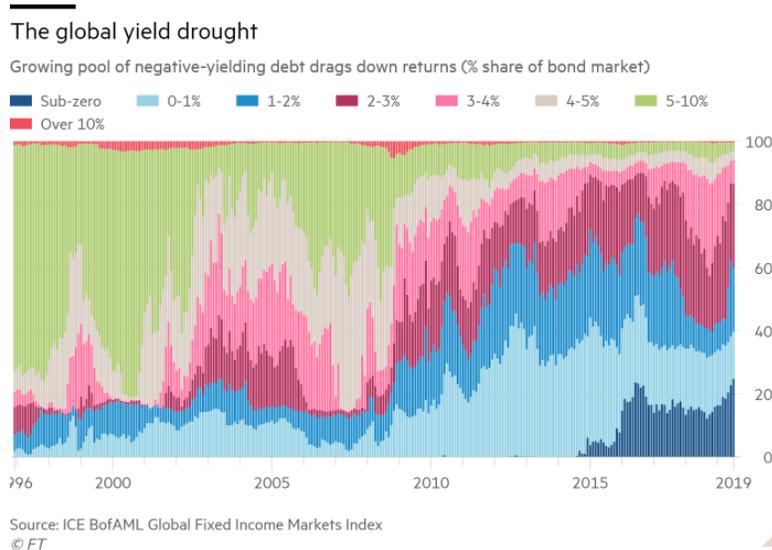


Market Commentary August 2019

In our pursuit to build a world-class discretionary portfolio management platform, Madison & Main will be publishing a monthly market commentary for all of our existing and prospective clients. Each month, we will discuss the events shaping the investment landscape and how they are driving our portfolio management process. Moving forward, we will also publish in-depth quarterly investment outlooks that take a deeper look into many of the issues covered in our monthly commentaries. We feel it is important that our investment process is transparent and that our clients are informed about the developments in global markets. While market movements predominantly affect their portfolios, they also affect their financial plans, personal goals, and business endeavors. As such, we feel it is our duty to our clients to interpret these events to the best of our ability as part of our holistic planning approach. We hope you enjoy our commentary and please feel free to reach out with any questions or comments – dialogue is encouraged!

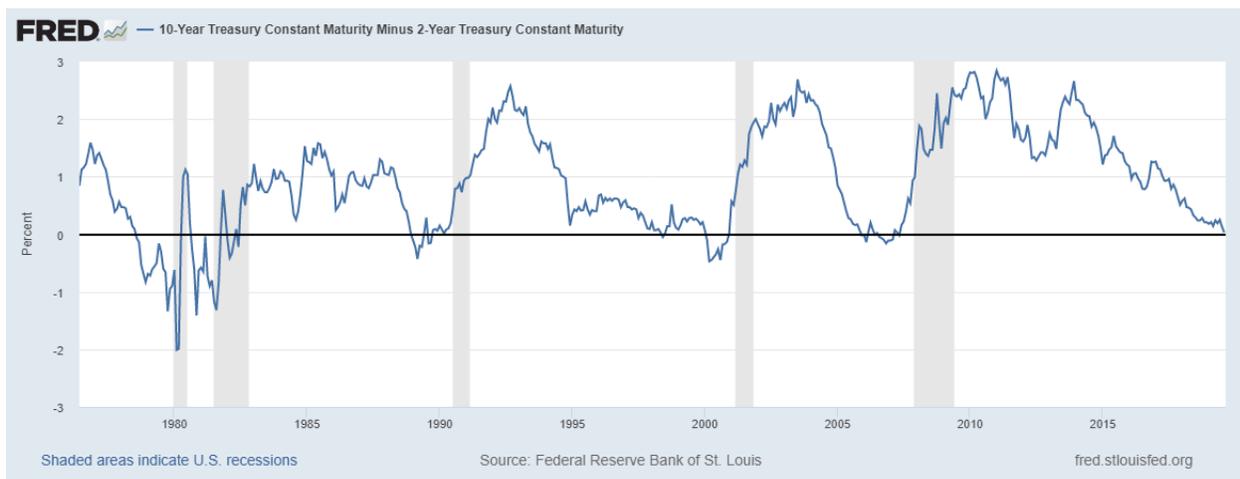
Two major developments occurred in August: a relatively large move lower in longer term yields in the US debt market and the subsequent inversion of the 2-year/10-year segment of the yield curve. These moves were accompanied by a small sell off in equity markets and a strong rally in safe haven assets, namely the Japanese Yen and gold. Unfortunately, when examined as a whole, none of this has a particularly optimistic interpretation for the investment horizon.

We live in a world that is starved for yield. \$16 trillion dollars, over 20% of the global supply of bonds, come with a negative yield – effectively a guaranteed loss. As the U.S. economy remained relatively strong with inflation approaching 2%, the U.S. Treasury market stood out as a relatively high yielding and safe option for investors who required income. Furthermore, U.S. corporate and municipal bonds offered slightly higher yields in exchange for moving further out the risk spectrum.



Moving out the risk spectrum is an important concept to understand. By depressing available yields on safe assets, global central bank policy pushed investors further out the risk spectrum to capture higher expected returns. Risk free debt investors started buying riskier corporate and municipal debt. Corporate and municipal debt holders starting buying equities. Equity buyers started buying private equity and other alternative assets. This process has unfolded for the better part of the last ten years. During the expansion phase, moving out the risk spectrum boosted asset prices tremendously. As investors, we must always be on the lookout for signs this process is reversing because processes that build up slowly over years tend to unfold sharply in markets.

In that regard, the yield curve inverting is an important signal. The 2Y-10Y segment of the curve inverting has a strong track record of predicting recessions. An inverted curve occurs when the yield on the 2-year note is higher than the yield on the 10-year note shown by the blue line in the chart below falling below zero. The shaded grey areas are recessions.



Why the shape of the yield curve is a strong predictor of recessions is an in-depth topic but can be summarized as it mechanically tightens the amount of credit and capital available to fuel the expansion amongst other things. Bank profitability falls and investors have become concerned enough about the outlook to lock in safe but lower levels of gains for the future. As central bank policy is unable to respond quickly enough to offset these concerns, long term yields fall faster than short term yields and the curve inverts. Historically, the average lead time between an inverted yield curve and a recession is 22 months. However, given all of the media attention on the curve this cycle, it is reasonable to expect the lead time to be shorter this time around.

The character of the yield curve inversion is also important to consider. This instance we have had a bull flattening – which means long term yields fell more than short term yields (as opposed to a bear flattening in which short term yields rise more than long term yields). The bond market is sending a signal that the prospects for growth and inflation have deteriorated for the future. With 30-year yields in the U.S. at an absolute all-time low level of yield, this is a significant

development as it implies these conditions may exist for an extended horizon. The bond market's signals are also corroborated by many of the important commodity markets including copper and oil.

So, one interpretation of this month's events is that investors, fearing that a recession is looming have started to move back towards the less risky end of the spectrum seeking safer harbor. Another interpretation is that investors have determined that the likelihood of materially higher yields has diminished amidst a global central bank easing cycle and deteriorating growth prospects. Given that outlook, investors are rushing to capture whatever yield is available before it is all gone. Of course, this all could be a bout of fear in a generally quiet August market or it could be something else entirely. Too many signs are pointing in the same direction, however, to remain sanguine.

Looking forward, we expect the increased levels of market volatility to persist as these issues are digested by the markets. We believe strongly it is time for all of our clients to reassess their risk tolerance in light of the possibility of significant equity market weakness looming on the horizon. Our clients, and particular those not currently invested in our discretionary Wealth Trajectory strategies, should ask themselves how would a substantial loss of equity holdings value impact their financial stability and planning. Furthermore, how will they generate income in a world of low to negative yields globally?

Moving on to our investment performance, I am pleased to announce that we were well positioned for these developments in all of our strategies. Our strategies were significantly overweight bonds and underweight stocks to their benchmarks. Our bond positions were overweight safe haven treasuries and had lengthened duration relative to benchmarks benefitting from the flattening of the yield curve. The equity positions we hold are focused in defensive sectors. Additionally, gold positions in all of our strategies benefited from the rally in gold.

Thank you for reading and please feel free to reach out with any comments or questions. Your feedback is important to us. Keep an eye out for our Q4 investment outlook which will cover many of these topics and others in more detail.

Steven Segarra, CFA
Chief Investment Officer
Madison & Main Advisors

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Investors cannot invest directly in an index.

Diversification does not ensure a profit or protect against loss in a declining market.

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