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Takeaways From Recent Research Meetings

Over the last few weeks, I've had the chance to travel and sit down with a number of fixed income and equity portfolio managers, asset management firm strategists, and finance professionals. In between meetings on the road and in San Francisco, I've been reading a number of outlooks in order to lead the conversation with our team about how we want to tweak our client's portfolios and what our approach will be for 2020. Here are some of the themes discussed, and my thoughts around them:

- The number one consensus risk is a geopolitical one. One portfolio manager had a great quote: "Economic cycles don't die of old age. They get murdered in their sleep." What will murder this economic cycle? One big suspect is politics, particularly the ongoing trade tensions. While leading economic indicators are still good, a big talking point amongst equity portfolio managers is supply chain disruption and Capital Expenditure (CAPEX) spending, or lack thereof. An economic recession will start if businesses fail to invest in projects and, more importantly, human capital. As we head into an election year that will lead to even more uncertainty, many businesses are primed to put a pause on projects as they wait for the election to unfold. One portfolio manager told me that from his conversations with his portfolio companies' management teams that "they all have a five-year plan but have no idea what the next five quarters are going to look like." The other big risk stemming from geopolitics is that management teams will be quick to blame ongoing trade tensions for poor earnings / quarterly results, when, in fact, there are deeper underlying issues that are systematically wrong with the business that they are failing to address. This is something that we are mindful of discussing when meeting with our active managers, both on the equity and fixed income side.

- Despite the negative sentiment above, the consensus is that a recession risk is higher than it's been in a while, but it's still not likely to happen next year (40% is the number that I'm hearing). One comment I heard earlier this year that still stands true today is that "I can show you 5 charts that say that things are looking rosy, and 5 charts that show you that the world is ending." From a solely economic perspective, things are okay. Yes, manufacturing is down, but earnings and GDP are growing (albeit slowly). Consumer confidence is high, which is important, as the U.S. consumer makes up roughly 70% of GDP. Central banks are also in an easing mode, which is helping improve financial conditions. Once there is some clarity around trade, especially if there is a resolution, the economic cycle should be prolonged. If growth occurs, overseas, that will be even better for global investors.

- One of the biggest red flags right now is "yield curve inversion," which occurred in May. On average, that has given a 12 month warning to a recession. And while I did hear one strategist dismiss it ("it was a technical glitch"), the most dangerous words in finance are "this time will be different." There is a lot of risk in the fixed income markets, as global investors have flooded

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into the U.S. markets chasing yield. For the first time really in history, international buyers are purchasing U.S. municipal bonds, which don't have any tax benefit to them, but do provide attractive returns. Because of the rich valuations in the bond market, our active managers have raised cash positions because the return profile of securities on the market do not outweigh their risk.

- This leads me to my concluding thought. One comment from a pm that resonated with me is "know what you own." We as a team have ongoing conversations with our active managers and are continually evaluating their performance as well as their role in our client's portfolios. We are doing the same level of work and have the same level of scrutiny for our passive, rules based strategies. Over the last 12 months, we have positioned our portfolios to better protect on the downside and are evaluating a couple of proposed changes before 2020. Much like the management teams of corporations, we have an idea and an expected return target for asset classes for the next five years; we just don't know how the next five quarters will play out. Our job as long term investors is to be cognizant of known risks and design a portfolio that will provide downside protection if we do slip into a recession, but participate in upside if this economic growth continues. We feel that we have done just that and are continually looking to refine and improve our portfolios.

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