Quarterly Outlook

OCTOBER 2019

Third Quarter 2019

The resilience of the US economy remained on display in the third quarter of 2019, even as global growth slowed, domestic manufacturing sputtered, and geopolitical risks proliferated. Furthermore, political turmoil in Washington and trade policy uncertainty stoked increased recession fears. Despite these obstacles, large-cap stocks and bonds still managed to produce positive returns in the quarter, while smaller company stocks retreated as growth moderated.

The last two years of trade tensions are beginning to adversely affect the US economy, which has exhibited significant flexibility since the Great Recession. Although exports account for just a small share of US GDP, the accumulated costs of the trade conflict and consequent erosion of business confidence have taken a toll on growth. Britain's potential pullout from the European Union and a weakening Eurozone economy throughout 2019 have also weighed on growth at home. Recent ISM data indicates that the US has moved into a manufacturing recession and that the service economy has slowed dramatically. In contrast, the US consumer continues to steadily move the economy forward, albeit at a much slower pace than in the first half of the year. Importantly, consumer confidence remains elevated, a key intangible for continued spending. While the unemployment rate remains historically low, the economy is creating fewer jobs, on average, than it did last year. Nevertheless, jobs are plentiful enough to keep consumers spending.

While recession fears have remained consistent, none of the typical excesses associated with recession are currently present.

All of this puts the Federal Open Market Committee (FOMC) in the very strange position of cutting interest rates multiple times in 2019 despite record unemployment and a lack of inflation (as measured by Core Personal Consumption Expenditure, the Fed's preferred measure of inflation). In a world that is more interconnected than ever, central bank planning has become more challenging, and the Fed faces great difficulty in eliciting intended outcomes with their current modeling tools. Consequently, we expect the Fed to steward the economy forward cautiously and deliberately in order to avoid another policy mistake.

Going Forward: Tandem's Outlook

While recession fears have remained consistent, none of the typical excesses associated with recession are currently present. Interest rates are not prohibitive, inflation is not pervasive, and household balance sheets are healthy. Stock valuations are elevated, yet not extremely so, and credit spreads have not widened substantially. Still, the risk remains that a lack of business confidence and capital investment could bleed into the consumer economy, weakening the labor market that has been the pillar of this expansion.

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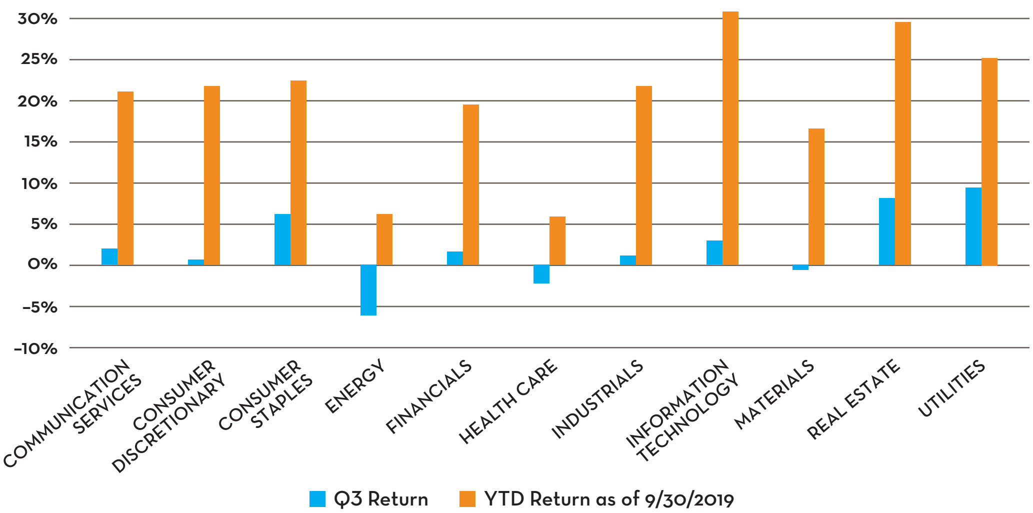
Index/Instrument	Category	Q3 Total Return	YTD Total Return (as of 9/30/2019)
S&P 500	Large-capitalization US stocks	1.70%	20.55%
S&P 400	Mid-capitalization US stocks	-0.09%	17.86%
Russell 2000	Small-capitalization US stocks	-2.41%	14.15%
MSCI World ex USA Index	Developed markets international stocks	-0.84%	14.17%
MSCI Emerging Markets Index	Emerging markets international stocks	-4.16%	6.14%
Bloomberg Barclays US Aggregate Bond Index	Broad investment-grade, US bonds	2.27%	8.52%
US Treasuries	US government bonds	2.40%	7.71%

Q3 2019 Sector Performance



As real GDP slows from its 2.9% pace in 2018 towards 2%, most investors expect the Fed to deliver further rate cuts in October and December. However, the effectiveness of such measures remains an open question given a nervous business community and lack of trade clarity. Federal Reserve Chairman Jerome Powell remains noncommittal, noting that the FOMC would decide rates "meeting by meeting." Investors, though, fully expect interest rate reductions going forward as insurance against weakening economic data. Should a weaker consumer outlook materialize, aggressive easing will likely occur.

Tandem continues to monitor economic and market conditions at home and abroad to apply a disciplined approach to portfolio management.

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