

ECONOMIC OUTLOOK

Summary

We received our first look at Q3 real GDP recently and it was a fairly sturdy 3.5% quarter-over-quarter annual rate. Despite this solid performance, Q3 growth was slightly slower than Q2 growth, 4.2%, in the U.S. data. Consumer spending added 2.7% and government added 0.6%. The private nonresidential fixed investment contribution was 0.1%, a modest disappointment. Inventory growth boosted growth by 2.1% and was offset by net exports (-1.8%) and housing (-0.2%). All in all, a very good report and one that bodes well for continued growth, but with a slightly softer bias.

One of the reasons for this was a marked slowdown in real private nonresidential fixed investment as noted above, although a slightly different measure. This data point only grew 0.8% quarter-over-quarter in Q3 after expanding 11.5% in Q1 and 8.7% in Q2. This is a little perplexing as business tax cuts were in full force and new equipment spending, which benefits from an accelerated depreciation schedule, didn't budge much last quarter. So maybe the threat of a wider trade war and supply chain disruptions are causing business owners to be more cautious with their discretionary outlays.

It's widely acknowledged that raw input prices have risen for many goods (supply disruption and actual increases from tariffs) and wages are increasing due to a tight labor market. This is a recipe for a potential profit margin squeeze with sellers experiencing limited pricing power. The natural reaction would be to cut back on big-ticket capital expenditures in order to offset these other operating cost increases. Additionally, new ISM Manufacturing

orders for export and domestic customers have slumped recently, curtailing the need for any immediate capacity increases. This suggests a more prudent spending pattern from the business side of the economy, contributing to a further softening in demand as we approach year-end.

Positives

ADP employment change was +227K, 187K was the expectation

Non-farm payrolls increased 250K, 200k was the expectation

Average hourly earnings increased 3.1% year-over-year, a high for this business cycle

Negatives

ISM Manufacturing New Orders Index was 57.4 in October, 63.5 in June

ISM Manufacturing New Export Order Index was 52.2 in October, 56.3 in June

New Home Sales were 553K (annualized) in October, 625K was the expectation

EQUITY OUTLOOK

Summary

To say the least, equity markets were not kind to investors during the month of October. The S&P shed 6.8%, the largest monthly decline for the index since September 2011. Weakness was broad across most industries, equity asset classes and geographic categories. Investors continued to focus on uncertainty regarding trade disputes and the mid-term elections. Markets also reacted to Q3 earnings results, which were largely positive. However, there were many examples of stocks selling off following results which might have missed expectations slightly, lowered forward guidance or hinted slightly toward some negative tariff impact. It seemed as if traders were looking for any excuse to sell following the overall strength of the markets over the last several years.

Value stocks, while still down, held up better during the month relative to growth stocks with the Russell 1000 Value and Russell 1000 Growth dropping 5.2% and 8.9% respectively. Nine of the eleven S&P 500 economic sectors were lower, the lone exceptions being defensive consumer staples up 2.3% and utilities up 2.0%. Regionally speaking, neither developed international nor emerging markets offered a place to hide. The MSCI EAFE Index (developed) fell 8.0% and the MSCI Emerging Market Index dipped 8.7%.

Historically, the conclusion of mid-term elections has marked an opportune time to invest in equity markets as stocks have traditionally rallied to close out those years. Given the recent pullback, we believe long-term investors have an even better opportunity to take advantage of more reasonable equity valuations. Economic conditions remain favorable and while the rate of corporate earnings

growth will inevitably slow over the coming quarters, U.S. companies should continue to benefit from lower tax rates and reduced regulation.

President Trump's bargaining position, when it comes to trade disputes, may be significantly impacted by the outcome of the election, which may prolong trade negotiations with China. Investors in foreign equities should brace for continued volatility in the near term. However, long-term valuation levels and demographic trends in emerging markets support an allocation to international markets. We currently remain underweight international stocks relative to our long-term targets.

Positives

Equity valuations seem more reasonable following recent earnings growth

Resilient consumer and business sentiment

Negatives

Rising wages and input costs

Global economic relationships strained

Unknown

Duration of the "trade war"

FIXED INCOME OUTLOOK

Summary

Early in October, on the back of exceptionally strong employment and service sector reports, the yield on the 10-year Treasury note broke above this year's previous high of 3.11%. This established a new trading range with most days closing between 3.10% and 3.20%. For the month, it moved 8 basis points (bps) higher to end at 3.14%, the highest monthly close since June of 2011. The 2-year note yield increased by about 5 bps to 2.87%, which was the highest since the summer of 2008. Intermediate (1-year to 10-year) Treasury notes squeezed out a small gain of 4 bps for the month, but when longer maturity bonds are included, the overall Treasury market return was -0.48%.

Usually when economic data is good, the risk that companies will be unable to service and repay their debt diminishes. When credit risks decline, usually credit spreads narrow relative to Treasury bonds. Contrary to convention, corporate bonds performed poorly in October as spreads increased by about 10 bps. The risk-off sentiment that rocked the stock market bled into investment-grade corporate bonds even though the market had a significant decline in new issuance (-27% year-over-year). Intermediate investment-grade corporate bonds returned -0.45% for the month and with the inclusion of longer maturity bonds, the return was -1.46%. Corporate bond spreads look attractive to us at these levels.

Much of our overall interest rate forecast for 2019 hinges on the path of the economy, both domestic and abroad, and corresponding actions of the Federal Reserve. We see no reason to expect this prolonged economic expansion to end, but acknowledge that it is long in the tooth and that certain sectors such as housing and auto may have peaked. With a softening global growth story, especially in Europe, the Fed should be

able to take a pause in their progress towards normalization. Like the consensus, we expect that the December rate increase will happen but after that further rate hikes are in doubt. By our calculations, the 2-year Treasury note yield is already pricing in all 3 rate hikes that the Fed is telegraphing for 2019. Even if that path is followed, there is little reason to expect short rates to grind higher by more than a few bps per month. We have had a target of 3.25% for the 10-year Treasury note yield and we still think that represents a fair valuation. Much above that level would be a gift from the bond gods.

Positives

Slowing global growth, particularly in Europe and China

The Fed seems to be considering a pause to evaluate the impact of policy changes

Negatives

Average hourly earnings above 3% could stoke inflationary fears

Tariffs can increase input prices for many industries

Unknowns

Trade and geopolitical relationships with China

A split congress could impact policy initiatives