Economic Update

A Review of Third Quarter 2019

Impeachment proceedings have begun in Washington D.C. The recently announced formal House investigation will likely continue through the end of the year, assuming prior impeachments are any guide. Meanwhile, while politics are heating up, the U.S. economy has been cooling down. The most recent estimate of second quarter GDP was 2.0%, down from a 3.1% annualized rate during the first quarter of this year. Projections for the third quarter are even lower. As of this writing, the St. Louis Fed expects that our economy grew at just a 1.8% rate in the third.

Yield curve inversion in the U.S. bond market has not shown any improvement over the last three months. In fact, long-term yields have drifted down even lower than they were at the beginning of the quarter. As of the end of September, the 30-year treasury yield sat at 2.12% after hitting record lows just below 2% earlier in the month. The yield curve has now been inverted for over six months. While short-term inversions have been inconsistent economic predictors in the past, those that were sustained for longer periods like this one have been worth paying attention to. According to Duke economist Campbell Harvey, each of the last seven times that we experienced an inverted yield curve for more than three months, it was followed by recession during the subsequent nine to 18 months.

U.S. Economy

The most recent Chicago Purchasing Managers Index is telling a similar recession story, as it declined to 47.1 in September. Readings below 50.0 predict economic contraction. Companies that produce machinery cited softening demand while food, beverage and tobacco producers confirmed that Chinese tariffs are hurting their businesses. The recent trend in this index is decidedly negative, as it was 64.7 just eight months ago.

Corporate profit estimates for the second half of the year have also declined in recent months. FactSet analysts now estimate only 1.5% total profit growth for S&P 500 companies during 2019. Original estimates were for over 6% growth this year. Not surprisingly, they call out manufacturers, miners and retailers as being especially vulnerable.

On the other hand, jobs numbers have been solid during the past few months. It was just announced that 136,000 jobs were created in September. This follows 166,000 new jobs created in July and 168,000 created during August. This calculates to a three-month average of approximately 156,000, which is just above the 150,000 benchmark that economists have historically thought was needed in order to keep up with expected population growth.

However, that historical benchmark may no longer be a good estimate given that we now have an aging population with reduced birth rates and also reduced immigration. Additional job creation should continue to be difficult going forward simply because we are running out of workers with the skills to do those jobs. The national unemployment rate is now 3.5%, which is a 50-year low mark.

The tight labor market has been moderately good for wage growth. The Federal Reserve Bank of Atlanta's three-month moving average hourly wage for August showed a 3.7% increase from August 2018. This is consistent with readings throughout the last six months and higher than we had been seeing for most of the past decade.

Inflation still remains under control. As of the end of August, the Consumer Price Index for All Urban Consumers (CPI-U) was up 1.8% year-over-year. However, lower food and energy prices contributed to that headline number. Instead, the Fed seems to prefer focusing on the inflation rate excluding food and energy. That reading was 2.4% for the month, slightly higher than the 2.0% annual rate that the Fed targets.

September energy inflation will certainly be higher after a devastating attack on the heart of Saudi oil production last month. 5.7 million barrels of daily production were taken out of global supply for a few weeks, which was the biggest oil supply disruption event in history. U.S. oil futures spiked 14.7% in one day but have since drifted back down as President Trump vowed to use U.S. strategic reserves to make up the temporary gap.

The next Fed meeting will be held on Oct. 31. There has recently been some dissent between the various members of the group. Many "hawks" are said to want to pause given that their dual mandate of both full employment and moderate inflation seem to be currently on target. Other "doves" point to poor global economic data and the disparity between domestic interest rates and those found abroad. As of this writing, the market estimates approximately a 75% chance that the doves will ultimately win the argument and we will get a 25 basis point cut at month's end.

International Economy

The World Trade Organization recently scaled back its growth forecast for global trade down to just 1.2% this year and 2.7% in 2020. This would amount to the lowest global trade growth in a decade. The WTO points to ongoing trade conflicts, Brexit uncertainty, and global shifts in monetary policy. Note that this poor forecast was made even before the most recent round of tariffs were finalized on $7.5 billion of European consumer products.

Ongoing uncertainty concerning global trade has resulted in weak manufacturing purchasing manager's surveys overseas as well. In addition to the aforementioned Chicago PMI in the U.S., manufacturing PMI for the Euro area was also deep in contraction territory at 45.7 during September.

Germany, in particular, had a dismal manufacturing PMI reading of 41.7 for the month, which is its lowest level since the 2008 Financial Crisis. Trade war uncertainty and Brexit concerns are said to be paralyzing the German auto industry in particular. The German economy shrank by 0.1% during the second quarter and economists are forecasting a similar performance in the third. Two straight quarters of negative growth generally define the beginning of a recession.

The European Central Bank has responded with a fresh stimulus package in September, including a 10 basis point cut that pushed the deposit rate further into the hole at -0.5%. Additional quantitative easing will likely continue as long as inflation remains benign.

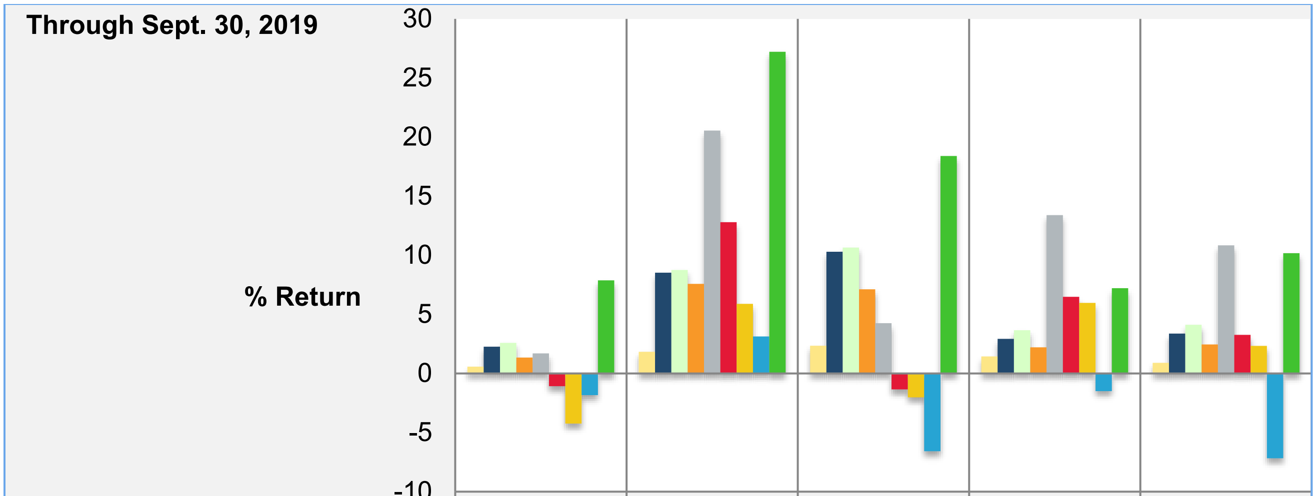
Results out of China have been mixed. On one hand, their manufacturing PMI has remained in expansion territory, at 51.4 in September. On the other hand, the jobless rate in Chinese cities recently hit its highest level since regular reporting on that data began.

Markets

The third quarter of 2019 was mixed for markets throughout the world. U.S. large-cap equities, as represented by the S&P 500 Index, gained 1.70% for the quarter and are now up 20.55% year-to-date. Developed international equity markets, as represented by the MSCI EAFE Index, finished the quarter down 1.07%, but are still up a total of 12.80% for the year as a whole.

Emerging markets continued to fall behind as U.S./China relations have not improved. The MSCI Emerging Markets Index finished the quarter down 4.25%. Still, this index is up 5.89% year-to-date. Alternatives such as commodities and real estate were mixed. The Dow Jones UBS Commodity Index lost 1.84% for the quarter. The Wilshire REIT Index was up 7.88% during the period. For the year, the two indexes are up 3.13 and 27.21% respectively.

Lower interest rates throughout the world allowed bonds to continue to flourish. All of the benchmarks that we track have had good returns during the quarter and for the year thus far. The Barclays U.S. Aggregate Bond Index gained 2.27% for the quarter and is up 8.52% for the year. The Barclays U.S. Inflation-Linked Bond gained 1.35% for the quarter and is up 7.58% for the year. The Barclays Global Aggregate Bond Index gained 2.59% during the quarter and is now up 8.75% for the year.



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.58	1.84	2.35	1.44	0.90
Barclays US Agg Bond Index	2.27	8.52	10.30	2.92	3.38
Barclays Global Agg Bond Index	2.59	8.75	10.65	3.65	4.12
Barclays US Infl Linked Bond Index	1.35	7.58	7.13	2.21	2.45
S&P 500 Index	1.70	20.55	4.25	13.39	10.84
MSCI EAFE Index	-1.07	12.80	-1.34	6.48	3.27
MSCI Emerging Markets Index	-4.25	5.89	-2.02	5.97	2.33
DJ UBS Commodity Index	-1.84	3.13	-6.57	-1.50	-7.18
Wilshire REIT Index	7.88	27.21	18.39	7.21	10.17

Source: Morningstar. Past performance does not guarantee future results. An investment cannot be made directly in an index.

(Refer to the end for index definitions.)

Outlook

China is struggling, Germany may already be in a recession, and the U.S. shows signs of weakening as well. However, the U.S. economy has shown resilience up until this point so there is no guarantee that we will fall into a recession despite what the yield curve says. U.S. employment remains historically strong and the resulting wage growth continues to be respectable as well.

Political uncertainty could be significant for the near future. Still, this political uncertainty will not necessarily result in market volatility as it seems likely that any impeachment vote will ultimately die in the Senate. Furthermore, whoever wins the 2020 Presidential election will likely be facing a split Congress, which will make it very difficult for them to implement an aggressive agenda, regardless of what they might promise on the campaign trail.

Longer duration fixed income continues to look unattractive right now due to the state of the yield curve. Cash, stable value and short duration bonds are good fixed income alternatives in the meantime.

Stock valuation also seems a little stretched in many parts of the market. However, current low long-term interest rates are very supportive for equities, so stocks could very well still continue to climb from here. Small-cap value stocks, in particular, continue to look undervalued as compared to the market as a whole.

Barclays US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Barclays Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized sub indices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Barclays Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

DJ UBS Commodity Index: Dow Jones-UBS Commodity Index℠ and Dow Jones-UBS Commodity Index Total Return℠ the DJ-UBSCI℠ family includes both the DJ-UBSCI℠, which is calculated on an excess-return basis, and the DJ-UBSCITR℠, a total return index based on the DJ-UBSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.