.2	13.7	12.3	8.7
Russell Midcap® Growth	US Mid Cap Growth	1.9	27.6	18.9	16.8	10.9
Russell Midcap® Value	US Mid Cap Value	0.5	20.1	10.1	8.9	6.9
Russell 2000®	US Small Cap Equity	2.6	17.2	4.9	11.0	7.4
Russell 2000® Growth	US Small Cap Growth	2.8	18.6	6.4	13.2	8.4
Russell 2000® Value	US Small Cap Value	2.4	15.5	3.2	8.6	6.2
MSCI ACWI ex-US	Global Equity ex-US	3.5	15.5	11.3	8.1	3.8
MSCI EAFE	Global Developed Mkts Equity	3.6	16.9	11.0	8.5	4.3
MSCI EM	Emerging Mkts Equity	4.2	10.4	11.9	7.4	2.9
Bloomberg/Barclays US Agg	US Core Fixed Income	0.3	8.8	11.5	3.3	3.2
Bloomberg/Barclays US Interm. Agg	US Intermediate Fixed Income	0.4	6.6	8.8	2.6	2.7
Bloomberg/Barclays US Credit	US Corporate Bonds	0.6	13.3	14.9	4.8	4.4
Bloomberg/Barclays US MBS	US Mortgage Backed Securities	0.4	6.0	8.9	2.5	2.7
Bloomberg/Barclays US Corp HY	US High Yield	0.3	11.7	8.4	6.0	5.2
FTSE Non-US WGBI	Global Fixed Income ex-US	0.8	6.3	9.3	2.5	1.6