Davenport Asset Management Quarterly Update | Q3 2019

September 30, 2019

Equity investors experienced a wild ride in the third quarter. After a solid start in July, we witnessed a sharp swoon in August as trade tensions again took center stage. The S&P 500® Index posted declines of nearly 3% on August 5th and August 14th as volatility surged. Fortunately, the damage was mitigated by a late August rally followed by a decent September. In the end, the S&P 500 Index finished the quarter up 1.7% while the Russell 2000® Index was down 2.4%. Year-to-date, the S&P 500 Index and Russell 2000 Index finished the period up 20.6% and 14.2%, respectively.

All of our strategies outperformed their benchmarks during the quarter. While one month typically isn't worth highlighting, we are also pleased to report our strategies again held up better than their benchmarks in August during market tumult (the same held true during periods of volatility in May). While we never enjoy pullbacks, we do strive to demonstrate less risk than the broader market. On a year-to-date basis, three of our strategies are nicely outperforming their benchmarks, while the other two are lagging.

Market Returns	Q3 2019	YTD
U.S. Large Caps	1.7	20.6
U.S. Mid Caps	0.5	21.9
U.S. Small Caps	-2.4	14.2
International Developed Markets	-1.1	12.8
Emerging Markets	-4.2	5.9
Intermediate Term Bonds	1.4	6.4

Source: Morningstar Direct.
Please see last page for index definitions.

Slowing economic growth, an intensifying trade war, a partially inverted yield curve and negative interest rates in many parts of the world seem to be suggesting deflationary pressures and/or rising chances of a recession. According to the Wall Street Journal, a recent survey of economists put the odds of a recession at 35%. True to form, the media has latched onto recent volatility to double down on calls for bad outcomes. It often seems the greatest risk is talking ourselves into a recession. For the moment, economic growth actually remains decent as evidenced by 2.0% GDP growth in Q2 and calls for 1.9% growth in Q3.

Economic worries and falling long-term interest rates have renewed pressure on the Federal Reserve to lower short-term rates. Indeed, the Fed lowered rates 0.25% at its September meeting and most economists expect one more rate reduction by year end. "Easy" policy could provide support to equities, although we note the Fed has less room than in prior easing cycles. The current fed funds rate is 2% as opposed to 5-6% at the beginning of the last two easing cycles. Put differently, the efficacy of monetary easing may be exhausted at some point.

Then there's the "TINA" argument. In other words, "there is no alternative" to stocks and other risk assets if looking for decent returns in a world of ultra-low interest rates. Most would certainly rather borrow money than lend it in this cheap money environment. True, low rates should support equity valuations and the market's current forward price-to-earnings ratio of 16.9x (or an earnings yield of 5.9%) actually looks reasonable in the context of 10-year Treasury rates at 1.7%. However, this argument breaks down if rates are low because they portend a recession.

Where do these contradictory signals leave us? We have no idea what the near term holds and expect trade talks and political chicanery may induce periodic volatility. But, we are sticking by our case for more moderate returns in coming years. This seems to be in the early stages of coming to fruition. While markets are up nicely year-to-date, they are essentially flat over the past year.

This type of environment should play to our strengths. We think stock selection could become more critical. At this point in the cycle, being valuation sensitive and watching out for high risk situations may matter more than it has for much of this decade. We are seeing indications of this, as the red-hot initial public offering (IPO) market of Q2 cooled significantly in Q3.

Bond Market Update

Our last quarter's commentary observed, "The 'Goldilocks*' environment was perpetual and asset prices reflected this optimism." Boy what a quarter of weakening economic data can do to financial markets.

Over the last quarter Germany's economic engine has stalled, Italy is in a recession, we don't know what Boris will do with Brexit, China's GDP rate is sub-6%, and domestic data are weak in the manufacturing sector as well as slowing employment numbers.

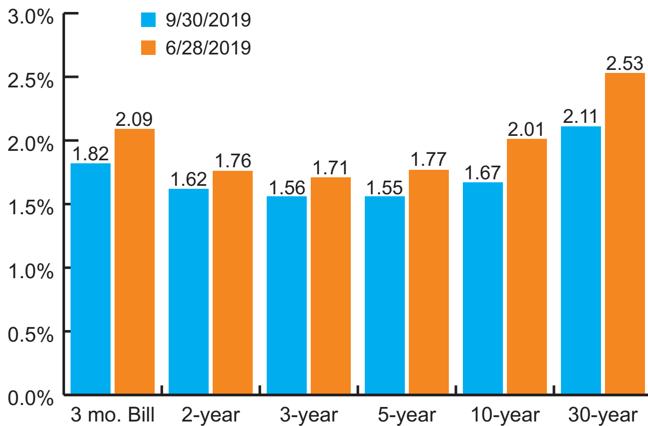
Significant to our economy is the fact that the Treasury yield curve, the difference between short-term and long-term yields, inverted in May of this year. It is important because an inverted yield curve has historically been a leading indicator of a weakening domestic economy.

The response to the evidence of a slowing domestic economy has been lower rates across the treasury curve and a rate reduction by the Federal Reserve. Ten-year Treasury yields fell to 1.67%, lower by 34 basis points, and thirty-year Treasuries fell to 2.11%, lower by 42 basis points, at the end of the quarter. Short-term rates fell as well but not by as much as longer dated Treasuries.

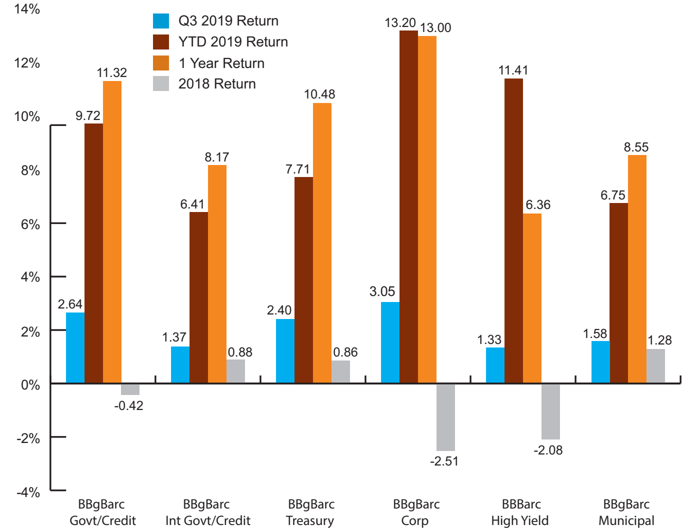
Bond market returns for 2019 through the end of the quarter are above 6.4% for the Bloomberg Barclays Intermediate Government/Credit Index. Returns for this index averaged 1.6% over the last four years. Indices with longer effective maturities are over 10% through the end of September.

The rate environment outside the US is very different. As of the end of September, over $17 trillion in bond assets were negative yields. German ten-year sovereign debt closed the quarter at -0.58%. We will not know whether these low rates are a sign of deflation or expectations of a significant recession hitting the European Union. In an effort to avoid a recession central banks have been aggressive in providing liquidity to stimulate economic growth.

Our focus has been to remain slightly shorter than our benchmark index while emphasizing high quality assets. A year ago, we allocated close to 35% of our accounts to floating rate notes. That position has been pared to around 20% with proceeds going into Treasury notes and quality corporate issues. We will be vigilant, yet we find it challenging to become structurally aggressive in a low rate environment.



Source: Bloomberg Barclays.



Source: Morningstar Direct. Please see below for index definitions.

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*The **Goldilocks Economy** term describes an ideal state for an economic system. In this perfect state, there is full employment, economic stability, and stable growth. The economy is not expanding or contracting by a large margin. A Goldilocks economy is warm enough with steady economic growth to prevent a recession.

Index Definitions: U.S. Large Caps represented by the **S&P 500 Index**. U.S. Mid Caps represented by the **Russell Midcap® Index**. U.S. Small Caps represented by the **Russell 2000 Index**. International Developed Markets represented by the **MSCI EAFE Index**. Emerging Markets represented by the **MSCI EM Index**. Intermediate Term Bonds represented by the **Bloomberg Barclays Intermediate Government/Credit Index**.

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An investor cannot invest in these indices and their returns are not indicative of the performance of any specific investment.