HAVERFORD

2019 FALL OUTLOOK

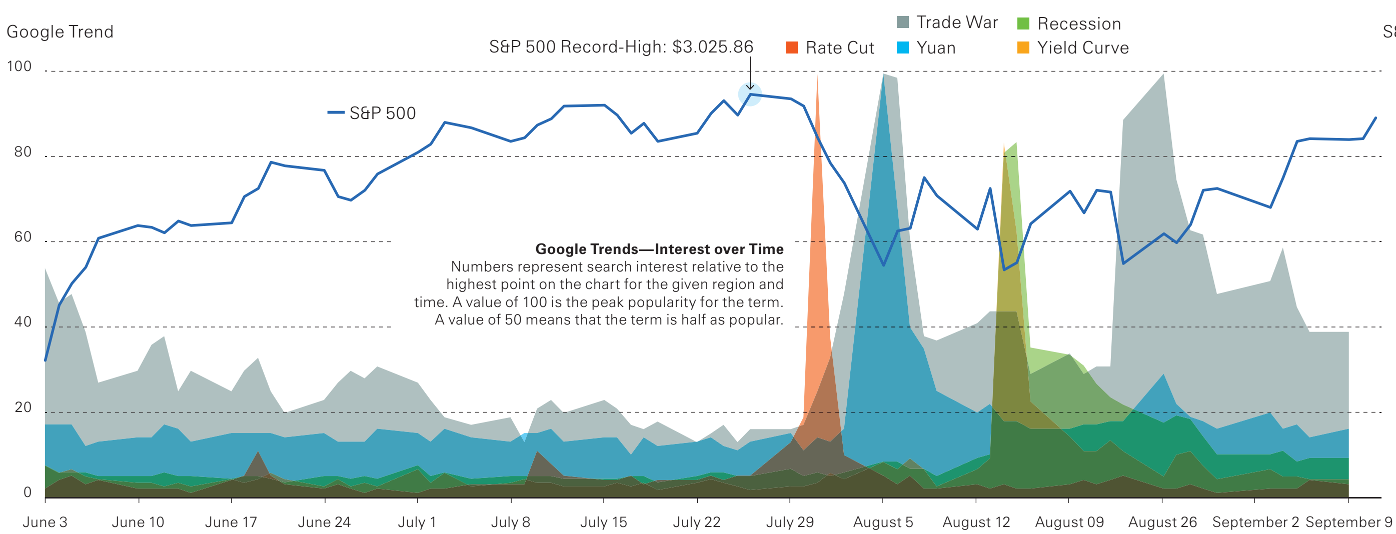
Market's rope-a-dope strategy

On October 30, 1974, Muhammad Ali knocked out undefeated heavyweight champion George Foreman in the closing seconds of the eighth round. Ali won this historic boxing event, known now as the "Rumble in the Jungle," by employing a new tactic: the rope-a-dope. In the rope-a-dope, a boxer assumes a protected stance, allowing his opponent to land multiple punches in an attempt to tire the opponent out. The heavy-hitting Foreman landed massive blows against Ali, which Ali had cunningly trained to efficiently absorb. As anticipated, Foreman ran out of energy, allowing Ali to counter-attack and win.

The U.S. stock market reminds us of a boxer taking blow after blow, round after round, yet still able to stand at the end of each round looking for the chance to counter-punch.

Despite "punches" to the stock market like tariffs, the inverted yield curve, slower economic growth, and foreign currency pressure, the market has successfully absorbed the

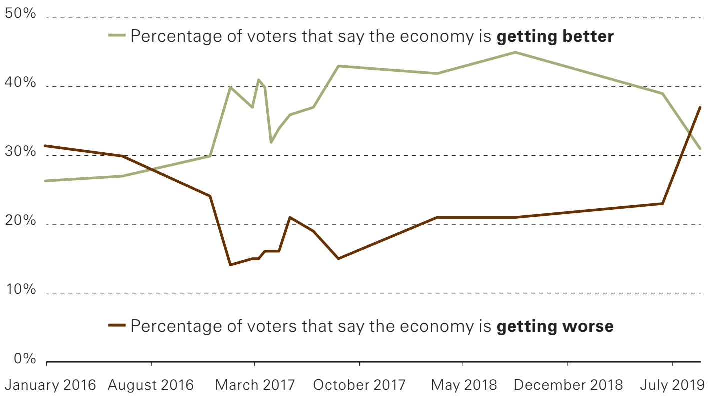
The Market has Absorbed Many Punches



Source: Google Trends

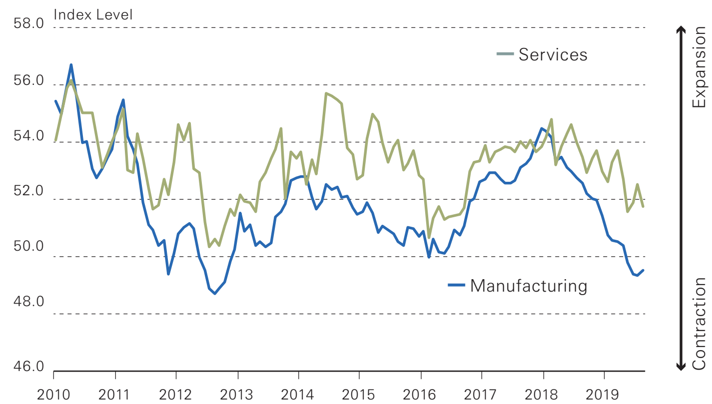
Investments in securities are not FDIC insured, not guaranteed by any bank, and may lose value.

Quinnipiac Poll: "Is the economy getting better or worse?"



Source: Quinnipiac University, August 28, 2019

JPMorgan Global PMI Indices



Source: JP Morgan

blows thus far. For instance, the S&P 500 tumbled 3% on news that the Chinese yuan had weakened to the psychologically important 7Y per $ level. It since recovered all those losses despite the yuan subsequently trading even lower.

The market may be absorbing multiple body blows, but it is far from on the ropes. In fact, the S&P 500 currently sits just below all-time highs. Cushioning the market from these punishing blows is an accommodative Federal Reserve, a strong U.S. consumer, and the fact that equity valuations and dividend yields look attractive relative to most investment alternatives.

The challenges to this market, and ultimately the U.S. and global economies, have grown. We must therefore reduce our base case for economic growth. Earlier this year, we believed 2.5% Gross Domestic Product (GDP) growth was achievable; we now see an economic growth rate of 1.5% as more realistic.

Round One: Trade Wars and Tariffs

Escalating trade tensions and rising tariffs, which could have been knockout blows, have been quickly shaken-off by the market this year. Yet the ongoing trade war is currently the greatest threat to near-term economic growth and asset prices. We believe business and consumer confidence is being seriously damaged. This is not a result of the trade dispute itself, nor the goals of a more equitable relationship, but rather by the seemingly haphazard and capricious way trade policy is being implemented. For the first time since Trump's 2016 election, more consumers believe the economy is getting worse than is getting better. Likewise, business confidence surveys have weakened. The shift in optimism is not lost on the policy makers in Washington or Beijing. The tariffs scheduled for September were delayed to December 15, on concern that the cost of consumer goods could rise ahead of the 2019 holiday season.

News outlets have reported the possibility of a face-to-face meeting between high-level officials in October, but we are skeptical it will break the current impasse. After imposing new tariffs, President Trump has only reversed them once. We also increasingly believe that the President sees the trade war as winning stump speech material, and for this reason, we anticipate the President will stand firm in negotiations. As for the Chinese, they do not want to lose face and appear to be the losers in any negotiation. Up until recently, they may have been forecasting a more conciliatory occupant of the Oval Office in 2020, although Elizabeth Warren's recent climb in the polls may force them to rethink any delay tactics. While we continue to hope for a trade deal, we no longer factor it into our base case assumptions.

Round Two: Bond Yields Turn Upside-Down

Worries of a yield curve inversion, meaning that the 10-year U.S. Treasury yield would drop below that of short-term rates, sent the market down by 6% in late July. When the actual inversion occurred, the blow was absorbed and was not met with much selling. That said, the yield curve flirts with inversion, which signals an increased chance of recession within 18-24 months. An inverted curve preceded every U.S. recession since the 1950s, but not every inverted yield presaged a recession.

The four most dangerous words in investing are "it's different this time," so it would be foolish to downplay the risks the current curve presents. With that caveat in mind, we do recognize that there are technical factors that have driven demand for U.S. bonds, and thus pushed interest rates lower. Yields are much higher in the United States compared to other developed markets. With $16 trillion in global debt now trading at a negative yield, the 10-year U.S. Treasury yield of 1.6% looks quite attractive. A negative yield means that the holders of these bonds are accepting principal and income payments over the life of the bond that are less than what they paid, guaranteeing a loss. Bonds with negative yields are concentrated in Japan and Europe, whose central banks are conducting large-scale asset purchases. We expect global investors to continue to seek out higher yields putting further downward pressure on U.S. yields.

Another reason to question the usefulness of the yield curve as a predictor of an impending recession is the fact that the domestic economy, although growing slower, is still strong. An inverted curve that presages a recession is usually accompanied by other negative signals, such as layoffs and credit deterioration, neither of which is occurring today. Regardless, after inversion, stocks typically continue to rise, peaking 18 months later on average.

Often, when the yield curve inverts, it is due to the Fed raising short-term rates above long-term rates in an effort to stave off inflation. The current inversion has occurred due to falling long-term rates. There are very few historical examples of the Federal Open Market Committee (FOMC) lowering rates in an effort to rectify an inverted yield curve. We are hopeful that quick action to lower the Fed Funds Rate will help shore up confidence, make it less expensive to finance capital projects and to purchase a new home.

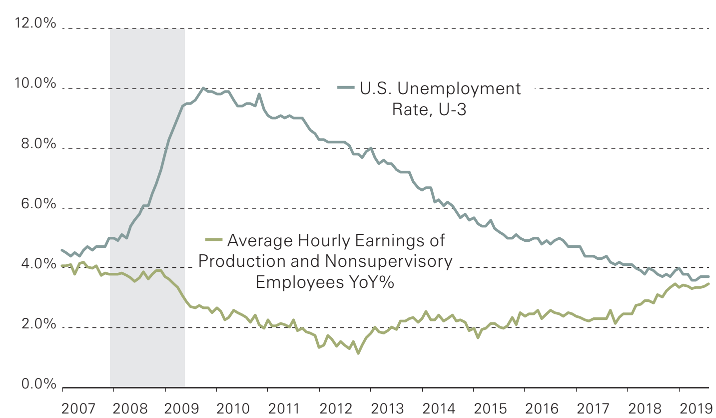
We anticipate the FOMC will reduce rates by another 25 basis points when they meet in late September. A rate cut of 50 basis points is possible, but unlikely. While we do not often opine on what the Fed will do versus what it should do, as investors we would like to see them take whatever actions are necessary to fix the slope of the yield curve. That could mean more aggressive cuts, jawboning, or even encouraging the Treasury to issue more 10-, 30-, and even 50-year bonds. Regardless of tactic, normalizing the yield curve should be priority number one. The Fed has plenty of room to maneuver since inflation really isn't a problem at present.

Lower yields have prompted corporations, state and local governments, and consumers to lock in lower borrowing costs. For borrowers, lower cash costs for debt service add to earnings and spendable income. New municipal bond issues totaled $44.5 billion in August, a dollar record and one of the highest volume months ever during what is usually a quiet summer month. The Mortgage Bankers Association's Mortgage Refinance Index is 152% higher than the same period a year ago. The Tuesday after Labor Day saw 21 large investment-grade corporations tap the market with long-term debt, a record number of issuers for a single day. All of these are supportive of the economy as consumers have additional income. With the ready acceptance of all this market supply, we see absolutely no evidence that the $1 trillion federal deficit is crowding anyone out of the market. The specter of a drag on the markets from U.S. Treasury debt issuance is just not materializing.

Round Three: Slowing Economy

Economic indicators look healthy, particularly for the U.S. consumer. The job market remains robust with the unemployment rate of 3.7% close to 50-year lows. The most recent ADP jobs data showed that the economy added 195,000 private sector jobs in August, while the Labor Department reported non-farm payrolls gained 130,000. Although job creation is slower than 2018's pace, it is still more than sufficient to offset new entrants into the workforce. Wage growth of 3.5% year-over-year is in the sweet spot, high enough to satisfy workers but not inflationary enough to concern the Fed. A strong job market and rising incomes equals a strong U.S. consumer, and a healthy consumer reduces the chance of an imminent recession. Weakness in international economies does not often portend U.S. recession. It is usually the other way around: it was America that led the global recessions of 1975, 1982, 1991, and 2009. Everyone, including Chinese policy makers, are rooting on the U.S. consumer.

Unemployment Rate versus Wage Growth



Source: FactSet Research Systems

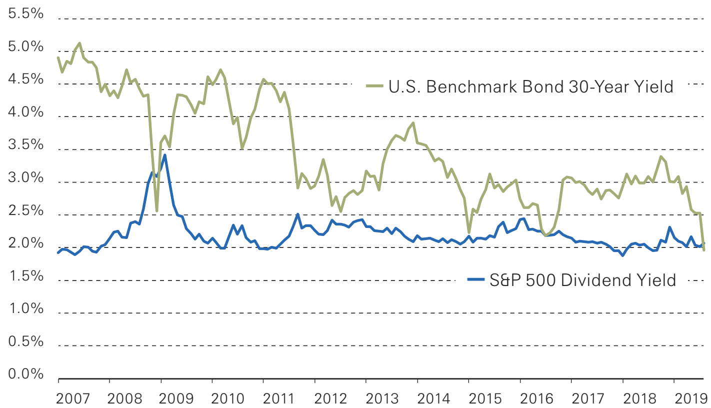
Round Four: Market Sentiment

Investors remain optimistic on the prospects for equities, with the S&P 500 trading close to all-time highs. Many companies have indicated they will be able to manage tariffs successfully by re-negotiating contracts, shifting sourcing out of China, and in some cases, passing the tariffs along to consumers. Inevitably, some of the tariffs will be borne by the companies themselves, affecting earnings growth for 2020. S&P 500 earnings estimates are 5% lower now than at the beginning of 2019, but high single-digit growth in 2020 is still a reasonable expectation given the strength of the domestic economy.

The market, too, is holding up because it is increasingly comprised of consumer-facing companies and fewer traditional industrial, economically sensitive firms. The Industrial sector's weight in the S&P 500 peaked at close to 16% in 1989, while the Energy sector peaked at over 20% in the early 1980s. Today, the market's top sectors, and drivers of market performance, are consumer-oriented technology, consumer-oriented communication, and consumer stocks.

The equity markets are also attractive relative to other investment alternatives. The dividend yield on the S&P 500 recently rose above the yield on the 30-year Treasury bond. The previous two times the yields on stocks compared this favorably to bonds was in 2009 after the bear market and in early 2016 after the market corrected 19%. Any decline in equity prices will result in an even more attractive yield compared to bonds.

S&P 500 Dividend Yield versus 30-Year Treasury Yield



Source: FactSet Research Systems

Despite the market's and the economy's resilience to the heavyweight punches thrown their way, we can't discount the mounting economic risks due to trade tensions, and we certainly can't blindly hope that in the case of the yield curve that "it's different this time." Growth is slower than it was a year ago, but the chances of a recession remain quite low. In this environment, we are confident in our portfolio positioning.

All data as of September 9, 2019, unless otherwise noted.

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QUALITY INVESTING

THE HAVERFORD TRUST COMPANY

Three Radnor Corporate Center, Suite 450 Radnor, Pennsylvania 19087-4580

T 610-995-8700 / 888-995-5995 / F 610-995-8796 / haverfordquality.com