Quarterly Commentary

2019 | Q3

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ECONOMIC OVERVIEW

The Yield Curve Inverts

The S&P 500 continues to flirt with all-time highs, in spite of some volatility driven by trade war or political headlines. As the current record-length economic expansion persists, the obvious questions are: how long can it continue, and what could bring about the next recession? Over the past 18 months, we have written about two potential recession indicators that we have been monitoring closely: the spread between the 2-year Treasury and 10-year Treasury yields and the year-over-year job growth numbers. A year-over-year job growth reading below 1% and a yield curve "inversion" (where the 10-year yield falls below the 2-year yield) are generally reliable indicators that portend an upcoming recession.

Year-over-year job growth remains comfortably over 1%, with the most recent reading at 1.39%. Still, it has decelerated over the last several months and so we continue to watch this closely as a sign of the health of the U.S. labor market. We witnessed inversions at other parts of the yield curve earlier this year (the 3-month/10-year spread went negative in March of 2019), but in late August we officially saw a negative spread between the 2-year and 10-year Treasury, the indicator we have been monitoring. Granted, the negative spread was only 5 basis points (0.05%), and only stayed negative for seven days before moving into positive territory. Nevertheless, it begs the question: is this the recession indicator we have been waiting for, or was it just a blip that can be explained away by a variety of external factors?

When we wrote last year about the possibility of a Fed-induced recession, we envisioned a scenario involving the Fed raising short-term interest rates too quickly and subsequently causing the yield curve to invert. However, the Fed has since made an abrupt reversal in its interest rate policy, cutting its benchmark target rate by 0.25% at its most recent policy meeting—the second cut this year—with yet another cut anticipated in 2019. Negative-yielding debt abroad has made U.S. Treasuries more attractive, driving demand higher and bringing down the longer end of the yield curve. Therefore, the yield curve inversion was driven by falling long-term rates, not rising short-term rates. In other words, maybe it actually is different this time.

Index Performance	Q3 '19	YTD
Dow Jones Industrials	1.83%	17.51%
Standard & Poor's 500	1.70%	20.55%
EAFE (international stocks)	-1.00%	13.39%
Russell 2000 (small stocks)	-2.41%	14.15%
Barclays Interm. Gov/Credit	1.37%	6.41%
Barclays Municipal	1.58%	6.75%

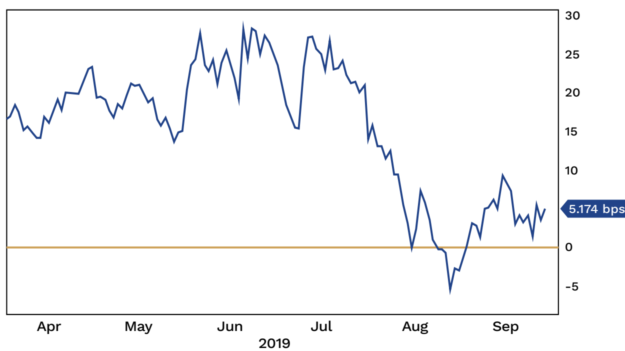
We apply rigorous analysis in asset selection so you can focus on your passion

ECONOMIC OVERVIEW

The Yield Curve Inverts (cont.)

Still, it is possible we could see the spread between the 2-year and 10-year yields turn negative again, and if it stays more dramatically inverted for longer, this will be a more convincing signal. Furthermore, we cannot help but worry that the existence of approximately $15 trillion in negative-yielding debt overseas might portend something more ominous. We have never before seen anything like this in history, so it is nearly impossible to predict what impact this negative-yielding debt might have, or how it might resolve.

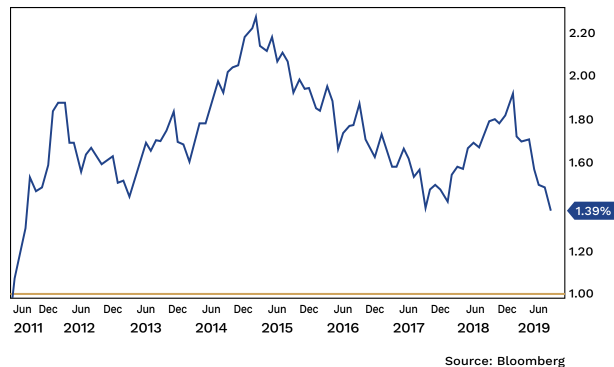
10-2 Year Treasury Yield Spread



Source: Bloomberg

In the U.S., equity valuations remain fairly reasonable, the labor market is generally healthy, and corporate earnings are growing, albeit at a slower rate than in 2018, which had the benefit of the tax cut. The trade war with China is the largest overhang, and frequent headlines indicating a hint of resolution or deepening conflict should continue to swing the stock market one direction or the other. It seems logical to think that the Trump administration might want to reach a trade deal with China ahead of the election next year. But logic has not been a hallmark of this administration, and we do not feel that we can handicap this brand of uncertainty in this government-by-tweet environment.

Percent Change in Nonfarm Payrolls



Source: Bloomberg

Globally, the trade war has led to a manufacturing slowdown, exacerbated by an ongoing deceleration in China GDP growth. The doubt surrounding the outcome of Brexit also remains a headwind that is halting business decisions and investment in Europe. The European Central Bank recently reignited its quantitative easing program, pledging indefinite stimulus in an effort to invigorate the ailing euro zone economy, although many doubt whether this will actually work. Inflation remains elusive, and in fact the value of real assets such as gold and other precious metals has risen alongside fears of deflation.

In this year's first quarter commentary, we wrote that it was time for a thoughtful evaluation of asset allocation. We remain convinced that now is a good time to make sure clients have appropriate liquidity. We have seen the first hint of a yield curve inversion, a yellow flag. Although we would not recommend acting on this alone, as it is still too early to predict a coming recession, we continue to tilt more toward value-oriented stocks that carry low price-to-earnings ratios and high dividend yields.

ASSET TRANSACTIONS

Reducing Volatility and Adding Value Stocks

Trading activity this quarter is consistent with Nelson Roberts' pivot to reduce volatility and add more value-oriented stocks to our portfolios. In the financial sector, we exited SVB Financial Group (tkr: SIVB). As the trade war continues with no deal in sight, we feel it is important to limit exposure to Chinese markets. SVB Financial Group has exposure to China not only through a joint venture, but also through Chinese investors as a source of funding for their clients. 2019 has marked a banner year for IPOs, with many of these companies being SVB clients. This drove stronger earnings the past few quarters, but SVB will be challenged to carry that momentum forward. SVB does not pay a dividend and is more volatile compared to traditional banks. We do not see a catalyst for SVB to return to a significant valuation premium relative to other banks in the near term.

Selling SVB Financial Group enabled us to add to our position in Charles Schwab (tkr: SCHW). Schwab is trading more in line with traditional banks rather than online brokerage firms with a P/E ratio of about 9x. Schwab is the leader in the Registered Investment Advisor (RIA) market, which has enjoyed greater growth than the broader financial sector. Schwab's current valuation is low and has been beaten down recently as a result of the lower interest rate environment and negative investor sentiment, providing us an opportunity to add to our position at an attractive price.

In the technology sector, we took advantage of strong performance to trim our position in Akamai Technologies (tkr: AKAM) with shares trading near an all-time high. We maintain a position in Akamai because of the upside potential from over-the-top (OTT) video content streaming, particularly with Disney and Warner Media streaming services launching this year. However, Akamai was a large position in our portfolios and we believed that much of this upside may already be priced in. Akamai also has a tendency to be a volatile stock, especially around earnings and it does not pay a dividend. We concluded that reducing our position in Akamai was appropriate, though we still maintain an overweight relative to the S&P 500.

Finally, in the healthcare sector, we sold Pfizer (tkr: PFE) due to the news of its complex upcoming transaction that contradicts our initial investment thesis. We originally bought Pfizer due to its solid pipeline, commitment to R&D, and its healthy cash flow which could support a generous dividend and buybacks. In mid-2020, Pfizer plans to spin off Upjohn, the off-patent medicine unit, and merge that company with Mylan (tkr: MYL), creating a new global pharmaceutical company focused on off-patent medicines. The new company will be U.S.-based and will likely become the largest generic company in the world, surpassing Teva (tkr: TEVA). Mylan, a troubled company with high debt and lack of transparency, is not a component we would like in our portfolio at this time. The new Pfizer is aiming to see increased EPS growth, as it will no longer be dragged down by slowing sales of off-patent medicine, and the recent acquisition of Array BioPharma Inc. holds significant promise for new drugs. However, we believe it will likely take a couple years before all the dust settles. The major changes resulting from the upcoming transaction represent a significant shift in strategic direction for Pfizer, from a stable and reliable pharmaceutical company to a riskier growth company.

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FIRM UPDATES

Nelson Roberts is looking forward to hosting our upcoming Fall Presentation at Quadrus Conference Center, 2400 Sand Hill Road, Room Q1 in Menlo Park. Please join us either Tuesday, October 29 or Thursday, October 31 at 12 pm. RSVP by October 22 to Erin Rodriguez (erodriguez@nelsonroberts.com or 650-322-4000).

FIXED INCOME

Negative Yields

At the start of 2019, the yield on the 10-year U.S. Treasury was 2.68% and the market was expecting the Federal Reserve to increase rates several times over the course of the year. Amid concerns over trade tensions with China and a global slowdown that could affect the U.S. economy, the Fed reversed course quickly and cut rates by 0.25% in July and in September to a range of 1.75% to 2.0%. The yield on the 10-year Treasury has fallen to 1.72% and the market does not believe the Fed is done cutting. There is now a debate about whether the U.S. will follow other countries and push rates into negative territory. How low can yields go? And what does negative-yielding debt mean?

Approximately $15 trillion in overseas bonds currently trades with a negative yield. The Bank of Japan and European Central Bank cut short-term target rates to zero and then into negative territory to respond to global growth concerns and help stimulate their economies. The recent decline of longer rates has been unprecedented. German bonds, for example, have negative yields across the entire yield curve. An investor can buy a 10-year German bond yielding -0.56% or a 30-year bond yielding -0.02%.

Negative-yielding bonds are not new, but why an individual investor would buy a bond with a negative yield is difficult to comprehend. For many large banks and pension plans, investment policies require portfolio managers to buy and hold minimum levels of highly-rated government bonds regardless of yield. In many of these cases, the managers of funds are buying negative-yielding bonds, but are generating positive returns through complex cross-currency basis swaps.

Could we see negative yields in the U.S.?

We do not believe negative rates are on the horizon here in the U.S., but a severe recession that leads to deflation could force the Federal Reserve to follow the Bank of Japan and European Central Bank, something it has never done before. The Fed cut rates to zero in response to the 2008-2009 financial crisis, but never crossed below zero. President Trump recently voiced his opinion, stating that the Fed needed to cut rates to zero or below to keep the economy growing. Fed President Powell disagreed and said he did not foresee negative rates.

The current low interest rate environment presents challenges to generating real yields and penalizes savers and those living off fixed income. In light of these low yields, we continue to recommend owning high-quality bonds in our portfolios for both diversification and as a hedge against a downturn in the stock market.

Global Negative-Yielding Debt

Source: Bloomberg

FEATURED EQUITY

Digital Realty Trust

Our search for value-oriented stocks led us to the Real Estate Investment Trust (REIT) sector and Digital Realty Trust (tkr: DLR). The company manages 210+ data centers in 14 countries for 2,300+ customers globally while bringing in over $3 billion of annual revenue. They provide a turnkey solution to enable the deployment of offsite IT infrastructure that can scale with company growth. Digital Realty owns the buildings and provides multiple power and cooling systems, which are critical components to the reliability of data centers, and is able to execute on a customized data center solution for medium to large deployments in a matter of weeks.

Digital Realty's three core offerings include wholesale data centers (77% of revenues), colocation data centers (13% of revenues) and connectivity (10% of revenues). Wholesale data centers are vast spaces (either a suite within a larger building or the entire building itself) leased to companies with only the

space and power provided. Colocation or retail data centers rent out space in increments as small as a cage or cabinet and can scale up from there. The benefit of colocation is that multiple tenants can be hosted within the same building and there is an opportunity for connectivity.

Interconnection is an IT strategy that enables companies to exchange data directly, privately and securely. This strategy is often used to minimize bandwidth costs, increase security, reduce latency and help companies operate more efficiently. Colocation and connectivity services offer upside opportunities for Digital Realty, generating revenue growth and higher margins.

Wholesale data center providers in particular are seeing pricing pressures from large companies as these companies push towards more favorable contracts, though it is unlikely these large companies could easily switch data center providers due to extremely high switching costs. Despite this, recent strategic international expansions and land acquisitions have helped Digital Realty to diversify away from slower North American wholesale data center markets. These acquisitions have expanded Digital Realty into new markets around the world and broadened the company's product offerings.

Digital Realty is poised to benefit from an increase in demand for colocation and connectivity around the world. Their contracts average at least five years, which provides more stable and predictable revenues, while also realizing cost advantages from scale and property ownership. Digital Realty's focus on sustainability and efforts to create more energy efficient data centers benefit both their customers and the environment. The company pays a solid dividend of 3.5% and management expects positive momentum and acceleration to carry on through the remainder of the year.

REITs have proven to be more resilient late in the economic cycle and during recessions, outperforming the S&P 500 by 7% since 1991, which is yet another reason why we anticipate Digital Realty will be a solid holding as we begin to see warnings signs of a potential economic downturn.

(The preceding information regarding the featured equity should not be construed as a recommendation to purchase the security. It should not be assumed that future returns will be profitable or will equal the historical performance. Please contact us for a complete list of holdings.)

TOP 15 HOLDINGS

- iSHARES S&P SMALL-CAP ETF
- VANGUARD DEVELOPED MARKET ETF
- ALPHABET INC.
- AMAZON.COM INC.
- COSTCO WHOLESALE CORP.
- MICROSOFT CORP.
- TJX COMPANIES INC.
- MEDTRONIC
- CISCO SYSTEMS INC.
- VERIZON COMMUNICATIONS INC.
- ILLUMINA INC.
- VANGUARD EMERGING MARKET ETF
- HOME DEPOT INC.
- TRAVELERS COS INC.
- UNITEDHEALTH GROUP INC.

OUR TEAM

Brooks Nelson, CFA
Brian Roberts, CFA, MBA
Steve Philpott, CFP®, MBA
Ann Oglesby, MD, MBA
Darcy Nelson Smoot, CFA
Evan Nelson, CFP®
Sarah Sinclair
Erin Rodriguez
Chrissy Domingo
Marissa Wisniewski

SPECIAL TOPIC

What are Companies for?

On August 19, the Business Roundtable announced a new statement outlining the purpose of a corporation. The Business Roundtable is an association of chief executive officers of America's leading companies. The current chairman is Jamie Dimon, chairman and CEO of JPMorgan. JPMorgan is a preeminent U.S. bank and one of our longest finance sector holdings. 181 CEOs signed this statement committing to lead their companies for the benefit of all stakeholders: customers, employees, suppliers, communities and shareholders.

This is a significant departure from the focus of corporate purpose that has been a hallmark of corporate management for decades, if not centuries. In 1962, Milton Friedman, who received the 1976 Nobel Prize in Economic Sciences, wrote "there is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud." For more than 50 years, Friedman's quote has been most often referenced as the definitive statement on the primacy of shareholder value and the focus on shareholders in business management.

We think this change is long overdue and absolutely correct. As investment advisors, registered with the Securities and Exchange Commission, we are required by law to act as fiduciaries. This means that we must always do what is in the best interest of our clients. For 45 years, since Phil Nelson first became a Registered Investment Advisor (RIA), that has been rule #1.

For simplicity, and to make the focus of our priorities absolutely clear, we have long stated to all of our team members, clients, prospects and providers of services to our clients, the following:

1. In everything that we do, our first priority is to do what is in our clients' best interest.
2. As long as it does not conflict with rule #1, we are to do what is in our business's best interest.
3. As long as it does not conflict with rules #1 or #2, we are to do what is in our employees' best interest.

It goes without saying that without caring for our clients, our business would not exist. If our business did not exist, then our employees would be without jobs. If our employees' needs are not met, then our business cannot succeed in meeting the needs of our clients.

In these three rules we do not mention our shareholders' interest, for we believe that as business owners we will benefit over the long term by first taking care of all of the constituents of our business. This then becomes our unstated rule #4, which implies that shareholder value has always been subsidiary to clients, our business and its employees. We welcome the evolution in the change of corporate focus in the U.S. and hope to see this become a reality in all commercial enterprises.

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Past performance is not necessarily a guide to future performance. There are risks involved in investing, including possible loss of principal. This information is provided for informational purposes only and does not constitute a recommendation for any investment strategy, security or product described herein. Please contact us for a complete list of portfolio holdings.

For additional information on the services of Nelson Roberts Investment Advisors, or to receive our newsletters via e-mail or be removed from our mailing list, please contact us at 650-322-4000.

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