Garden State Trust Company
Spanning Generations

888.323.5535
gstrustco.com

OUTLOOKS

October 2017

ECONOMIC OUTLOOK

Summary

The U.S. economy is vast, complex and changing rapidly and may be evolving more quickly than those tasked with managing it legislatively and financially. Two of the biggest disruptors are Apple and Amazon with the former creating the modern digital highway and the latter driving a new competitive wedge upon all the streets and back alleyways in the economy. Although this is not a new phenomenon, the size, scale and rapidity of these new economic forces have created real trauma in large parts of our economic system. There are always winners and losers when technology and innovation collide but the victors accrue much more of the spoils in today's hyper competitive markets.

Bricks and mortar are being disintermediated by clicks and picks and this has a huge impact on supply chains, transportation companies and commercial real estate owners. Electric vehicle manufacturer, Tesla, has never had positive cash flow or a profit and is systematically altering the economics, profitability and future of the legacy auto and truck makers. Facebook and Google together take in over 90% of all digital advertising. How's that going for the newspaper/magazine, radio and cable/TV broadcast media companies? We all know the answer. Not very well for employees (wages/health benefits/retirement-401K's) and shareholders/creditors (earnings/dividends/credit metrics).

So, what we know is the FAANG (Facebook, Apple, Amazon, Netflix and Google) stocks have been the darlings of Wall Street and for good reason. However, what is less well understood and appreciated is the significant capital destruction and business model interruption that these innovative firms have created. This is all great news for a highly educated consumer with a well-rounded and differentiated skill set. More convenience and choice at a lower price. But the broader economic collateral damage helps to explain why a 4.4% unemployment rate with very subpar average hourly earnings growth isn't as wonderful as our central bank seems to believe. Robotic Process Automation (RPA) is the new consultancy buzzword and emphasis in corporate America today that has yet to be implemented. As the name suggests, these hot button initiatives could help ensure that labor may be in steady supply as the restructuring of economic business models continues apace in a very competitive and transparent marketplace.

Positives

2Q GDP revised higher to 3.1% from 3.0%

Household sector net worth increases $1.7 trillion in 2Q 2017

ISM Manufacturing index increases to 60.8 while 58.1 was expected

Negatives

New home sales disappoint and drop 3.4% month over month

Personal Income and Personal Spending continue their lackluster pace

Fed indicates a strong likelihood of another rate hike in December 2017

Garden State Trust Company
Spanning Generations

888.323.5535
gstrustco.com

EQUITY OUTLOOK

Summary

The equity market momentum in September moved on in spite of the impacts of Harvey, Irma, Maria, Janet Yellen, Kim Jong and President Trump. The S&P 500 added another 2.1% for the month bringing the total return for the third quarter to 4.5% and 14.2% year-to-date. Equity markets are behaving like a well-oiled machine driven by favorable economic conditions, accommodative central banks and solid corporate earnings growth. As long as these catalysts remain in place, it appears likely the upward trend will continue unfettered.

Growth leadership took a relative pause in September rising just 1.3% versus a 3.0% increase in value stocks. Value stocks were led by the energy (9.9%) and financial (5.1%) sectors. Energy stocks were buoyed by a 9.4% monthly increase in West Texas Intermediate crude prices and financials were in part aided by renewed discussion of tax reform and a slight bump in interest rates over the last few weeks. Potential tax reform also helped more U.S.-centric, small-cap stocks (Russell 2000) outperform their large-cap peers (Russell 1000) at a rate of 6.2% to 2.1% last month.

Developed international and emerging market equities outperformed large-cap domestic stocks for the quarter but tapped the brakes a bit in September when the U.S. dollar's decline finally slowed. Developed markets rose 2.5% and emerging markets fell 0.4% for the month. However, the year-to-date returns of 20.0% and 27.8% respectively have soundly outpaced the 14.3% return of the S&P 500.

Corporate earnings are expected to expand rather considerably for the balance of 2017 and continue to strengthen into next year. The market seems to have become comfortable with political gridlock and any progress toward regulatory or tax reform will likely function as a mechanism to further fuel the market engines. The Federal Reserve Open Market Committee will begin reducing the size of their balance sheet in October but will proceed with caution by letting just $10 billion roll off the first month and gradually increasing from there. This will likely cause the committee to remain vigilant with future rate hikes, which should continue to provide a favorable backdrop for equity markets.

Positives

- Corporate earnings momentum
- Accommodative central banks globally
- Tight labor markets finally leading to wage growth

Negatives

- Geopolitical overhangs
- Stubborn inflation growth
- Rising consumer/federal debt

Garden State Trust Company

Spanning Generations

888.323.5535
gstrustco.com

OUTLOOKS

October 2017

FIXED INCOME OUTLOOK

Summary

After moving lower in August on North Korea related geopolitical fears and the continued discord in the Trump administration, interest rates reversed the trend and increased sharply in September. The 2-year Treasury note ended the month 16 basis points (bps) higher at 1.48%, which was the highest level since the fall of 2008. The 5-year increased 23 bps to end at 1.94%. The 10 and 30-year notes ended 22 and 13 bps higher to end at 2.33% and 2.86%, respectively.

The increase in yields caused negative monthly returns for investment-grade bonds across all sectors and maturities. Corporate bonds delivered better (less negative) returns than treasury bonds as credit spreads narrowed by about 11 bps on average. High-quality, intermediate-maturity corporate bonds have now delivered more than 2% better returns than comparable intermediate treasury notes for the year-to-date period.

Traditional measures of economic momentum and inflation measures will likely be disrupted as the impact of the back-to-back-to-back hurricanes that pounded Texas, Florida, and Puerto Rico will take months to assess. While the exact magnitude is unknown, they will dampen economic activity in the short-run, but ultimately, will be stimulative and somewhat inflationary as the rebuilding process begins and goes on for years to come.

Notwithstanding these events, the Fed stands committed to increasing the Fed Funds rate again by end of year and is still anticipating doing up to three more hikes in 2018. They have also formally announced that beginning in October, they will be reducing the amount of their balance sheet reinvestment by $10 billion per month. This monthly portfolio run-off is expected to increase by $10 billion every three months until they are allowing their massive $4.5 trillion balance sheet to shrink by $50 billion per month. Obviously, the exact impact of their reduction in open market purchases is yet unknown, but at this point, no market participants will be surprised by this move, so theoretically it is somewhat discounted by investors.

Barring any exogenous event like a terror attack or escalation of the tensions with North Korea, we expect the entire yield curve to continue to grind slightly higher and modestly flatter (2 to 10-years). Returning to a 10-year yield of 2.50-2.60% continues to seem plausible for the final few months of the year, but we are not overly concerned that rates will spike significantly higher. It will be difficult for corporate bonds to continue to deliver the level of outperformance that they have recently, but we still favor the sector over the long-term.

Positives

U.S. interest rates still compare favorably to other high-quality nations

Geopolitical tensions create demand for the security of government bonds

Aging baby boomers will likely increase allocation to bonds if rates rise much at all

Negatives

Fed will increase the overnight rate further and begin to reduce purchases

Heavy corporate issuance will compete for investors with increasing treasury debt

Unknowns

Escalation of North Korea tensions. Russia, Syria, Iran.

Potential for unexpected inflationary pressures with hurricane rebuilding efforts