



The strategy added modest risk exposure in July after being fully invested in fixed income positions to end the second quarter. Equity allocations were to preferred shares and to the consumer discretionary sector. The portfolio’s fixed income holdings were diversified amongst municipal bonds, treasuries and ultrashort bond positions. The third quarter was a strong quarter for bonds due primarily to the Fed cutting rates twice (in July and September). August in particular was a difficult month for riskier assets as equities and commodities, with the exception of precious metals, sold off, while bonds shined. As a result, the strategy was again invested only in fixed income positions by month-end. Equity positions held in July were reallocated back into ultrashort bonds and additionally into long-term corporates. By September, markets got more comfortable with the Fed’s messaging on rates leading to an equity market rebound and a modest decline in bonds. In response, the strategy added risk exposure, allocating into equities and diversifying fixed income positions into riskier and higher duration holdings. The strategy’s equity allocations were to preferred shares and utilities. Ultrashort bond holdings were reduced in favor of mortgage backed securities and high yield bonds. The strategy held no commodity exposure during the quarter. While we are pleased with the strategy’s performance during the quarter, the environment over the past year has been a challenging one for tactical and quantitative strategies that rely on trend following, momentum or relative strength. Trends in many asset classes have been too short for technical models to pick up on for sustained periods. Anxiety over the trade war, a lower growth outlook and monetary policy have contributed to three sizable sell-offs in the past year: fourth quarter 2018 along with May and August of this year. All three sell-offs cut the legs out from intermediate trends in equities, affecting the amount of risk exposure in our portfolio.

The strategy held the following allocations (individual portfolio allocations may vary) to equities, fixed income, commodities and cash/cash equivalents at the end of July, August and September:

	Equities	Fixed Income	Commodities	Cash*
July	19.59%	30.33%	0.00%	50.08%
August	0.00%	49.92%	0.00%	50.08%
September	30.45%	40.13%	0.00%	29.42%

***Please note that cash holdings include cash equivalents such as ultra short duration bond positions.**

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

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1000 Continental Drive (800) 891-9092
 Suite 570 (610) 989-9090
 King of Prussia, PA 19406 (610) 989-9092 FAX
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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.

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		ISM at trough	S&P 500 total return in subsequent			
	before recession	from 50 to trough		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

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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

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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,

PJ Grzywacz
President

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King of Prussia, PA 19406 (610) 989-9092 FAX
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