BUCKHORN
INVESTMENT ADVISORS

Third Quarter Market Review and Comment
October 2019

Updated Market Performance

Returns	3rd Quarter 2019	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**1.70%**	**4.25%**	**13.39%**	**10.84%**	**13.24%**
DJIA	**1.83%**	**4.21%**	**16.44%**	**12.28%**	**13.56%**

Performance: July began right where June left off notching a return of 1.31%. August gave up July gains posting a -1.81% decrease. September (historically the worst month of the year for the S&P 500) ended on a positive note, up 1.72%, but could have been way worse. In September an oil field strike cut global production by 5%, liquidity caused institutional money rates to jump into double digits before the Fed provided additional liquidity, and the House started impeachment proceedings against Trump. The net result from a quarter that could have been worse was 1.19%. So far, we are maintaining a great 2019 as we enter the final stretch of the year with a return of 20.55% including dividends, the best 9 month start since 1997's 27.88%.

After a volatile 2nd quarter with the S&P 500 up 4.25% the 3rd quarter of 2019 brought major events without increased volatility, the S&P 500 (SP500) posted a 1.19% return in the 3rd quarter that just ended on September 30, 2019. The Dow Jones Industrial Average (DJIA) bested the SP500, posting 1.83% over the same period. For the previous twelve months the SP500 has returned 4.25%, barely outpacing the DJIA which returned 4.21% over the same period. The annualized three-year returns are better than near term returns, with the SP500 posting 13.39%, while the DJIA is running at 16.44%. Over the last five years the annualized returns are running above historical norms (around 10%), with the SP500 returning 10.84% and the DJIA posting 12.28%. The ten-year annualized numbers are also running above long-term averages (around 10.00%); the S&P500 posted 13.24% vs the DJIA which turned in 13.56%.

Breaking down the returns for the Q3 2019, we note that there were six outperforming sectors and five underperformers. **The best sectors were Utilities (8.40%), Real Estate (6.88%) and Consumer Staples (5.36%)**. **The losers during the quarter were Energy (-7.25%), Health Care (-2.71%) and Materials (-0.68%).** The clear winners the last twelve months were Utilities (22.90%), Real Estate (20.68%) and Consumer Staples (13.42%). Bringing up the rear were Energy (-22.07%), Health Care (-5.27%) and Industrials (-0.63%).

The DJIA continued its rise in the 3rd quarter as the Fed continued its dovish stance and we continued to hope for an eventual trade deal with China. Trade tensions continue to be visible, but there has been renewed hope of a trade deal. Trade tensions and slowing economic growth are still top of mind. Global trade and global economic growth are important since more than half of the 30 Dow components get 50% or more of their revenue from outside the U.S., according to FactSet. The SP500 by comparison derives 38% of revenue from outside the U.S.

Buckhorn Investment Advisors LLC
13850 Ballantyne Corporate Place, Suite 500, Charlotte, NC 28277
(p) 704-887-4942 (w) www.buckhornadvisors.com

Economy: Economic growth for the 3rd and 4th quarter are expected to remain below average.

The third estimate of 2nd quarter Gross Domestic Product (GDP) is 2.0% according to the report released at the end of September by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 2nd quarter decelerated by ~1.1% compared to the 1st quarter 2019 when GDP was running at a rate of 3.1%. Overall, the economic recovery has continued so far in 2019 following growth of 2.9% in 2018 and 2.2% in 2017. The long slow recovery which has been in place since mid-2009 should continue for the foreseeable future although we continue to see slowing and begin to see more vulnerabilities. Currently the New York Fed Staff Nowcast (Forecast of U.S. GDP Growth) has forecasted Q3 GDP growth at 1.94% and Q4 GDP growth at 1.05%. By comparison, China says their GDP grew at 6.0% in the 3rd quarter of 2019. China's 2018 GDP was 6.6% compared to 6.8% in 2017. The weakest annual growth rate in 27.5 years, due to the continued trade pressure from the US as well as slowing global demand and alarming off-balance-sheet borrowings by local governments. Declines were not as bad as feared by economists due to a continued increase in policy driven stimulus. Growth rates for the European Union (EU) and the Euro Area were 1.4% and 1.2% respectively in the 2nd quarter 2019. For 2018, GDP rose 1.9% for the EU and 1.8% for the Euro Area. This is down from the 2.4% growth both achieved in 2017 giving further evidence to the slowing of global growth.

Unemployment continues to stay historically low. According to the Bureau of Labor Statistics, September unemployment declined to 3.5%. Unemployment for 2018 came in at 3.9%, the last time the unemployment rate maintained an average of 4.0% or lower was in the late 1960s. Job growth continued to trend up in healthcare and in professional and business services. The labor force participation rate was 63.2% for September, was little changed for the month and has been in a narrow range over the last 12 months.

Inflation is still below historical averages. After averaging ~1.81% in the 2nd quarter, inflation as measured by the Consumer Price Index (CPI) decreased to an average of 1.76% in the 3rd quarter. The average rate of inflation for 2018 was 2.45% and continues to be subdued by historical standards (2.60% over last 30 years). September came in at 1.7%, unchanged from August's reading.

Consumption is an important driver of the economy as it represented 68% of 2nd quarter 2019 nominal GDP. The U.S. Census Bureau announced in October that retail sales for September 2019 were down -0.3% compared to August but were up 4.1% above September 2018. Non-store Retailers were up 12.9% from September 2018, while miscellaneous stores were up 9.3% from last year.

Manufacturing economy contracted in September. Economic activity in the **manufacturing sector** contracted for the second consecutive month in September, with the Purchasing Managers Index (PMI®) registering 47.8, a decrease of 1.3 from August reading of 49.1. This is the lowest reading since June 2009, the last month of the Great Recession. The PMI®'s continued contraction has reached six months of softening. Only one of the sub-indices (Supplier Deliveries) registered a level of expansion. Two of the six big industries expanded, while the other four contracted. The **overall economy** grew for the 125th consecutive month, according to the nation's supply executives in the latest **Manufacturing ISM®** *Report on Business®*. Based on historically relationships between PMI and GDP, a PMI of 47.8 corresponds to a 1.5% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices continue to rise, but price increase have continued to slow since the peak in 2017. According to the S&P Case-Shiller Home Price Indices home prices rose in July with the S&P CoreLogic Case-Shiller National Home Price Index rising 3.2% over the last 12 months. Phoenix, Las Vegas and Charlotte had the largest year over year increases of 5.8%, 4.7% and 4.6% respectively. Fundamentals indicate renewed housing demand. According to the National Association of Realtors, the year over year change in existing home sales was positive in July for the first time in a number of months, and housing supply tightened since peaking in June.

Markets: We have made it over ¾ of the year and the S&P 500 is currently up a little over 20%. We have so far avoided major pullbacks. We still have a trade war (Maybe a partial/temporary resolution), Impeachment proceedings, slowing manufacturing as well as global growth. The Fed is still dovish and ready to step in when needed. All this and we have a new acronym NABAF (Not as bad as feared). Let's hope the remainder of the year is NABAF and we end the year at current levels or higher.

- **Earnings growth for the SP500 is expected to decline -4.7% for the 3rd quarter 2019. If actual growth comes in as estimated, it will be the first time the index has reported three straight quarters of year over year declines in earnings since Q4 2015 and Q2 2016.** According to FACTSET, of the SP500 companies that have reported earnings as of 18 October (Approximately 75), 84% reported earnings above the mean estimate and 64% have reported sales above the mean estimate. **Earnings guidance has been skewed to the downside with 9 companies issuing negative EPS (Earnings per Share) guidance and 4 issuing positive EPS guidance**. Estimated earnings for the quarter fell by -4.7% from the end of Q2 2019 through the end of Q3 2019. This percentage decline was below the 5-year average 6.9%. Looking at future quarters, analysts see a increase in earnings growth in the 4th quarter 2019 and low mid to single-digit earnings growth in the 1st Quarter 2020.

- **Stocks are rich. There is not much room for more P/E expansion, so we need earnings growth to increase to relieve the current extended valuations.** ***It doesn't look like we will receive any meaningful earnings expansion until early 2020.*** The current 12-month forward Price Earnings (PE) multiple on stocks is 16.8. The long term (20 Year Average) PE for stocks is 15.6, so we don't see a lot of room for valuations to move higher without growth or lower interest rates. There is no room for PE expansion now, so to get continued appreciation we will need an increase in earnings and/or widening profit margins.
- **Global trade tensions continue to persist.** This continues to leave a cloud of uncertainty on the market. With trade concerns in the news often and continually being put off, the likelihood of real measurable impacts on U.S. businesses from domestic trade tariffs and retaliatory measures continue to be present. We are starting to see the tariffs flowing through in the manufacturing sector and don't be surprised if we feel it a little during holiday shopping. There have been positive developments lately with China (Conversations) and we are closer today to a partial deal than we were last quarter.

- **Falling interest rates.** The Federal Reserve decided to lower the target range for the federal funds rate to between 1.75% and 2.00% during its September meeting. The decision to lower was predicated by uncertainties about the economic outlook and muted inflation. Fed officials expect that considering the uncertainties along with muted inflation pressures, the fed will closely monitor the implications of new information for the economic outlook and will act as appropriate to sustain the expansion with a strong labor market and inflation near its symmetric 2% objective. In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. The market is currently pricing in at least 93.5% chance of a .25% cut at the 30 Oct 2019 Fed Meeting according to the CME FedWatch Tool.

Forecast: Great first 3/4 of the year leads to cautious and dwindling forward expectations but hopes that we don't repeat 4th Quarter 2018.

Slowing growth, low unemployment, and low inflation. *Slowing global growth in the 3rd quarter has led to lower earnings*. Economic growth will continue to decrease although it looks like it will pick back up towards the beginning of next year. Unemployment has reached lows not seen since the 1960s and continues to run below historically averages. Inflation continues to run below average.

Earnings Growth & Maintained/Increasing Profit Margins. We need earnings growth. After all the negative earnings revisions and negative earnings guidance for Q3 2019 the bar has been lowered, so the focus and attention will be on forward guidance. Profit margins will continue to be pressured by rising wage and labor costs.

What risks are out there that might disrupt the recovery?

- **Negative earnings guidance and negative earnings surprises**. There have already been negative earnings revisions from SP 500 companies for their current earnings reports due to tariffs and slowing global growth impacting earnings. If forward guidance is disappointing, stocks will be pressured to the downside. There is not currently a compelling reason to sell based on valuations. The probability of this scenario is medium but could increase if we see a meaningful increase in negative earnings guidance.

- **The Fed not giving the market the rate cuts it has priced in**. Given the continued low inflation and low unemployment, we think the risk of rate increases by the Fed is low. After the Fed made 4.25% increases in 2018, they decided to pause rate increases in January and made a rate cut in July and September. The recent easing has been a positive for equity prices. If we do not receive the stimulus the market has priced in, don't be surprised if we have a temporary pull back in valuations.

- **Global trade tensions.** We are continuing to see trade tensions which will continue to hold back business and consumer spending, leading to slower economic growth. We hope to see some type of resolution with some of the trade tensions by year end or early next year as we draw closer to the 2020 presidential election.

We think the biggest threat to the stock market is the uncertainty presented by slowing economic growth as well as rising corporate debt levels. This uncertainty will persist until there is clarity over what the final resolution will be on the trade front. It will also depend on the amount of economic stimulus injected globally to spur growth. After the rally so far this year it will not take much negative market sentiment and fear to get the market to head to the downside. We think the SP500 will end the 4th quarter between 3,000 and 3,100. At this juncture, we venture a guess that stocks will end up somewhere between 20%-23% for the year.

For the next six to nine months, the Federal Funds rate should decrease from its current range of 1.75%-2.00% to 1.25%-1.50%. **The 10-year Treasury which is currently priced at ~1.76% should remain at current levels through the end of the 4th quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

Julian F. Patton, Jr. CFA, CFP®, CAIA
Chief Investment Officer

Disclosure: Information provided reflects Buckhorn Investment Advisors LLC ("Buckhorn") views and opinions. Views are subject to change. Any forward-looking statements or forecasts are based on assumptions and actual results may vary. Past performance is not indicative of future performance.