

To: Aequitas Client

From: Aequitas Investment Advisors

Re: **Is the Glass Half Full or Half Empty?**

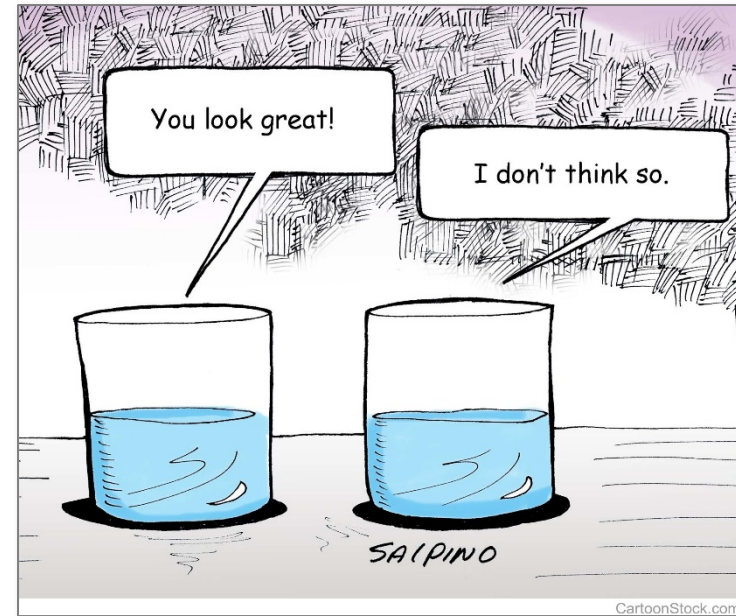
Dear Aequitas Client,

In looking across the investment landscape, one sees a wide range of economic uncertainties ranging from potential outcomes for the U.S. vs. China trade war and Brexit, both of which could turn out favorably or unfavorably. Added to the list of uncertainties is the impeachment inquiry which, so far, has had little impact on the stock market. Based upon the Nixon and Clinton examples, the underlying health of the economy probably has more of an effect on stock prices than does the political outcome (stocks went up during Clinton's inquiry and declined during Nixon's). The good news is that the global economy is still *relatively* healthy, albeit in a weaker state than twelve months ago; however, the outcome of the trade war will probably play the greatest role in determining whether we experience a global recession sooner rather than later and to what severity.

Global economic growth has been slowing for more than a year and has apparently reached a point referred to by some economists as *stall speed*, i.e., a time when the growth trajectory slows sufficiently to cause businesses and consumers to become more cautious about their spending. In such an environment, the stock market tends to move sideways in a seesaw pattern, as it has over the past twelve months, during which time investors digest new economic information and adjust their expectations for future corporate earnings growth. In assessing the current data, one can build a case that the economic outlook is either relatively positive or negative, i.e., a glass half full or half empty.

### Half Full Case

The glass half full case rests on several favorable indicators, including historic low unemployment in the U.S. and historically high levels of consumer sentiment around the globe according to the October 9<sup>th</sup> Conference Board Consumer Confidence Index update. With consumer spending being the largest component of global economic growth, a confident consumer is a good sign. Furthermore,



in its attempt to support continued growth, the Federal Reserve has been lowering borrowing rates, as have other central banks in Europe and Asia. While lower interest rates are designed to stimulate economic growth, they have also created a situation where high quality bond yields are now generally lower than the average dividend yield on stocks. Of course, stock prices are *much more* volatile than bonds, but in conjunction with lower yields on bonds and reasonably attractive global stock valuations, the glass half full case appears defensible, especially for those stocks and asset classes trading at reasonable valuations. Developments which might improve the economic outlook include the U.S. and China reaching some sort of agreement on the trade war front as well as a resolution to the Brexit quagmire (there appears to be some progress on both fronts as this letter is being written).

### Half Empty Case

With the media's incessant drumbeat of doom and gloom, it seems much easier building the case for the glass being half empty (or even close to empty!). It's possible the trade war will go unresolved, or get worse, and there's still a chance the United Kingdom might leave the EU without a deal causing further economic

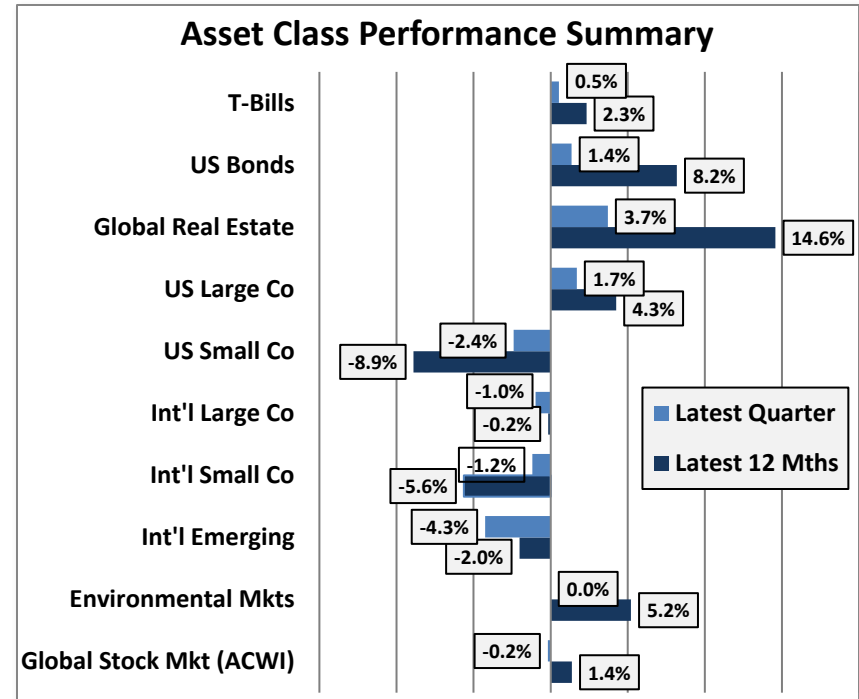
disruption. The impeachment fight and potential geopolitical events are additional wildcards for the stock market which are not currently “priced in.” And while a recession does not appear imminent based upon current economic data, it’s possible that the drumbeat of negativity in the media might raise the fear of a recession to the point where we might actually talk ourselves into one should consumers and businesses react by cutting back on spending. To echo the famous quote of President Franklin Delano Roosevelt, “[perhaps] the only thing we have to fear is fear itself.”

### Of Course, the Glass is Half Full *and* Half Empty!

Given that we do not know how future events will unfold, we believe the best course of action is to prepare for a variety of scenarios ranging from the positive to the negative. As financial planners, in forecasting potential future investment outcomes for our clients, we utilize Monte Carlo simulations to account for uncertainty and risk. We also draw upon extensive academic research to understand how markets have behaved during various economic scenarios in the past, including recessions and expansions. Statistical analysis, academic research and our own experience have led us to conclude that the best way to prepare for an uncertain future is to diversify broadly across a wide variety of asset classes. Once an investor’s time horizon and future financial needs are assessed, the critical first step in portfolio construction is to determine how much of the portfolio should be invested in stable assets, such as high-quality bonds, in order to meet the client’s financial needs over the short and intermediate term (a potential solution to the glass half full perspective). For longer-term needs, we generally recommend investing across a wide spectrum of assets classes within global equities in order to gain broad diversification (i.e., to avoid having too many eggs in one basket). The combination of stable assets and diversified global equities has performed favorably during both recessions and expansions since our founding in 1991 and we believe this strategy should continue to serve our clients well in the future.

### Asset Class Performance Review

For the trailing 12 months, the Global Stock Market (ACWI) was relatively flat with a return of just 1.4%. The worst performing asset class was US Small Caps (-8.9%) with the best being Global Real Estate (+14.6%). Non-US equities were all in negative territory with Int’l Small Caps (-5.6%) down the most, followed by Emerging Markets (-2.0%) and Int’l Large Caps (-0.2%). The strength of the US Dollar had a lot to do with the negative non-US returns over the past 12 months as the Dollar appreciated by more than 5% against foreign currencies (a great time to travel abroad!). Beyond Global Real Estate, asset classes which posted gains were US Bonds (+8.2%), Environmental Markets (+5.2%), US

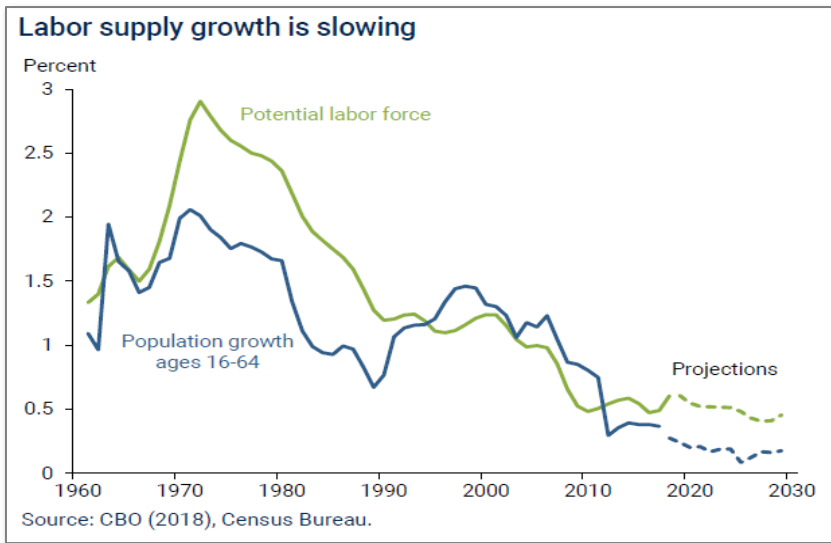


Large Caps (+4.3%) and US T-Bills (+2.3%). In sum, the past 12 months were more of a “wait and see” situation for investors as mixed economic signals, the trade war and Brexit weighed on the markets.

The range of returns for the latest quarter were more constrained with the Global Stock Market (ACWI) being virtually unchanged (-0.2%). The best return was Global Real Estate (+3.7%) and the worst was Emerging Markets (-4.3%). Otherwise, in the asset class loss column were US Small Caps (-2.4%), Int’l Small (-1.2%) and Int’l Large Cos (-1.0%). The Environmental Markets asset class was flat. Modest gains were registered in US Large Caps (+1.7%), US Bonds (+1.4%) and US T-Bills (+0.5%). Clearly, an unremarkable quarter overall.

### Structural Constraints to Economic Growth

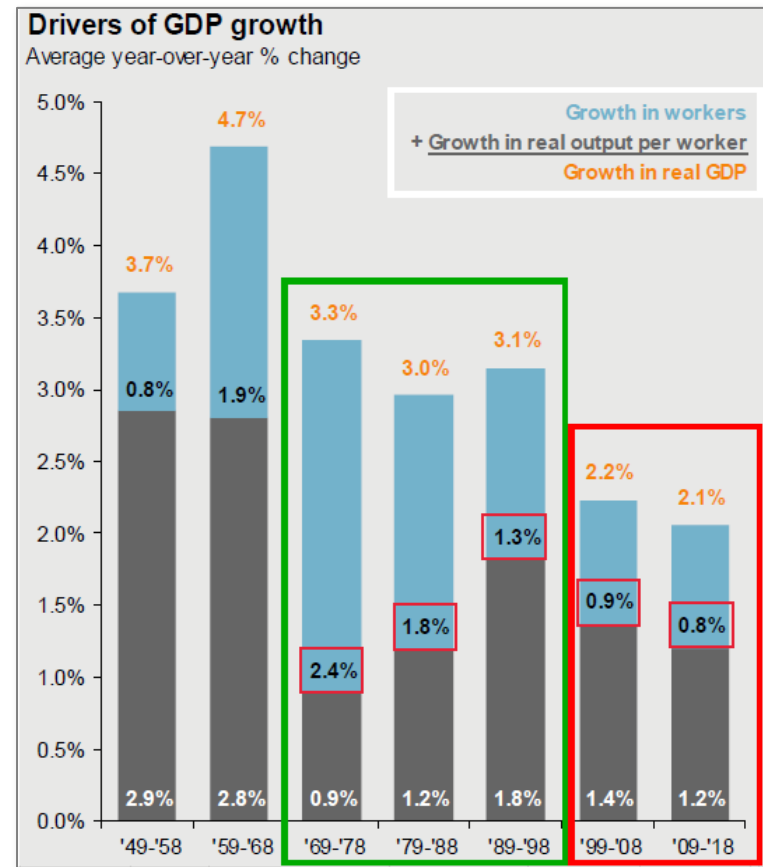
The current administration’s economic strategy since taking office was to reduce government regulations and lower income taxes in an effort to achieve the high level of economic growth experienced from the 1960s through the 1990s. For better or worse, the global economy has changed significantly since that time, including globalization, technological advancements and the emergence of China as the world’s second largest economy. Further, perhaps an even more challenging constraint on achieving faster growth is the structural reality that the



working age population and potential labor force is simply not growing at the same rate it once did (refer to the chart above). Since 1990, immigrants have comprised about one-half of the working-age population growth with the other half being native born. From its peak in 1960, the annual growth rate in the working age population (ages 16-64) has fallen from a peak of 2% to under 0.5% today with an even lower growth rate projected into 2030. Economic research indicates there is a very high correlation between the growth in working age population and the rate of GDP growth given that workers tend to consume and spend more than non-workers (consumer spending accounts for more than two-thirds of GDP growth in the U.S. and more than 55% globally). In the *Drivers of GDP Growth* chart to the right, courtesy of JP Morgan, note in the thirty-year period between 1969 and 1998 (green box), the growth rate in the working age population (blue portion of the bars) averaged about 1.8% annually compared to just 0.9% over the past twenty years (red box), or one-half the rate of growth! This aging trend is not unique to the U.S. as birth rates have been declining in most developed countries.

A second major driver of economic growth is productivity (gray portion of the bars) which is a measure of the output per worker. Workers today produce far more than in the past thanks to technological advancements. (There once was a time when economists predicted we would all enjoy shorter work weeks by being able to get the same job done in less time!) However, we're not only producing more for every hour worked today, we're also working more hours. Technological improvements in productivity have helped pick up some of the GDP growth slack as our population has been aging, but these advancements are serving as a double-edged sword by also reducing the need for workers, especially

in manufacturing and other sectors involving physical labor. A study by the McKinsey consulting firm indicated that by 2030, should trends continue, automation may replace the jobs of as many as 70 million workers, or as much as one-third the U.S. workforce! This mega-trend is referred to as *Fourth Industrial Revolution* which is defined by breakthroughs in emerging technologies, including robotics, artificial intelligence and biotechnology. Of course, while productivity gains may be economically desirable, our major societal challenge will be to create safety nets and training programs so that replaced workers will



have opportunities in the new economy (we hope there will be much attention given to this topic leading up to the 2020 election and beyond).

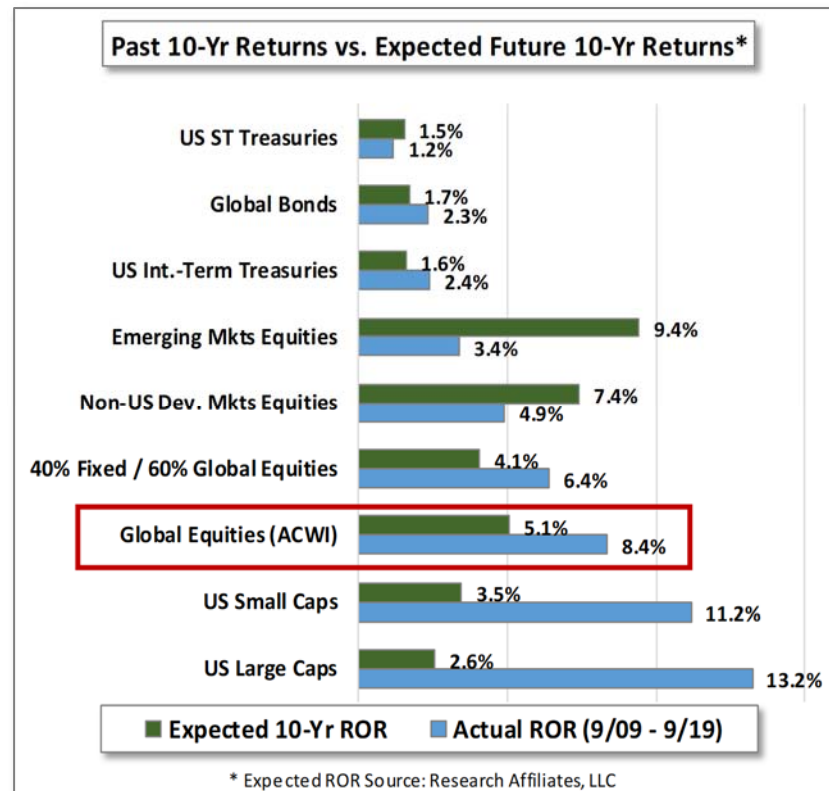
Given the reality of a shrinking workforce, consumer spending is likely to weaken which would imply slower GDP growth in the U.S. and throughout most of the developed world. Emerging economies, on the other hand, generally have more favorable demographics and correspondingly brighter prospects for consumer spending. The International Monetary Fund recently published its semi-annual

World Economic Outlook which reduced their April global GDP growth estimate from 3.3% to 3.0%. The report referred to a *Group of Four* economies (the U.S., the Eurozone, China and Japan) which account for about one-half of global GDP growth. The IMF forecasts that future long-term growth for the *Group of Four* will be constrained by structural factors including a decline in the growth of the working age population.

### What Does a Slower Growing Global Economy Imply for Investors?

With a lower rate of growth in the working age population and slower expected global GDP growth, it's likely that future returns on stocks will be lower as well. A study by the Vanguard Group found that trends in GDP growth, however, are not highly accurate predictors of future stock market returns over subsequent 10-year periods as there are many different stock asset classes with unique valuations and performance characteristics. Rather, the Vanguard study found that the CAPE Ratio is a far more reliable predictor of specific asset class performance over subsequent 10-year periods. (The CAPE Ratio stands for Cyclically Adjusted Price-to-Earnings and is a valuation measure created by Nobel Prize winning economist Robert Shiller of Yale.) Essentially, a low CAPE Ratio means that the investor is paying a lower price relative to the trailing 10-year inflation-adjusted earnings and might expect a higher return in the future based upon historic data. Conversely, a high CAPE Ratio indicates the investor would be paying a high price relative to the 10-year historic earnings stream with an implied lower expected return. Unfortunately, the CAPE Ratio has little value in forecasting 3 to 5-year returns, but it has proven to be very useful in predicting 10-year future returns.

In the chart at the upper right, we've listed the past 10-year returns for many of the major asset classes, including bonds, as well as the expected future 10-year returns. For bonds, we're utilizing the approximate current interest rates given that rates are expected to remain low for the foreseeable future. For the stock asset classes, we've listed expected returns calculated by Research Affiliates, LLC, which are based on CAPE Ratio methodology as well as other economic assumptions. Over the past 10 years, Global Equities (ACWI Index) generated an average annual return of 8.4% comprised of US Large Cap stocks at the high end (13.2%) and Emerging Markets stocks at the low end (3.4%). As might be expected, stock asset classes which have outperformed over long periods tend to have higher CAPE Ratios than the laggards, so looking forward, Emerging Markets have the highest expected return (9.4%) and U.S. Large Cap stocks the lowest (2.6%). Global Equities are expected to provide an average return of 5.1% over the next 10 years which is far below the 8.4% average return over the past 10 years. However, there are other factors which might significantly improve the potential for achieving better 10-year returns, including favoring stocks of smaller



companies, stocks with attractive valuations and stocks with higher profitability. In our own experience, we have found that incorporating these additional factors into portfolio construction has been beneficial since our founding in 1991.

### Closing Comment

Given that one can make a case for the economic glass being half full or half empty, we feel it is prudent to prepare for both scenarios. We believe portfolios can be structured to help weather various economic storms thereby improving the likelihood of our clients achieving their life-long financial goals and reaching their desired destinations.

In closing, here's to hope over fear and to calmer seas ahead!

**AEQUITAS INVESTMENT ADVISORS, LLC**  
**FINANCIAL PLANNING AND PORTFOLIO MANAGEMENT FOR LIFE'S JOURNEY**