MALVERN CAPITAL MANAGEMENT

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Third Quarter 2019 Market Review and Outlook

October 2019

The Third Quarter 2019 Review

For the third quarter 2019, the equity markets were mixed. Larger-cap stocks and mid-cap stocks added to already impressive gains for the year with the S&P 500 Index adding 1.70% in the quarter giving it a year-to-date return of 20.55%. The Dow Jones Industrial Average was up 1.83% in the quarter and has returned 17.51% year-to-date. Domestically, one outlier was small-cap stocks that actually declined in the quarter. Some market watchers consider small-cap stocks a leading indicator foretelling the fate of the broader stock market. We view the small-cap Russell 2000 Index's decline this quarter with some concern. Developed international and emerging markets stocks were also down in the quarter but still show decent gains for the year so far.

Bonds appreciated this quarter as represented by the broad Bloomberg Barclays U.S. Aggregate Bond Index. The index gained on the heels of declining interest rates. The 10-year U.S. Treasury Note yield started the third quarter at 2.0% and ended the quarter at 1.675% after hitting an intra-quarter low of 1.429% in early September. The 10-year U.S. Treasury Note's price was boosted by continued foreign buying of our government bonds (the price of bonds moves in the opposite direction of their yield). Some of that buying may be due to global growth concerns as U.S. government bonds are seen as the safe haven around the world. Also, some foreign government bonds are trading with negative interest rates so our government bonds become more attractive to foreign investors. Nonetheless, the decline in interest rates continues a trend that began in late 2018.

Index Performance

Category	Representative Index	3rd Qtr 2019	Y-T-D 2019	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Company	DJ Industrial Average	1.83	17.51	4.21	16.44	12.28	13.56
Broad US Large Companies	S&P 500 Index	1.70	20.55	4.25	13.39	10.84	13.24
US Small Cap Companies	Russell 2000 Index	-2.40	14.18	-8.89	8.23	8.19	11.19
US Mid Cap Companies	Russell Mid Cap Index	0.48	21.93	3.19	10.69	9.10	13.07
Largest 100 NASDAQ Companies	NASDAQ 100 Index	1.29	23.42	2.73	18.01	15.19	17.58
Developed International	MSCI EAFE Index	-1.07	12.80	-1.34	6.48	3.27	4.90
Emerging Markets	FTSE All Emerging Markets	-3.81	7.48	0.86	6.12	2.56	3.55
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	2.27	8.52	10.30	2.92	3.38	3.75
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	1.33	11.41	6.36	6.07	5.37	7.94
Commodities	Bloomberg Commodity	-1.84	3.13	-6.57	-1.50	-7.18	-4.32
Total US Market (all cap stocks)	Russell 3000 Index	1.16	20.09	2.92	12.83	10.44	13.08
Real Estate Investment Trusts	Wilshire US REIT Index	7.88	27.21	18.39	7.21	10.17	13.06
Oil	West Texas Crude Intermediate Oil	-7.06	19.80	-26.07	4.27	-9.91	-2.61
Cash	US T-Bill 90 Day	0.49	1.66	2.25	1.55	0.98	0.53

** 3 year, 5 year and 10 year returns are annualized. All periods ending September 30, 2019.*
All returns include the reinvestment of dividends.

Despite certain indices' decline this past quarter, we are pleased with the rebound in all stocks so far in 2019. As we enter the last quarter of 2019, investors wonder if we'll see a repeat of last year's fourth quarter slide or will we continue to advance further. The U.S. economy continues to grow, inflation is tame and the Federal Reserve may become more accommodative. Trade wars and tariffs are impacting the markets. There is a presidential election on the horizon which will potentially impact the markets as well. We look at these issues facing the markets as we finish the year and move into 2020.

Moving Forward; Our Market Outlook

Fears of Recession

The media and investors have become fixated with a potential recession in the United States. We have experienced over 10 straight years of economic expansion following the Great Recession of 2008 and 2009. There have been mixed signals leading some to think a recession is imminent. The yield curve has inverted which has been a warning sign of recessions in the past. Some data points have shown a slowing economy. But other facts are much more positive. The consumer remains strong, interest rates are low and corporations are profitable. Recessions are a part of the normal business cycle and eventually one will occur.

Trade War

Most would consider our current trade situation with China to be a full-blown trade war. Both sides seem to be digging in their heels and holding steady on their positions. The financial markets remain very sensitive to any news that comes out either positive or negative.

In early September, President Trump imposed a 15% tariff on several items including clothing and food. Immediately, China retaliated by imposing $75 billion of tariffs on American products. Trump maintains that China is suffering more than the United States is from this so-called trade war. Even if China is suffering more, there are Americans who are being hurt, and will likely hurt more the longer it carries on.

Both sides are talking as they have been for over the past two years. Many U.S. companies exporting to China have lowered their sales and earnings forecasts as a result of the trade dispute. Trump says that short-term pain is necessary for a long-term gain. He claims that China has been taking advantage of us through their unfair trade practices for a long time and this needs to change. Many Americans do agree with him while many do not.

China and the United States are the two largest economies and if they have a prolonged trade war, the potential is there to sink global economies. Investors are also concerned about the impact on financial assets. Anything that may lead to slower economic growth has the potential to rattle the markets.

Federal Reserve and Interest Rates

The Federal Reserve cut the Fed Funds rate two times in the third quarter 2019 at both the July and September meetings. They claim to be ready to cut further if it looks like the economy is slowing or weakening. If one looks at the Fed's dual mandate of full employment and price stability, one could wonder if rate cuts at this point are even necessary. Overall unemployment is low and we are currently hovering around the Fed's target inflation rate of 2%. This seems to support a neutral policy coming from the Fed.

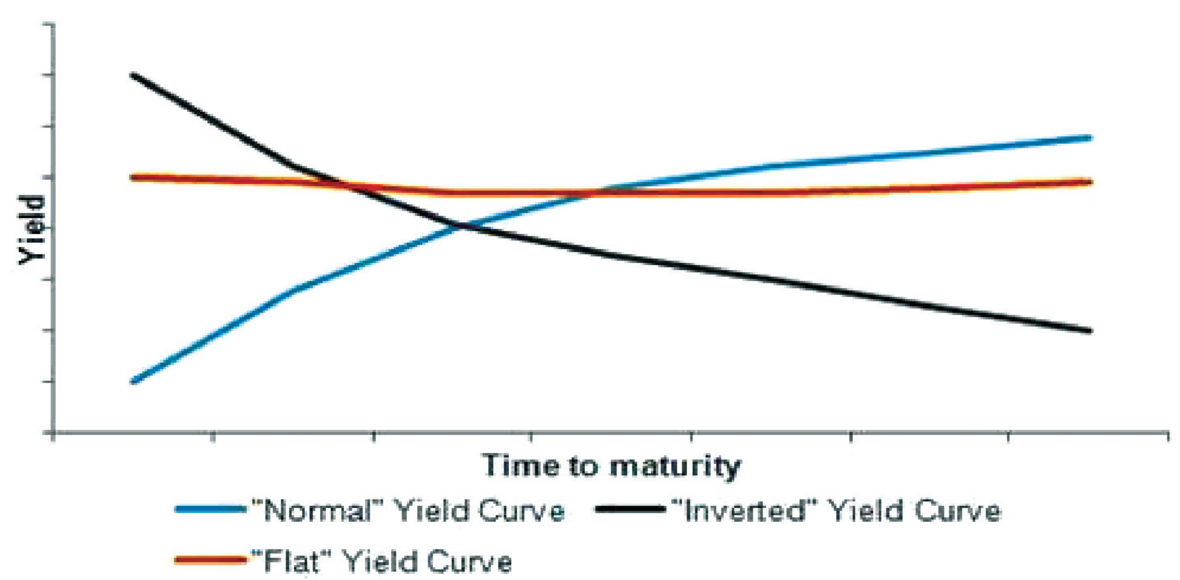
In general, the markets like lower interest rates. When the Fed is more accommodative, stocks rally. Lower rates are better for economic growth, but if rates are too low, that can lead to inflation. So, the Fed is very careful about when it raises or lowers interest rates.

President Trump has been very critical of the Federal Reserve for a while claiming that its raising of interest rates will hurt all the progress we have made on the economy. However, the Fed is an independent organization and does not take orders from the President. It acts when it sees fit to act. We want it to be independent.

Interest rates are historically low and have fallen further this year (as we mentioned earlier with regard to the 10-year U.S. Treasury Note). The Fed only really impacts short-term interest rates unless it implements a quantitative easing program which has only been reserved for an extreme circumstance such as the Great Recession. The bond market impacts longer-term interest rates and the market has driven those rates down this year.

As interest rates have fallen this year, we become more concerned that the yield curve has inverted. Currently the Two-year U.S. Treasury Note yield is higher than the Five-year U.S. Treasury Note yield, thus a so-called inversion of the yield curve where shorter-term interest rates are higher than longer-term interest rates. An inverted yield curve is often used as a predictor of recession. Nevertheless, the 10-year U.S. Treasury Note yield is higher than the Two-year U.S. Treasury Note yield which only inverted for a brief few seconds recently. It is usually the Two-year/10-year spread that most economists focus on for the recession predictor, not the Two-Year/Five-Year spread. For now, there is no Two-year/10-year inversion but rates are low and will likely remain low for the time being.

Yield Curve



Source: TIMM (MentorMarket.io)

Washington and Politics

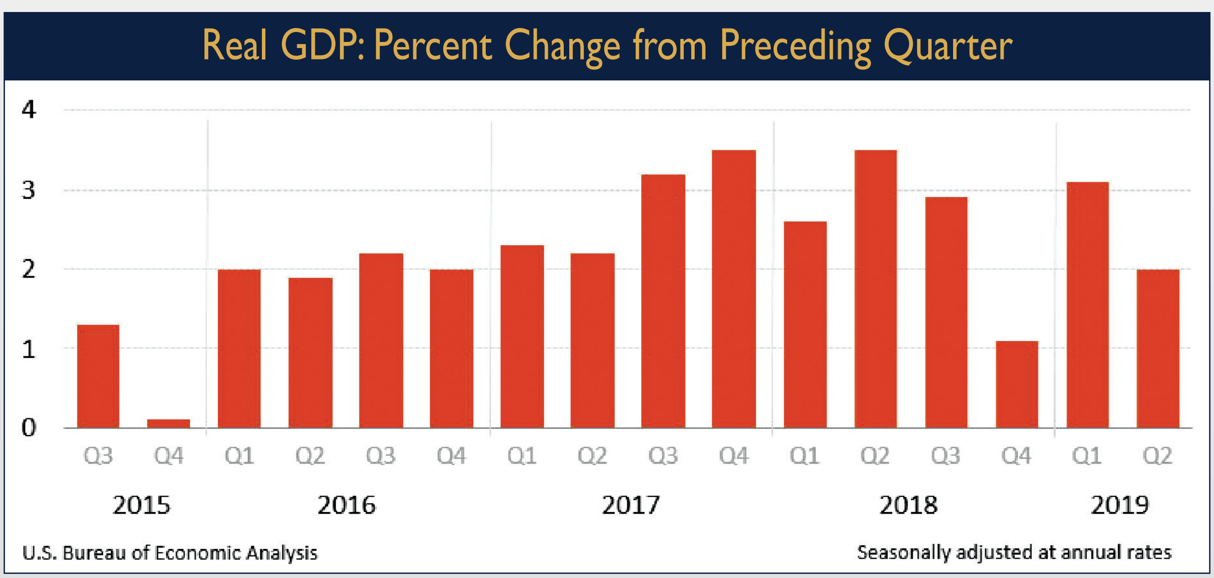
The United States-Mexico-Canada Agreement (USMCA) is intended to benefit farmers, ranchers and businesses and is slated to replace the previous trade treaty, the North American Free Trade Agreement (NAFTA). Mexico has already ratified it and it sits in the House of Representatives awaiting approval. It will probably continue to sit. There is little incentive for the Democrat majority held House to pass any legislation which may give a perceived “win” for the president. There are also many bills which have passed the House which are simply just sitting in the Republican controlled senate. This is the nature of politics today in this country.

Meaningful legislation will not likely make its way into law as both sides, Democrat and Republican, jockey for power and control. The House is seemingly focused on impeaching the president right now and the Senate has appeared to have closed its doors to bills coming its way. Voters made it clear in the last election that they wanted work done on healthcare, drug prices and infrastructure.

What will change the current state of politics in this country? It is hard to believe that there really is much hope that government will work together to get things done for the voters regardless of who wins the next election. The next presidential election is a little over a year away and it seems to be setting up to be nasty and divisive. Capitalism in its current state, may be on the ballot next year depending on who wins the Democrat nomination. The markets will be focused on polls and the country’s sentiment as the next year progresses.

The Economy

Despite all of the concerns about an impending recession, the U.S. economy is growing. Real Gross Domestic Production (GDP) grew by 2.0% in the second quarter 2019 following a growth rate of 3.1% in the first quarter 2019. A recession is generally defined as two consecutive quarters of negative GDP growth. 68% of the GDP is consumption. The consumer appears to be confident and spending on goods and services.



Two important contributors to the consumption component are the overall level of unemployment in this country and wage growth. The unemployment rate for September dropped to 3.5% from 3.7% the month before. This is the lowest level since December 1969. At the same time, employers added 136,000 new jobs in September. So far in 2019, the average number of new jobs added has been 161,000 per month. It must be noted that the average added per month in 2018 was 223,000.

Although wage growth in September was flat, workers' wages have increased by 2.9% over the past 12 months. Disposable personal income also has been increasing (salaries and wages are the biggest component of disposable personal income). Despite wages and disposable personal income, the consumer could be softening a bit as reflected in the recent Conference Board's consumer confidence survey results. These readings have been slipping in recent months reflecting a consumer that is becoming less confident about current day conditions and the outlook for jobs going forward.

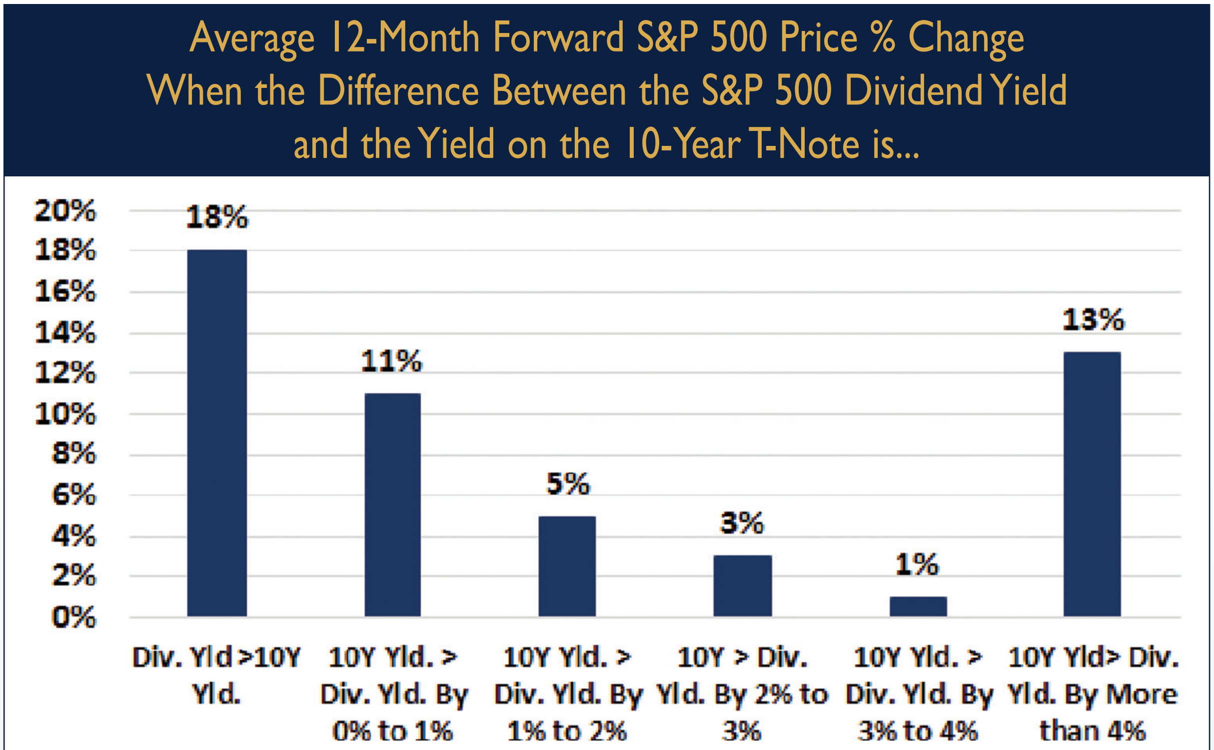
Earnings Growth May Be Slowing

Earnings on the S&P 500 Index component companies are projected to be $153.89 per share for the third quarter 2019. This represents a year-over-year gain of just 2.3% from the third quarter 2018. Actual earnings per share for the third quarter 2018 were $150.42 per share. Although earnings are growing slightly, the rate of growth is slowing. In September 2018, the Standard & Poor's Corporation projected earnings on the S&P 500 Index to be $172.21 for the third quarter 2019. This represents a decline of $18.32 per share ($172.21 minus $153.89) from last year's forecast to the current year's forecast for third quarter 2019 earnings. Analysts are taking down their earnings estimates. Is this cause for concern? Yes, it is a cause for concern. The impact of the corporate income tax rate cut may be wearing off. Also, companies are being adversely affected by the looming trade war. Plus, there may be some overall slowing in the economy. All of this is having a negative bearing on corporate earnings.

Market Valuation

A study done by CFRA in 2017 (CFRA, powered by data from S&P Global, U.S. Equity Research Sector Watch, February 6, 2017) showed market returns 12-months following various scenarios of the S&P 500 dividend yield versus the yield on the 10-year U.S. Treasury Note. As we mentioned earlier, the 10-year U.S. Treasury Note yield was 1.675% at the end of the third quarter. The yield on the S&P 500 Index at the end of the third quarter was 1.98%. Thus, the yield on stocks was higher than the yield on bonds. Bonds are either very expensive or stocks are really cheap or some combination of both. The CFRA study showed that in this scenario, stocks returned on average 18% over the next 12-months. As with any average, there will be returns that fall below the average and fall above the average. But this should be an encouraging statistic for market investors.

Other valuation metrics show that the market is reasonably valued right now and has room to appreciate further from here. The current "trailing" Price to Earnings (P/E) ratio is 19.34 which would represent a reasonably valued market. The 25-year average "trailing" P/E ratio is 19.34 times (average of quarter ending P/E ratios). We are currently exactly right at the average "trailing" P/E ratio. The current "forward" P/E ratio is 16.57 times. The "forward" P/E ratio divides the current price by the expected earnings 12-months from



Source: S&P DJ Indices, Federal Reserve. Past performance is no guarantee of future results. Data: 12/31/53 to 2/3/17.

now. The 25-year average "forward" P/E ratio is 16.22 times. We are currently in line based on the "forward" P/E ratio as well. Based on the current valuation versus historical valuations, we are reasonably valued.

Moving forward, if we assume that the current 12-month estimate for earnings on the S&P 500 Index are achieved ($174.25 per share by September 2020) and if the market will still support a P/E ratio of 19.34 times a year from now, this would suggest a value of 3370 on the S&P 500 Index. The quarter-end price of the S&P 500 Index was 2976.74 suggesting a total return of 15.2% (which includes the reinvestment of dividends) over the next 12-months.

Certainly, there is no guarantee that these earnings estimates will be achieved. A lot of variables will go into these estimates over the next 12-months. As we mentioned earlier, estimates have come down over the past 12-months and could possibly be taken down over the next 12-months affecting the valuation of the market.

Summary

The third quarter 2019 was mixed for the equity markets with larger capitalized U.S. stocks in the black and nearly every other equity asset class in the red. But overall all equity asset classes have performed very well for the year so far. The economy has averted recession even though many people fear that one is on the horizon. An ongoing trade war with China hangs over our heads but perhaps a resolution is forthcoming sooner rather than later.

The Federal Reserve has become more accommodative over the past few months after a few years of steady tightening. It doesn't seem like we are going to get much help from Washington to make our lives any better as impeachment is the only thing on Congress's agenda right now.

The economy is doing well, by and large. Jobs are plentiful and people are seeing a little bit more in their paychecks. Corporate earnings growth is slowing, but earnings are still growing. The market does not appear to be overvalued and our expectation is that we can see pretty healthy gains over the next 12-months.

As such, we are here to listen, counsel and provide direction to all of our clients.

James L. Olsen, CFA, CFP®
President & Chief Investment Officer

Michael P. Czajka
Chief Executive Officer