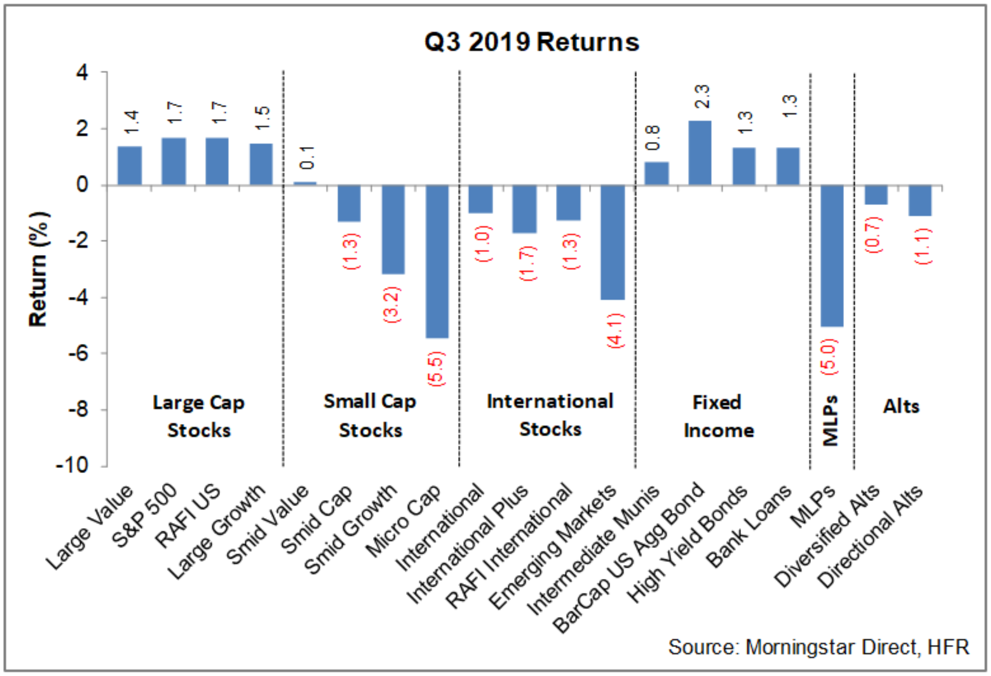
NEXTCAPITAL

Next Capital Management, LLC
Eleven Times Square, 15th Fl
New York, NY 10036
O: 212.433.1111
F: 212.382.2080
www.nextcapitalmgmt.com

Third Quarter 2019 Investment Review & Outlook



EXECUTIVE SUMMARY

Q3 2019 Recap:

- Global stocks were roughly flat in the quarter but remain up significantly YTD. In the last 20 months, however, global markets are roughly unchanged
- US large cap companies sharply outperformed small cap and international stocks in the quarter, as a general flight to safety trade took hold amid higher volatility
- Longer duration, high quality bonds continued their outperformance amid another push lower in interest rates. The yield on the 10-year Treasury has fallen more than 1.00% in 2019 and is not far from all-time lows

NEXT Outlook:

- Several binary-type risk factors hang over the market, including 2020 elections, a trade war with China, and potential impeachment of the President. Investors should retain a neutral risk stance given the potential for these factors to break in either direction
- The Fed has fully reversed course by returning to interest rate cuts (along with other less high-profile accommodation), which helps soften the market's concerns and will help support financial markets
- Fundamentals have softened amid the uncertainty regarding the aforementioned issues, but recent data points suggest that trend may be reversing

To Our Clients and Friends,

The global stock market was flat in the third quarter, buffeted by continued headlines around trade, Federal Reserve policy, and the potential impeachment of President Trump. Following an incredible first four months of the year, in which the stock market was up 16%, stocks have since moved sideways amid choppy trading. A broad range of assets remain up significantly in 2019, however, including global equities up nearly 17% through the end of the third quarter.

Of course, a wider lens reveals stocks have produced virtually no return since January 2018 (see chart at right). Last year proved to be an extremely difficult year for diversified investment portfolios, particularly in the fourth quarter when the stock market fell nearly 20%. The big gains we have enjoyed this year have simply gotten us out of the bear market-sized hole dug in the final months of 2018.

That is a disappointing outcome based on the strength of the economy and the corporate sector 20 months ago. Following 2017's Tax Cut & Jobs Act, the economy was primed to deliver its best period of expansion in more than a decade. For a year, at least, this was indeed the case: corporate earnings grew by more than 20%, US GDP put up the best calendar year of growth since the mid-2000s, and the unemployment rate fell to multi-decade lows. Confidence was high in both the corporate and consumer sector, and hopes were raised that companies would significantly restart capital investment for the first time since the financial crisis – a key to sustainable, meaningful economic growth.

Unfortunately, those positive forces were undermined by the emergence of trade tensions with China. The effect on confidence has been acute, as corporate capital spending plans have been slashed and CEO sentiment has fallen sharply. Corporate earnings predictably declined from 2018's abnormally high levels, but they have been weaker than expected amid this backdrop (current estimates call for a 4.6%[1] decline in the third quarter). Broader measures of economic data have indicated coordinated slowing across the globe.

[1] Source: Factset Earnings Insight, Oct. 11, 2019

Despite these issues, the markets have largely rallied in 2019 due to an about-face by the Federal Reserve (and other foreign central banks). While the Fed was still increasing short term interest rates late last year, the bank has since changed course and cut rates three times in 2019. Lower rates are, of course, simulative to the economy and investors hope that Fed action will be enough to shake off the negative momentum described above. Whether these three cuts will be enough – or whether the Fed intends to provide additional monetary stimulus – remains to be seen. It is abundantly clear, however, that Fed policy will continue to be the driving force behind market performance for the foreseeable future.

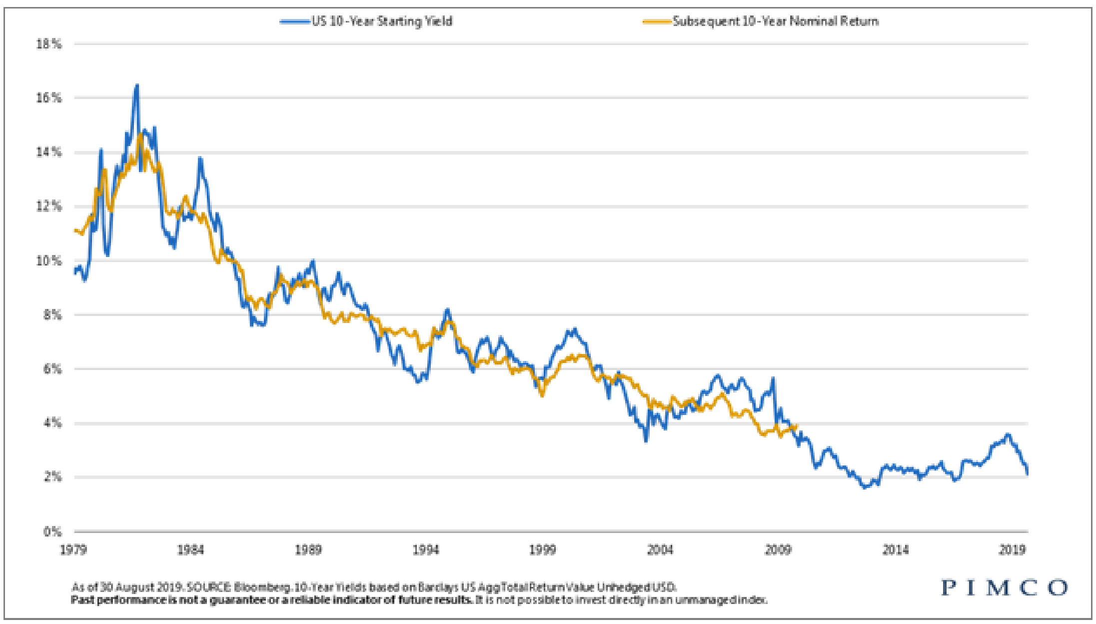
Market Review

US large cap stocks led market performance in the quarter, with the S&P 500 finishing the quarter up 1.7%. This sharply outperformed US small caps (down 2.4%), developed international stocks (down 1.0%), and emerging markets (down 4.1%). This leaves the US up significantly on the year over the other major global segments, continuing a pattern that we have observed for several years.

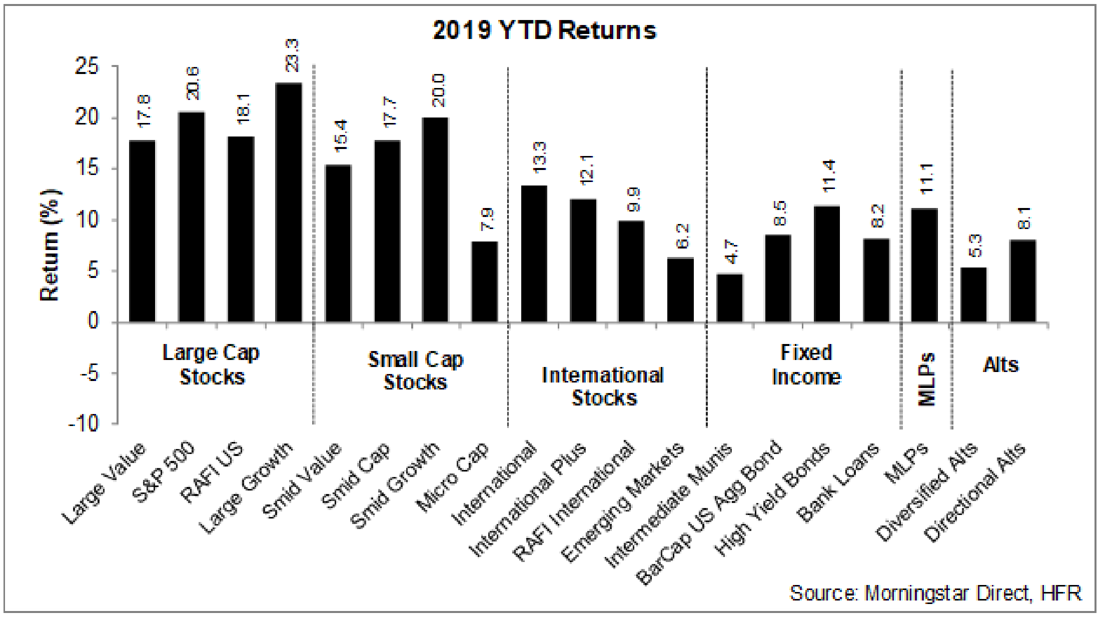
Although technology remained a strong performer, third quarter performance was dominated by more yield-oriented sectors. REITs and utilities, for example, were up 8% and 9%, respectively, in a generally flat market. A sharp decline in interest rates proved to be a tailwind for these highly interest rate sensitive sectors. Conversely, energy stocks fell more than 6% amid ongoing volatility in oil prices. For the year, technology stocks lead all sectors with a return of more than 30%.

Using the yield on the 10-year Treasury as a benchmark, interest rates have declined more than 1.50% from their 2018 highs and are more than 1.00% lower so far this year. These are enormous moves given how low interest rates already are, and this year's levels are threatening all-time lows. This has boosted bond prices, particularly longer dated, high quality bonds. The Barclays Aggregate Bond index, often used as a proxy for the bond market, was up 2.3% in the quarter and is up 8.5% for the year.

Unfortunately, this is not a sustainable phenomenon, as eventually bonds must price back to "par" (i.e., the promised price at maturity). It is for this reason that bond returns largely mirror their yield-to-maturities over the long-term (see chart at right for a comparison of yields with subsequent 10-year returns). With intermediate interest rates hovering around 2%, the long-term outlook for traditional fixed income returns has become somewhat discouraging.



It is for that reason that we continue to diversify portfolios through other sectors and asset classes like credit, real estate, and alternatives. These areas provided mixed performance in the third quarter. More credit sensitive fixed income sectors like high yield bonds and leveraged loans both posted returns of 1.3% in the quarter. Diversified private real estate was also modestly positive, gaining 1.3%. On the negative side, hedge funds declined, with diversified strategies falling 0.7% and directional long/short equity funds declining 1.1%. On the year, however, all of these areas are significantly positive and have benefited from the general rebound in risk assets.



Outlook

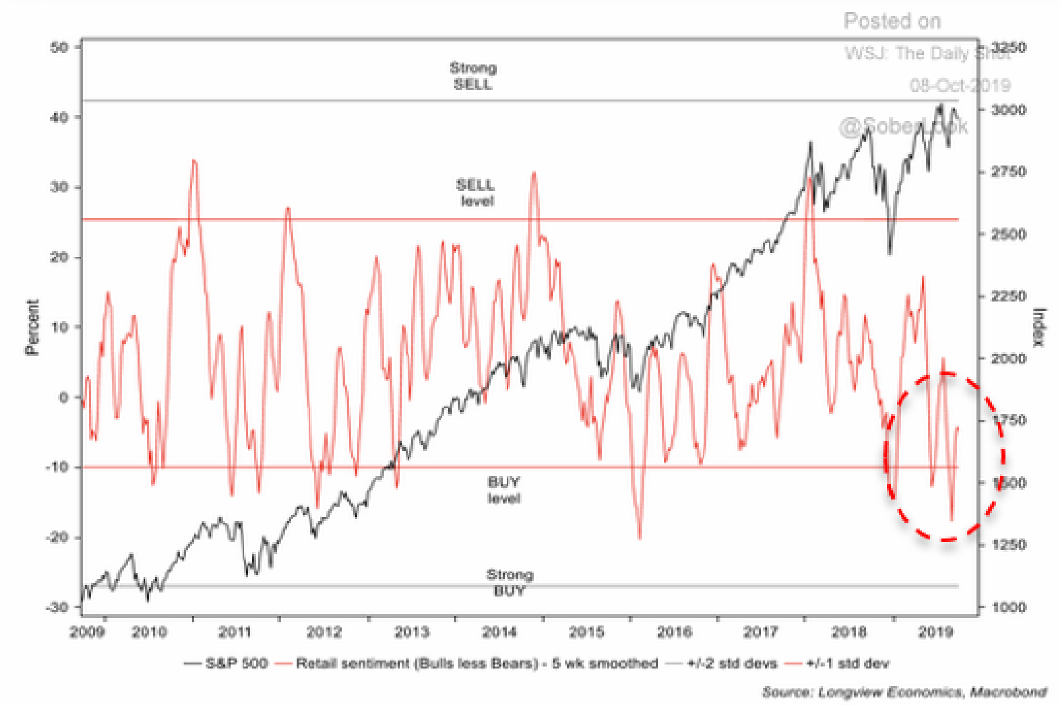
Investors appear to be facing mounting risks as we enter the fourth quarter: (1) the House has formally launched an impeachment inquiry into President Trump's interactions with Ukraine; (2) the markets may be too optimistic about the Federal Reserve's policy intentions; (3) uncertainty around trade with China has manifested into disappointing economic data; and, (4) the 2020 election looks poised to elevate populist policies that are likely a headwind to financial markets and corporate America.

Yet, as we complete this commentary in late-October, stock markets have reached all-time highs. How do we reconcile this contradiction?

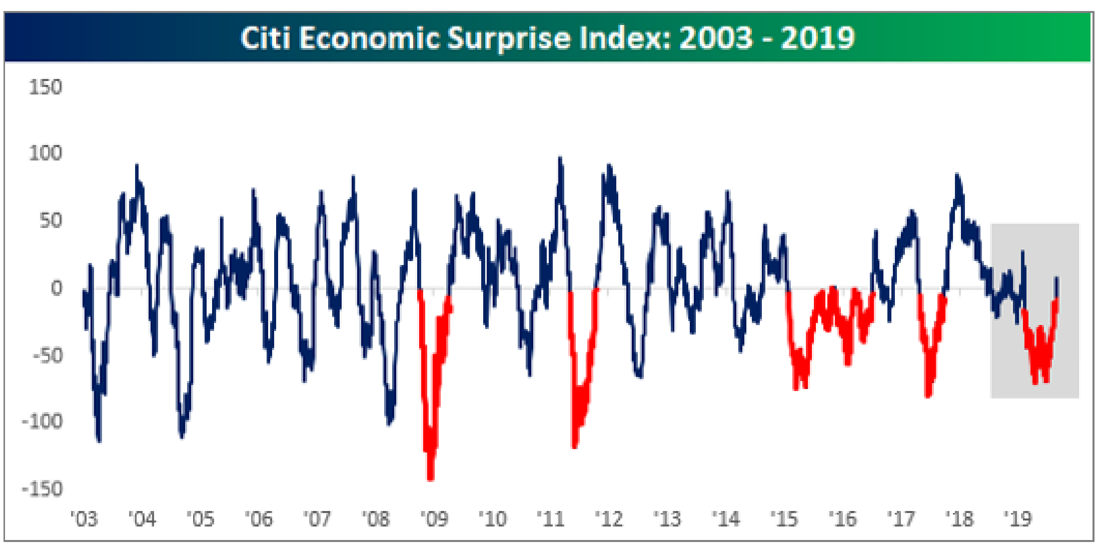
We must remember that the market is a forward-looking mechanism; today's data and news do not matter nearly as much as the future path of those variables. Indeed, one could argue the market has already priced in these concerns: we have, after all, gone nearly two years without any return on the global stock market.

To that end, despite strong equity market performance, investors are actually quite bearish on the market's outlook. Just a few weeks ago, investor sentiment reached its lowest level in more than three years. For those less familiar with such measures, poor investor sentiment has historically been a contrarian signal (i.e., markets often rally when investors think future performance will be poor). Thus, it is said that financial markets often climb the proverbial "wall of worry."

Fig 2aii: AAII retail sentiment survey (bulls less bears) shown vs. S&P500



Support for markets may also not just be technical, as economic data appears to be on the verge of rebounding. Both the ISM Manufacturing and Non-Manufacturing PMI indices – major measures of the US economy – recently reversed a nearly yearlong slide. The Citigroup Economic Surprise Index – a gauge that measures whether economic data is beating or missing estimates – also recently moved back into positive territory, suggesting that data is surprising to the upside. Green shoots like these show an economy that may be finally adjusting to the headwinds of a global trade war.



Despite these constructive signals, however, we are still exercising caution in the face of so many binary risks facing the financial markets. We do not advocate dramatically cutting risk, as ignoring the direction of Federal Reserve policy has proven to be a fool's errand. At the same time, it is very unclear how issues like the 2020 election and our trade war with China will unfold. We know mathematically that the corporate tax cut from 2017 has dramatically boosted earnings; any threat to the tax law from a new administration would be detrimental. Likewise, we seem to have reached a place of stabilization with China on trade, but that issue has been anything but predictable. Our best guess is that the President needs a deal (even if in name only) to support his re-election bid, but guesses are not sound investment strategy.

Therefore, as we close in on 2020, we continue to tell clients that now is not a time to take excessive risk. We are very deep into an economic expansion that will yield to a recession at some point. Bull markets also do not last indefinitely, no matter how much we want them to. In times like these, late in the cycle and with less clarity on the future direction of the economy and the markets, staying disciplined and sticking with your long-term asset allocation targets are critically important.

As always, if you feel your personal financial situation has changed or you would like to revisit your asset allocation, please do not hesitate to call or visit our offices.

Kindest regards,
Your Investment Team
11/8/2019

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