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“There are no bargains in a hotel mini-bar.” *- Jeffrey Gundlach*

The third quarter was not lacking in excitement by any means. Tariff uncertainty, Federal Reserve rate cuts, Iranian brinkmanship, the growing prospects of a hard Brexit, talk of impeachment and unrest in Hong Kong all led to an exciting summer for investors. In this edition of Viewpointe, we discuss the impact these events played on economic growth as well as the equity and fixed income markets. We also provide our outlook for the fourth quarter. In the Asset Allocation section, we highlight some recent portfolio changes. We conclude with a brief overview of Modern Monetary Theory.

Economic Review -
No Summer Break

Global economic growth has steadily decreased since the beginning of 2018. While the slowdown first took hold in the manufacturing space, it has now spread to the service sector as well as employment. While the U.S. has held up better than most, it has not been immune from weakening economic conditions. While growth has slowed in the U.S., we are not at the point where we believe a recession is imminent. While our second half of the year growth forecast is below 2%, strong growth at the beginning of the year should still put us close to our 2% full year growth target. While our 2020 growth outlook is below that of 2019, our base case still calls for U.S. growth somewhere right around 1.5%.

With that said, we acknowledge that forecasts have to remain nimble given the high degree of uncertainty and seemingly endless supply of new developments. The key drivers of economic growth in the U.S. remain trade related matters and Federal Reserve (Fed) policy. While we gained some relief on the monetary policy front trade uncertainty still remains. Since trade is really the big unknown we would like to take this opportunity to discuss the matter in more detail.

In the previous edition of ***Viewpointe,*** we discussed how during the second quarter it looked as though a U.S./China trade agreement was getting close. In fact, a draft agreement had been put together. Matters, however, deteriorated quickly when Chinese leadership later redlined many of the substantive provisions. This led to a breakdown in talks during the early part of the third quarter and an escalation in tariff rhetoric. While many of these threats came to pass, at the present time it appears the two sides are far from reaching a comprehensive trade agreement.

While a comprehensive trade deal may not be in the cards anytime soon, there may be an opportunity for what is being referred to as a “narrow trade deal”. Conditions for a temporary truce are building. With President Trump under increased political pressure as the 2020 election approaches, and China under heavy economic pressure, both sides may want to reach a preliminary deal to break the impasse. Such a deal may simply cover a handful of the less controversial matters that have been discussed. Both sides could benefit from such a deal from the standpoint of projecting the appearance that some progress has been made without either side coming across to their constituents as weak.

Regardless of whether a “narrow trade deal” with China comes to fruition in the fourth quarter or not, we expect the Trump administration to kick trade talks with other countries into high gear. Going into the election, the administration seems motivated to lock in some smaller

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scale trade wins. In their pursuit to score some smaller victories, we are hopeful that a trade deal will be struck with Japan that mitigates the threat of U.S. auto tariffs and expands access for U.S. agricultural exporters. In addition, it appears that ratification of the USMCA (NAFTA replacement) is getting closer as Democrats and Republicans are both making some concessions, moving the deal closer to a vote. Progress is also being made regarding trade negotiations with Vietnam and India with both countries highlighting increased purchases of U.S. goods and security cooperation. A trade agreement with the European Union (EU) may prove elusive, however, due to the appointment of a new EU trade commissioner that refuses to include agriculture in trade talks.

While it is difficult to predict with certainty how much progress will be made on the trade front, we are optimistic that some progress will be made. We view trade uncertainty as the key driver of slowing economic conditions in much of the world. Businesses are reluctant to expand when they don't know whether tariffs will go up or down, or what export restrictions they may face. This reluctance to expand is only exacerbated by geopolitical events such as the social unrest in Hong Kong, the threat of a hard Brexit, talk of impeachment and threats to the global oil supply. All of these factors are playing a role in whether we are moving closer to or further away from making progress on the trade front.

In summary, our base case calls for slower economic growth in the U.S. for 2020, but not a recession. Our current projections anticipate annual growth somewhere around 1.5%. We acknowledge that the odds of a recession significantly increase in the event we do not achieve progress on the trade front. It is important to note, however, that if a recession occurs in 2020 it is likely to be short lived and shallow as officials will enact significant pro-growth fiscal and monetary policy. With that said, we believe some of our trading partners may not fare as well. We do have concerns regarding a recession taking hold in certain parts of Europe in 2020 and expect some extremely slow growth in Japan.

Fixed Income Commentary - Rate Cuts Have Arrived

In July, the Federal Reserve (Fed) cut the Fed Funds Rate for the first time since the financial crisis. This rate reduction was the first since December 2008, when the Fed effectively dropped the Fed Funds Rate to 0%. The cut marked a shift in policy from rate hikes that began in December of 2015. While investors were pleased the Fed cut rates, they were not pleased with the narrative at the press conference following the cut. One would think that when you have a limited amount of arrows in your quiver, you would try to make the most of them. Chairman Powell, however, seemed to shoot one of the Fed's few arrows up in the air. At the press conference, Chairman Powell stated the cut was designed to "insure against downside risks." Powell stated that the committee viewed the cut as a "mid-cycle adjustment to policy." The death blow, however, was when referring to the decision to cut, Powell stated that "it's not the beginning of a long series of rate cuts."

That was not at all what investors wanted to hear. Once again, the Fed came across as out of touch with what investors' saw as deteriorating economic conditions combined with overly restrictive monetary policy. Did the Fed not realize that short-term interest rates were too high verses intermediate and long-term interest rates? Fixed income investors soon reacted resulting in one of the most volatile quarters in over a decade in the fixed income markets. Intermediate and long-term interest rates dropped significantly resulting in the inversion of the 2-year versus 10-year U.S. Treasury yield curves. An inversion simply means 2-year Treasury rates exceeded those of 10-year Treasury rates. This marked a significant event given it has only occurred five times over the last 40 years. In addition, 4 out of 5 times it presaged a recession, which was in retrospect attributed partially to a monetary policy error. Investors were no doubt on edge and they began to fear the Fed was in the midst of making another policy mistake.

Fortunately, tensions subsided a bit when the Fed came through with an additional .25% rate cut at their September meeting. It is important to note, however, that two Fed members opposed making the September cut, and it appeared clear that some other members were holding out hope that they are in the midst of a small easing cycle rather than an aggressive set of emergency cuts. Overall, the fixed income market reacted favorably to the Fed's more conciliatory message with intermediate and long-term yields moving up.

While we are not out of the woods yet, it appears the Fed is moving in the right direction. Two .25% rate cuts is definitely a much better place than where we were following the Fed's December 2018 rate hike. With that said, we place the betting odds of a December cut at about 50/50. Ultimately, an additional cut may not be necessary if economic conditions improve. To a large degree economic conditions will be driven by developments on the trade front. Positive developments will likely make the Fed hesitant to cut again in December. This does not, however, mean the yield curve will not steepen. Intermediate and long-term rates could continue to drift higher if economic conditions improve. We do, nonetheless, believe rates will remain low for an extended period of time in comparison to the historical norms.

Equity Commentary - Fairly Flat

The good news is that U.S. large-cap stocks did not go down in the third quarter. The bad news is they did not go up much either. Overall, that is not a bad outcome given all of the developments that took place during the quarter coupled with the typical drag of seasonality. U.S. mid-cap and small-cap stocks did not fair quite as well. Both were slightly down as of the final days of the third quarter. Developed international stocks were also slightly down. Emerging market stocks were in last place, with the MSCI Emerging Markets index off by around 5%.

While stock portfolios pretty much moved sideways during the third quarter, we are still sitting on a solid full year return thanks to the tremendous performance that we experienced earlier in the year. So, where do we go from here? In short, we need a positive market driver to get prices up much beyond this point. Corporate profits and earnings are decelerating overall and valuations look a bit stretched here in the U.S. While valuations look more attractive in some foreign markets, the growth outlook seems to justify these lower valuations. Ultimately, we continue to favor U.S. stocks while acknowledging that progress on the trade front will likely be necessary to gain much more upside traction. Progress on the trade front combined with a more dovish Fed will likely boost overall confidence, which would in turn boost market conditions. Until this happens equity markets will remain vulnerable to a build-up of negative developments.

The good news is that we are not seeing many signs of a market top. Net inflows into equities have been negative over the last decade. Market breadth has been relatively broad based. There are few signs of speculative excess. In addition, more accommodative central bank policy on a global scale is helping prop up equity markets. Furthermore, over the last three months we have experienced a significant increase in the money supply. Much of this added liquidity is making its way into the equity markets. We are also seeing the reintroduction of the T.I.N.A concept. T.I.N.A stands for There Is No Alternative. The idea behind T.I.N.A. is that there are a set amount of dollars that need to be placed to work in investments. Even though equities may not be perfect, they are likely to attract a significant amount of these dollars absent superior alternatives. At the present time, such alternatives are hard to find.

In conclusion, we view equity upside as limited for the remainder of the year, absent progress on the trade front. We view current gains as vulnerable to increasing downside risks. Our preference remains with large-cap U.S. stocks. We are monitoring conditions closely and took steps during the second and third quarters to bring our models back to their equity targets to protect gains that were made earlier in the year.

Asset Allocation - Fixed Income Frenzy

Extreme volatility in the fixed income space triggered a Lakepointe Classic model rebalance during the third quarter. While we did rebalance toward the end of August, only a few trades were necessary on the Classic equity front. As mentioned in the equity commentary, equity markets were pretty flat during the third quarter. By no means was that the case on the fixed income front. Intermediate and long-term interest rates dropped dramatically following Chairman Powell's July rate cut press conference. Investors did not like the message that future cuts may not be necessary and concerns of a policy error quickly grew. To give some perspective as to the scale of the rate drop let's consider the move in the 10-year U.S. Treasury. On July 30th, the day prior to the Fed's rate cut, the 10-year Treasury yielded 2.06%. One month later, on August 30th the yield had dropped to 1.5%. In percentage terms that resulted in a 27% drop in one month. Such a drastic shift in such a short period of time is extremely rare.

As the end of August approached, we were of the opinion that the move in rates was overdone and it was likely that yields would begin to drift back up. When yields on 10-year U.S. Treasury Inflation Protected Securities went negative we decided to move to reposition ourselves for an increase in interest rates. Our timing proved fortunate, since within days of making the move rates began to move back up. We are currently monitoring the situation closely since we think it is only a matter of time before we have to reposition once again for lower rates.

We also made some changes to our Lakepointe Premier equity model during the third quarter. In mid-August we added American Electric Power and T-Mobile to our individual stock portfolio. To make room for these two new additions in our 50 stock portfolio we only had to liquidate one position. That position was Raytheon. The reason only one name had to be removed was due to the merger of L3 Technologies and Harris Corporation. We held both of these securities prior to their merger. When they combined to form L3/Harris Technologies it resulted in a double weighting that we cut in half. This freed up cash to cover the other purchase. Those were the only changes made on the equity front. When it comes to Premier fixed income we find ourselves moving toward fixed income mutual funds in most cases since yields have dropped to such low levels. We just as soon stick with more liquid positions that can be sold easily when better individual fixed income options become available.

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Financial Planning -

Modern Monetary Theory

Worried about how the U.S. is going to pay off the growing national debt? Questioning how presidential candidates plan on paying for grand plans such as Medicare for All or the Green New Deal? According to some, there is nothing to worry about. All of these items can be managed by implementing the economic theory referred to as Modern Monetary Theory or MMT.

While precursors to MMT were first discussed during the early 1900's, it has not received widespread publicity until it was mentioned by some of the current presidential candidates. Perhaps the best place to start when learning about MMT is to establish a general understanding of the U.S. dollar. As a result of the demise of the gold standard in 1971, the U.S. dollar is no longer backed by gold. Instead the U.S. dollar is referred to as a "fiat" currency. In other words, the U.S. dollar's value is derived from the relationship between supply and demand and the financial stability of the underlying government. Absent such a backing, MMT's proponents claim the U.S. government is free to print as much as they want.

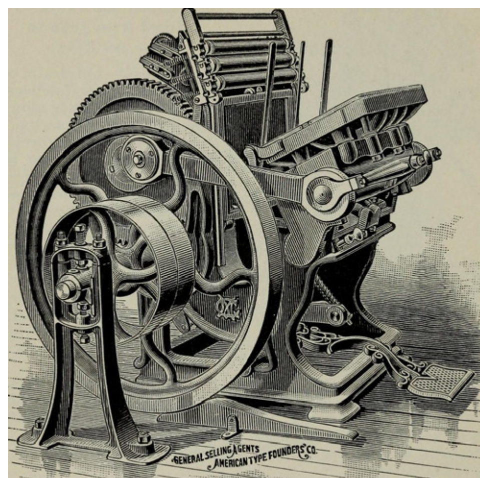
More importantly, they believe the government does not have to issue debt or raise taxes to raise money. Instead, they just need to print it. In general, they view taxation and debt issuance as policy controls used to control items such as economic growth and interest rates. According to proponents the primary constraint on government spending under MMT is inflation. They claim that inflation poses a threat when the public and private sectors spend too much at the same time. They assert that inflation can, however, be contained by increasing taxes in such situations. In short, MMT followers believe economies should be guided by increases and decreases in government spending and taxation. This rejects the modern consensus that economies should be steered by interest rates.

MMT is gaining the support of many who want to see the government provide more services. The way they view it is if all we have to do is print more money to pay for items such as "healthcare for all" or "universal employment," why not print it? They argue that after all, isn't that what the U.S. government did to fund Quantitative Easing?

Opponents see things differently. While they agree the U.S. government is free to print money, they argue that problems will develop when this ability is utilized in excess. A few core criticisms of MMT include the following. First off, opponents point out that inflation could pose a serious problem in the event the government spent too much and taxed too little. Critics often point out that higher taxes need to be approved by politicians who would be reluctant to take such action if it jeopardized their chances of re-election. They argue absent a willingness to increase taxes, hyperinflation would pose a serious threat under MMT.

Secondly, MMT is based upon paying off debts that are denominated in your home currency. In other words, a U.S. citizen paying off debt in U.S. dollars in this instance. What if the debt, however, was denominated in Euros? Here we have to consider the exchange rates. Opponents argue that a weakening of the dollar is inevitable as the supply of dollars increases. This would create an environment where paying for foreign denominated products and services would cost more dollars.

Third, the U.S. economy is not the only game in town. Opponents argue that historically countries that increase debt and experience currency deflation will often times have difficulty attracting outside capital. All countries have a limited supply of collateral. Once that collateral is exhausted, investors have a tendency to run for the hills. While MMT makes a solid argument against a technical default, opponents argue that a de facto default can result in similar economic consequences as foreign capital moves elsewhere.



Lastly, some opponents argue that utilizing MMT to fund a large scale welfare system would be difficult to control. The idea is that if all you have to do is print more money, why not provide citizens with everything they ask for in order to remain in power? They contend that at a certain point the government will run out of productive items to spend on. At that point they fear that it will be difficult to throttle back spending, resulting in expenses that do little to contribute to the health and growth of the economy. They further assert that such environments lead to mal-investment, which historically has led to bubbles.

In conclusion, our intention here is to provide you with a general understanding of MMT and some of its potential flaws. MMT is currently in a state of development and research, and articles on the topic are rather limited. We encourage you to use this opportunity to build a core understanding of the topic that can then develop as the debate progresses.