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CMG Beta Rotation Strategy
2019 Q3 Quarterly Update

The CMG Beta Rotation Strategy began the quarter in a risk-on position. The strategy began July invested in large cap equities. The strategy remained invested in large caps for the entire month, generating positive returns. However, by late in the month it was obvious that equity markets were headed for a pullback as our relative strength readings were showing signs of weakness. In early August, the strategy rotated into a defensive position in utilities. Equity markets sold off across the globe in August and bonds rallied after the Fed cut rates in July and signaled another cut for September. Utilities, which are interest rate sensitive due to the high debt loads they typically carry on their balance sheets, often trade like bond-proxies. In August, they benefited from the rally in bonds and outperformed broader equity indices significantly. Equity markets rebounded in September and utilities cooled off early in the month. As a result, the strategy traded out of utilities and back into large cap equities early in the month. However, the trade was short lived as utilities regained momentum around mid-month, with the Fed's second rate cut of the quarter serving as a tailwind. The strategy remained invested in utilities for the balance of the quarter and into early October. The strategy had a strong quarter, generating positive returns in each month, despite the dip in global equity markets in August.

Market Commentary

As expected the Fed cut rates twice during the quarter, easing the Fed Funds Rate from 2.25% to 1.75%. Although the moves were well telegraphed, the surprise was that the decisions were not unanimous: 8-2 in July and 7-3 in September. The September vote in particular was interesting as Jim Bullard was in favor of a 50 bps cut while Esther George and Eric Rosengren voted for no change. While a difference of opinion is healthy for debate, it does show how the crosscurrents of underlying economic data have flummoxed the Fed. Nobody ever said this job was easy.

Since the talk of a rate cut began last year, a number of economic indicators have turned negative. The real question is how bad will they get and are we close to a bottom or not. Specifically, sentiment, confidence and manufacturing indicators are all pointing down and paint a decidedly more negative picture than other economic fundamentals we look at. All three of these peaked in the last two years: sentiment peaked in late 2017 / early 2018 while confidence peaked in the second half of 2018 and has accelerated its decline. The ISM manufacturing indicators which are negative across the board (indicating contraction), peaked in late 2017 and represent the worst levels in a decade. Below is a table of the sub-components of the ISM's October 2019 manufacturing report. It is decidedly negative and at odds with the overall economy.

MANUFACTURING AT A GLANCE

Index	Sep Index	Aug Index	% Point Change	Direction	Rate of Change	Trend* (months)
PMI®	47.8	49.1	-1.3	Contracting	Faster	2
New Orders	47.3	47.2	+0.1	Contracting	Slower	2
Production	47.3	49.5	-2.2	Contracting	Faster	2
Employment	46.3	47.4	-1.1	Contracting	Faster	2
Supplier Deliveries	51.1	51.4	-0.3	Slowing	Slower	43
Inventories	46.9	49.9	-3.0	Contracting	Faster	4
Customers' Inventories	45.5	44.9	+0.6	Too Low	Slower	36
Prices	49.7	46.0	+3.7	Decreasing	Slower	4
Backlog of Orders	45.1	46.3	-1.2	Contracting	Faster	5
New Export Orders	41.0	43.3	-2.3	Contracting	Faster	3
Imports	48.1	46.0	+2.1	Contracting	Slower	3
OVERALL ECONOMY				**Growing**	**Slower**	**125**
Manufacturing Sector				**Contracting**	**Faster**	**2**

Number of months moving in current direction. Manufacturing ISM® Report On Business® data is seasonally adjusted for the New Orders, Production, Employment and Supplier Deliveries Indexes.

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When the index drops below 50, it signals contraction in the manufacturing sector. But what happens after and what impact does it have it on markets? The chart below summarizes how many times a recession has occurred after the ISM index falls below 50.

Exhibit 2: Equity market rises after ISM falls below 50 outside of recessions

as of September 5, 2019

Episodes when ISM Mfg. index first falls below 50 since 1975

First month ISM below 50	Months before recession	Months from 50 to trough	ISM at trough	S&P 500 total return in subsequent 3-mo	6-mo	12-mo	24-mo
31-Aug-79	6	9	29.4	(2)	4	16	21
31-Jan-81	7	16	35.5	5	3	(2)	26
28-Feb-85		3	47.1	6	6	30	68
31-May-89	15	20	39.2	11	10	16	30
31-May-95		8	45.5	6	15	28	66
30-Jun-98		6	46.8	(10)	9	23	32
31-Aug-00	8	14	40.8	(13)	(18)	(24)	(38)
31-Oct-02		6	46.1	(3)	4	21	32
29-Feb-08	0	10	34.5	6	(3)	(43)	(13)
30-Jun-12		5	48.9	6	6	21	50
31-Oct-15		3	48.0	(6)	0	5	29
Median							
Recession (n=5)	**7**	**14**	**35.5**	**5 %**	**3 %**	**(2)%**	**21 %**
No recession (n=6)		**6**	**47.0**	**1**	**6**	**22**	**41**

Source: ISM, FactSet, and Goldman Sachs Global Investment Research

It is a mixed picture but a couple of things stand out. First, the median trough for the index during recessions (35.5) is decidedly lower than when there is no recession (47.0). We currently stand at 47.8. The next several months will be critical to watch: if the index stays at or above 47, history suggests a recession will be avoided. If we break below 47, it could mean momentum takes us much lower. If that were to occur, expect sentiment and confidence to react negatively as well. What is more encouraging is that equity market returns are generally good in the 3, 6, 12 and 24 mo. subsequent periods after the ISM index breaks below 50. When recession is avoided, the returns are very good. In these cases, the ISM index acts as a countertrend indicator. What is particularly surprising is that even when the ISM index foretells a recession, median returns are generally positive. Although manufacturing accounts for a much smaller share of the U.S. economy than in the past, the ISM index has historically had an outsized role in shaping economic outlooks. In addition to the U.S., readings across the globe suggest we are facing a global slowdown that is affecting all of the major economic zones, not just the leading actors in the trade war (see chart of PMI indicators for European countries).

The Economist

It is all well and good that the Fed is attempting to get out in front of a downturn but how much more will lowering interest rates help? A lack of cheap money is not the issue. The committee, as is tradition, typically sends elusive, coded messages to the market, particularly in times of uncertainty. The last couple of months has been no exception especially as the demands from Trump on the Fed in public have intensified. In the latest press release, persistent low inflation along with poor manufacturing and service data are some of the data points supporting the cut. The mention of the trade war is more ethereal, like a ghost of recessions past, not to be discussed except in vague Fed speak: "In light of global developments…" or "…readings on financial and international development". That certainly doesn't sound like they're talking about a heavyweight trade war between the two largest economies in the world or a hard Brexit. More like a negotiated G7 communique, so watered down that it says nothing at all.

Of course it is obvious that the trade war is the key catalyst for the global slowdown. Markets have been trading off of "hope" for a trade deal for months now, shaking off the reality of the situation we find ourselves in. The most recent round of negotiations illustrates this point: all of the conversations between the administration and the Chinese are focused on freezing additional tariffs and other small tradeoffs – essentially an armistice…a détente, not a resolution. There has been no discussion, and we believe there will likely be no discussion, of rolling back the tariffs that have already been put in place. In our opinion, the trading relationship between the U.S. and China, and to an extent, globalization, have entered a new paradigm, one that will survive the Trump presidency no matter who succeeds him. Whether this shift in anti-trade sentiment kick starts a de-globalization movement is yet to be seen. Global businesses and CEO's continually cite trade uncertainty as the highest risk to growth and while the business community as a whole has been willing to wait and see on a deal, at some point everyone has to get on with business. On the ground, this will take the form of reconsidering supply chains, making them more local, regional and less global. The impact of such changes will inevitably be higher costs and slower growth in the short-to-intermediate term. No amount of rate cuts can remedy this situation. They can only numb the effects for a period of time, like a painkiller that doesn't actually treat the source of the pain but buys time for additional treatment. Finally, there is virtually no chance of fiscal policy (tax cut, infrastructure or stimulus) helping the Fed. Three years on from the publication of Mohamed El-Erian's last book, the Fed remains the "Only Game in Town". Without some action, beyond monetary policy, a recession (albeit a mild one) could become a self-fulfilling prophecy in 2020 or 2021. While we are not calling for a recession (it's more likely that there is just enough global liquidity that we will skirt by and build up more pressure for a larger event several years down the line), the probability continues to rise if constructive action is not taken.

Kindest regards,

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President

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