FALL 2019

LVW ADVISORS

the serious investor

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THE SERIOUS INVESTOR: FALL 2019

Welcome to the fall issue of *The Serious Investor*, in which we set aside the drama swirling around the markets and take a hard look at the data. That dispassionate look shows us that the economy has weakened considerably, both globally and in the United States. In this issue we discuss the potential ramifications for investors and the ways we're preparing for the increased possibility—but not certainty—of recession.

Quick take:

- Global economic problems are affecting the U.S. economy.
- The Federal Reserve is acknowledging the weaker economic data by cutting interest rates and adding liquidity to the markets.
- We continue to have a neutral view generally regarding equities.
- We continue to favor quality in both equity and fixed income, longer average durations in fixed income, and elevated cash positions.

THIRD QUARTER MARKET SUMMARY

The financial markets generally posted small gains in the third quarter, despite weakening economic data in the U.S. and around the world. The S&P 500 returned 1.2% for the three-month period, after the Federal Reserve's second interest rate cut of the quarter fueled a September rally. The Fed's actions relieved investors who were concerned about softening economies and the ongoing trade war between the U.S. and China.

Value outperformed growth as investors facing lower interest rates and a weaker economy favored defensive, income-producing stocks. Small caps slid, with the Russell 2000 Index dropping 2.4% for the quarter. So did international shares: The MSCI All Country World ex-U.S. Index lost 2.5% as certain foreign markets appeared to fall into recession. Like U.S. equities, international equity markets picked up in September as global central banks, particularly the European Central Bank, pledged easier monetary policy.

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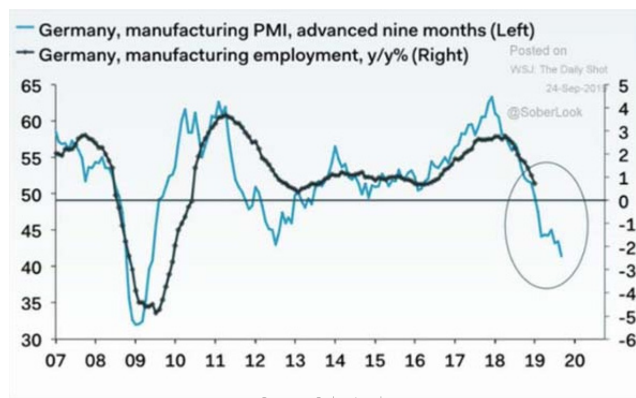
Interest rate cuts and falling bond yields helped U.S. Treasury bonds gain for the fourth consecutive quarter. *The Wall Street Journal* reported that the yield on the 10-year Treasury note fell 0.325 percentage points between July 1 and September 30, its largest quarterly decline in seven years.[1] Corporate and high yield bonds posted smaller gains.

FOCUS ON DATA, NOT DRAMA

The stock market is near all-time highs. Unemployment is at 50-year lows. Inflation is near the Fed's target. So why is the Fed cutting interest rates?

Jerome Powell and company are trimming interest rates for a much more concrete reason: *Hard data.*

What the data says. Many leading economic indicators have turned down. Much of the weakness comes from overseas. Global manufacturing looks especially frail, particularly in Europe, where the purchasing managers index (PMI) recently hit its lowest level since 2013. Germany has led the descent, with its worst PMI reading since 2009.



Source: SoberLook

Japan's manufacturing sector fell 4.7% year over year in August 2019, the worst since August 2015.

Source: SoberLook

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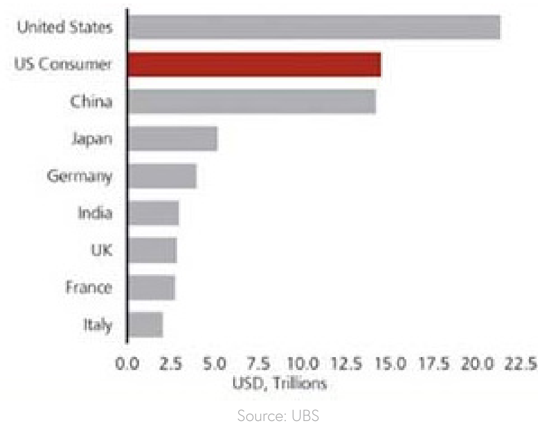
The U.S. consumer remains relatively strong. The resilience of the U.S. consumer is essential for our economy to weather the global slowdown. The U.S. consumer is about the same size in nominal GDP terms as China's entire economy.



Source: UBS

The United States is not immune from weak economies and low interest rates that exist in other parts of the world.

Central banks around the world have tried to shore up their economies by lowering interest rates. Sixteen central banks slashed rates between July and September, according to JP Morgan, which expects two dozen more to cut in the fourth quarter. In many cases, the countries' policy rates were negative even before the reductions. More than $15 trillion in bonds around the world now pay negative interest rates.[2]

Pushing bond rates below zero was supposed to stimulate economies by encouraging lending. It may be backfiring. Negative rates undermine banks' traditional business model by compressing the spread between deposit rates and long-term loan rates. Facing this squeeze on profits, banks can either curtail lending or charge more for their loans. Both options restrict the credit in the economy, the opposite of central bankers' intent.

No country is an island. The United States is not immune from weak economies and low interest rates that exist in other parts of the world, which inevitably put downward pressure on domestic economic growth and interest rates. There is a global shortage of safe assets in the form of government bonds. Generally speaking, a flight to safety has driven a massive amount of foreign investment into our markets, pushing our dollar higher and bond yields lower.

The yield curve between 3-month and 10-year Treasuries inverted in March. An inverted yield curve occurs when the interest rate is higher on a short-dated U.S. Treasury than on a longer-dated U.S Treasury. How reliable is the inverted yield curve indicator? A recession ensued after every previous

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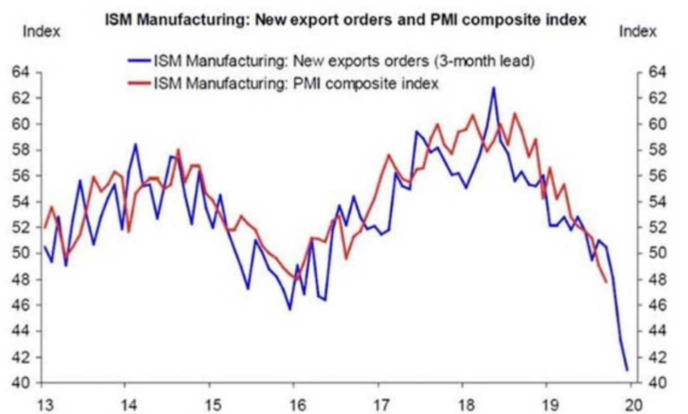
instance when the yield curve between the 2-year and 10-year Treasury notes inverted for three months or more. This indicator has a perfect track record (seven for seven). That said, recession has lagged inversion by anywhere between 10 and 34 months, making it impossible to time.[3]

The combination of tepid global demand, trade barriers and a strong dollar create headwinds for American exporters. That is one reason corporate results, sentiment and behavior also look pre-recessionary:

- The Institute for Supply Management's U.S. Manufacturing and New Export Orders indexes both fell to their lowest levels in 10 years.



Source: ISM, Haver Analytics, DB Global Research

- Corporate earnings were flat in the first half of the year, and consensus estimates for the third quarter point to a decline. In our opinion, 2020 earnings estimates for the S&P 500 are too optimistic.

Source: Factset, Morgan Standly Research

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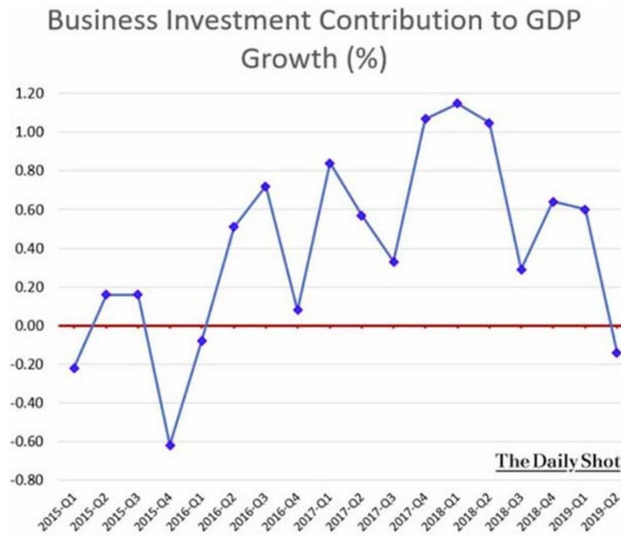
THE MARKET HAS BEEN RESILIENT IN THE FACE OF THESE ECONOMIC HEADWINDS.
BUT MARKET LEADERSHIP HAS SHIFTED TO DEFENSIVE SECTORS, SUGGESTING THAT INVESTORS ARE TRYING TO GUARD AGAINST ECONOMIC TROUBLE.

- Measures of business investment, including current and intended capital expenditures (CapEx), have weakened considerably as tariffs and trade uncertainty curb companies' intentions to invest in a global economy.



Source: The Daily Shot

- The Duke CFO Survey is considered by some as one of the better leading indicators. In its latest survey, two-thirds of Fortune 500 CFOs surveyed by Duke University expect recession by 2021. These executives determine how the country's biggest companies will allocate their capital, so their pessimism can be a self-fulfilling prophecy.

The market has been resilient in the face of these economic headwinds, buoyed by central bank easing. But market leadership has shifted to defensive sectors, suggesting that investors are trying to guard against economic trouble.

The Fed's dilemma. The Federal Reserve has tried to prop up the economy by shifting gears from tightening to easing. Policymakers reduced interest rates by 0.5 percentage points in the third quarter, and the markets are pricing in another half-point in cuts.

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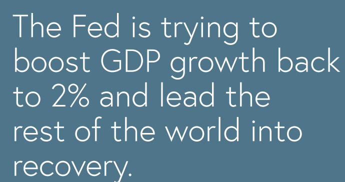

The Fed is trying to boost GDP growth back to 2% and lead the rest of the world into recovery.

The global economy has reached a critical juncture. Growth has been slowing since early 2018 and may be reaching the point where economic weakness begins to feed on itself, potentially triggering a recession. U.S. GDP grew 2% in the second quarter and likely expanded 1.7% in the third quarter, according to Macroeconomic Advisors. The Fed is once again accommodative in hopes of reaccelerating our GDP growth back to over 2%. If successful, this could provide a boost to other economies around the world.

The plan has a chance to succeed. Housing is a bright spot: Low interest rates are spurring growth in housing starts, building permits and home sales. Global financial conditions have eased significantly over the past four months, which usually bodes well for global growth.

Certain leading indicators have improved, making the puzzle more complex for the Fed. The Citigroup Global Economic Surprise Index has jumped recently. China's official manufacturing figures picked up last month and beat estimates, and the country is likely to increase the pace of its stimulus in the coming months. Any recovery there could help lift the rest of the world, especially trade-dependent countries in Europe and Asia. It may especially help manufacturing, which might be near the bottom of its cycle: Manufacturing slumps last an average of 18 months, historically, and September was month 21 for the current down leg. Weakness in the auto industry has played a disproportionately large role in the current downturn, and falling inventories and strengthening demand suggest its outlook could improve.

Policy will be important. Fiscal stimulus and regulatory changes could help hold off recession. And while it's impossible to predict the outcome of trade negotiations between the United States and China, the very fact that the two countries are talking lowers the degree of uncertainty. What's more, both sides seem to have incentives to reach a deal: President Trump to boost his election prospects and China to lock in an agreement before having to deal with either a reelected Trump or someone like Elizabeth Warren, who may take an even harder line.

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Inflation remains low—U.S. CPI rose 1.7% in the 12 months through August—and central bankers around the world are doing everything they can to prevent deflation. Yet some underlying figures suggest potential inflation pressure. Core CPI, which strips out food and energy costs, rose 2.4% for the same period, the highest rate since 2008. And during the three months through August, average hourly wages jumped at an annualized rate of 4.2%. Joe Zidle, chief investment strategist for Blackstone's Private Wealth Solutions group, notes that since the 1980s, wage gains of 4% or more have been associated with higher inflation and Fed hikes, not cuts. (Wage gains slowed in September, however.)[4]

The Fed continues to sit between a rock and a hard place.

WE DON'T KNOW FOR CERTAIN THAT THE ECONOMY WILL ENTER A RECESSION (OR WHETHER WE'RE IN ONE ALREADY). BUT WE STRIVE TO ENSURE THAT OUR PORTFOLIOS ARE POSITIONED APPROPRIATELY IN ADVANCE.

POSITIONING: LEARN FROM PAST RECESSIONS

We don't know for certain that the economy will enter a recession in the next year or two (or whether we're in one already). And if a recession does happen, we can't know what form it will take. Although the last two recessions were brutal, some are short and shallow.

Regardless, we strive to ensure that our portfolios are positioned appropriately in advance. By the time we can be certain a recession has started, we'll be in the midst of it. Our investment committee is suggesting focusing on several key themes:

- Maintaining our discipline and considering trimming segments where we believe valuations are extended.
- In equity portfolios, focus on companies with quality earnings growth, strong balance sheets and/or growing dividends.
- Where appropriate, source skill-based managers that we believe can create value by investing both long and short in equities, reducing portfolios' sensitivity to large swings in the equity markets.
- In fixed income, focus on increasing quality and extending duration.

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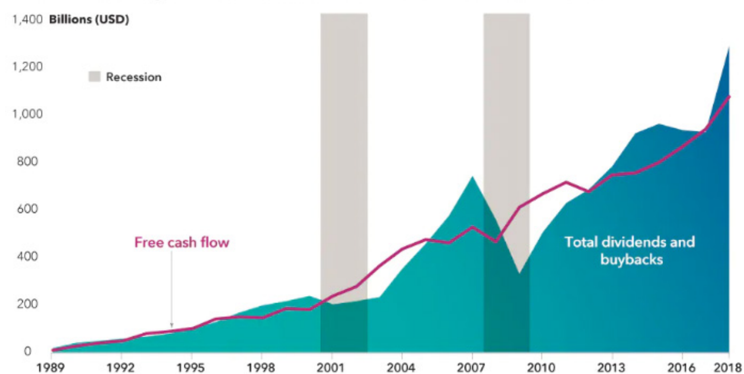
Emphasize quality. We generally remain neutral regarding equity allocations. We favor equities with a distinctly conservative tilt, with an emphasis on businesses that produce strong cash flow and growing dividends. Many companies appear to be comfortable taking on debt. Debt has been an engine for dividends and share buybacks as well as the source for acquisitions (see chart below). But companies cannot spend more than they make indefinitely. A look at interest coverage ratios paints a picture that is reminiscent of 1998-1999, a period of elevated leverage shortly before a recession.



Source: The Capital Group

WE FAVOR EQUITIES WITH A DISTINCTLY CONSERVATIVE TILT, WITH AN EMPHASIS ON BUSINESSES THAT PRODUCE STRONG CASH FLOW AND GROWING DIVIDENDS.

We draw a distinction between value stocks and companies that offer value—the latter of which practice responsible use of debt and manage their balance sheets prudently. In addition, where we deem prudent, we continue to favor long-short hedged equity and various private equity managers. Within private equity, we tend to utilize managers focused on small and middle-market companies and management focused on value creation, not financial engineering.

In international equities, we are less interested in passive index positions and favor emphasizing active, high-conviction managers who seek companies positioned to benefit from reshuffling trade relationships and changing supply chains. In general, we believe it is a mistake to think of international stocks based on the country in which a company is domiciled, and it's better to focus on where companies generate revenues and profits. It is our view that this approach will help the managers we use own companies that perform well in their respective industries, regardless of where they are headquartered. The sector composition of market indexes helps explain the valuation gap between U.S. and non-U.S. equities.

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Sector differences help explain why international stocks have lagged

Financials and materials are 29% of non-U.S. index. Technology and health care are 36% of the U.S.

INDEX/SECTOR	INDEX WEIGHT		
	NON-U.S.	U.S.	DIFFERENCE
Financials	22.0%	13.1%	8.9%
Materials	7.4	2.7	4.8
Health care	8.0	13.4	-5.4
Info tech	8.6	22.2	-13.6

Sources: MSCI, RIMES

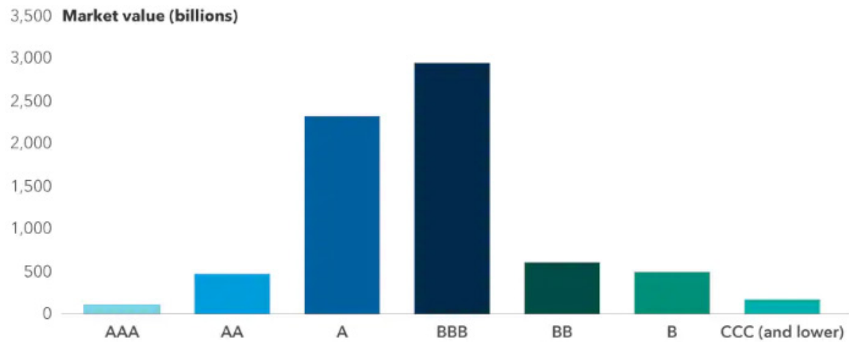
This late in the cycle, we think it is prudent to take a cautious approach to fixed income.

See our blog post on why we think investors should invest actively, not passively, when investing internationally. Read the post >

Fixed income — a focus on quality. We continue to favor high-quality bonds over non-investment grade credit and leveraged loans. This late in the cycle, we think it is prudent to take a cautious approach to fixed income, especially corporate debt. The rise of triple-B corporate debt is a development to keep an eye on. There is approximately $2.9 trillion of U.S. BBB corporate debt outstanding, more than four times as much as in 2008.

Appetite for debt has altered corporate America's credit profile

Size of BBB-rated corporate bond market has quadrupled to $2.9 trillion since 2008



Source: Bloomberg Index Services Ltd.

The rise in BBB-rated debt suggests that the next downturn may see a record number of downgrades to high yield, which could cause spreads to widen and liquidity to shrink. The silver lining is that such a development could create attractive entry points for investors.

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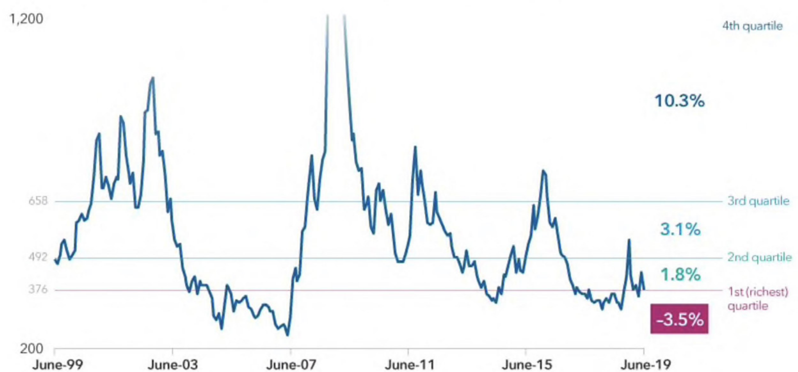
But for now, we believe fixed-income investments should provide an essential measure of stability and capital preservation, especially when equity markets are volatile. Bond portfolios with large allocations to non-investment grade credit have disappointed investors in prior drawdowns. We believe it is a mistake to reach for yield in a low-rate world. High yield credit spreads have tightened, and when this happened in the past, credit significantly lagged U.S. Treasuries.



Source: Bloomberg Index Services Ltd.

Meanwhile, we continue to review our use of cash positions, with an eye toward rebalancing into long-term assets in the event of market sell-offs. And while we can't predict a recession with certainty, we have confidence we can predict how people will behave if one happens, because the same thing happens every time: Investors sell stocks and other risk assets until prices fall well below fair value. If we're prepared and disciplined, we believe there will be opportunities to rebalance into quality long-term assets at attractive valuations. It is our view that such opportunistic investing can increase the likelihood of strong long-term returns.

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A Different Perspective on Entry Point,
a Singular Determinant of Future Returns

—S&P 500 TR USD(1936)

Source: Morningstar Direct

The above graphic illustrates rolling ten year returns for the unmanaged SP500 index from 1938 thru June 2019. The call-outs illustrate the prior ten year return and the forward returns for subsequent periods. Copyright LVW Advisors 2019.

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The economy moves in cycles, and the data tell us that the cycle is turning down. That doesn't necessarily mean disaster. For disciplined long-term investors, recessionary bear markets may offer opportunities to invest for the next leg up.

On balance, we are cautious yet constructive. We see madness in some asset classes that will ultimately create opportunities. We remain invested in equities to follow the markets higher, but with caution. We continue to emphasize quality.

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LVW NEWS

Awards and Accolades

London-based financial publishing group Citywire recognized LVW Advisors as a Future 50 RIA. Citywire's package highlights 50 RIA firms that best represent the future of the RIA industry through innovative sustainability initiatives, diversity, succession planning and client relations. LVW is thrilled to be recognized as a forward-thinking firm.

LVW ADVISORS

LVW's two principals, Lori Van Dusen, CEO, and Joe Zappia, CCO, each have 30 years of experience, and are backed by a team comprised of members with diverse backgrounds. The team began providing consulting services to institutional and ultra-high-net-worth families over three decades ago.

What will be the key difference in the successful RIAs of today versus those in 10 years?

Anchoring to 'this is how we do things' will make many RIAs irrelevant in the future. How we invest, charge for our advice, manage relationships, acquire new relationships, communicate with clients – it's all changing. Successful RIAs of the future will need to adapt.

Forbes recognized **Lori Van Dusen,** CIMA, Founder and CEO, in its list of Top 250 Wealth Advisors. Lori ranked 66th on the list, which includes advisors who collectively manage nearly $1 trillion in client assets.

Lori Van Dusen, CIMA, Founder and CEO, represented LVW Advisors on a Barron's-hosted panel with a group of elite independent advisors from Australia in September. She shared her thoughts on top strategic priorities and global investment trends.

Jeff Wagner, Senior Partner, was a panelist on *FundFire's* Exchange webcast titled "Prospects and Pitfalls: What to Look for in Opportunity Zone Funds." Jeff, along with several other industry panelists, discussed the many aspects that should be considered when performing due diligence on Opportunity Zone funds.

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LVW Advisors Founder and CEO, **Lori Van Dusen,** CIMA, was a featured speaker at the American Association of Individual Investors' Research Triangle Chapter meeting in August. Her presentation, "Is it different this time?," discussed the merits of building a robust portfolio to carry investors through any market cycle.

Employee News

Kim DeWitt joined LVW Advisors as a Client Operations Specialist. The SUNY Geneseo graduate held positions with AllianceBernstein, Deutsche Bank and Hefren-Tillotson Inc. before returning home to Rochester and joining the LVW team.

Having grown up on Lake Ontario, Kim enjoys kayaking and spending time near the water, horseback riding and reading. She is also a diehard Pittsburgh Steelers and NASCAR fan. Kim is passionate about volunteering and traveling, and has spent time working with Habitat for Humanity, both locally and in Guatemala. We are thrilled to have her as part of the team!

Welcome, Kim!

Kate Burt joined LVW Advisors as a marketing and branding consultant. She has worked in marketing across a variety of industries including financial services, software/technology, brick-and-mortar retail and real estate. Kate has a soft spot for strategy and an affection for creative—the perfect mix!

Outside of the office, Kate is an active member of the Junior League of Rochester. She also enjoys sipping on plenty of iced coffee, vacationing in New England, walking along the canal in Pittsford and spending time with her boyfriend and playful dog.

Welcome, Kate!

Danielle DiPaola, Compliance Analyst, ran the Rock 'n' Roll marathon to raise money for St. Jude Children Research Hospital. Danielle has participated in the run two years in a row and this year raised more than $1,500. Way to go, Danielle!

Andrew Brown, Operations Analyst, completed a great season as head coach for a local seventh-through ninth-grade boys lacrosse team. We love Drew's commitment to the community!

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Staying Current

In September**, Kim Pugliese,** Chief Operating Officer, Managing Partner, attended Fidelity's Inside Track conference, which included actionable insights and networking opportunities to help grow and transform RIA businesses. The event included numerous opportunities to discuss and exchange ideas and best practices with other COOs and leaders.

Conner Boillat, Private Wealth Advisor, Research Associate, recently attended the Wealth/Stack Conference in Scottsdale, Arizona. The conference, designed to be "for advisors, by advisors," provided the opportunity to hear from industry leaders, to network with other top-level advisors, to learn about the newest, most cutting-edge financial technology and investment opportunities, and to learn about practice management. Read about Conner's experience on his blog!

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Newsletter Citations:

1, 2 U.S. Government Bonds Advance, Post Fourth Consecutive Quarterly Gain." Wall Street Journal, 9/30/19.

3 Harvey, Campbell. "The Yield Curve Inversion Explained," LinkedIn, 7/11/19.

4 Zidle, Joseph. "The Right Question for This Stage of the Cycle," Blackstone, 9/27/19.

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Citywire's RIA Future 50 2019: To qualify, firms must be registered by the Securities and Exchange Commission as an RIA with between $250 million and $2 billion in assets under management at the end of 2018.Using our proprietary scoring system, we evaluated firms based on their degree of independent ownership; AUM growth; percentage of fee-based business; approaches to sustainability, including sustainability programs and diversity initiatives; processes in place for attracting and maintaining talent; succession planning; staff credentials; investment offerings and capabilities; client education and charitable work; and firm service offerings

Forbes Top 250 Wealth Advisors: The Forbes ranking of America's Top Wealth Advisors, developed by SHOOK Research, is based on an algorithm of qualitative criteria, mostly gained through telephone and in-person due diligence interviews, and quantitative data. Those advisors that are considered have a minimum of seven years experience, and the algorithm weighs factors like revenue trends, assets under management, compliance records, industry experience and those that encompass best practices in their practices and approach to working with clients. Portfolio performance is not a criterion due to varying client objectives and lack of audited data. Neither Forbes or SHOOK receive a fee in exchange for rankings.

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