

ECONOMIC OUTLOOK

Summary

The U.S. economy is at a crossroads where the strength of the consumer and high levels of employment wrestle with global trade tensions, weakening business confidence and a manufacturing slowdown. The scales currently tilt toward the strength of the consumer because it accounts for 68% of the U.S. gross domestic product. However, most of the incoming global and domestic economic data indicates a weakening trend. As the signs of potential economic weakness have become more evident, the Fed has moved toward a more accommodative monetary policy.

Consumer confidence remains elevated and the impact of lower mortgage rates is helping to buoy both new and existing home sales and multifamily construction. Auto and truck sales may have peaked for this business cycle but they are close to 17 million units annualized, which is a solid showing. As a counterbalance to these positives, the ISM Manufacturing PMI registered a 47.8 print last month. This was the lowest level since June 2009 and the index has now been down for six consecutive months. Weakness in the PMI data was most evident in production, the backlog, employment and exports.

We expect to see further weakness in the global economy, partly because Europe is on the cusp of recession and Southeast Asia is likely following suit. These developments are worrisome but they do not necessarily indicate the end of the growth cycle for the U.S. economy. Developments with the consumer will ultimately determine if the weakness in the U.S. manufacturing sector contaminates the much larger service sector. However, economic momentum in the U.S.

should stay positive as long as employment levels remain steady and include modest wage gains, trade tensions moderate and the Fed continues to ease monetary policy as expected. Of course, the impeachment inquiry of the President adds another layer of uncertainty to our outlook.

The pathway forward is more narrow and uncertain than we have experienced over much of this recent business cycle, but it is navigable.

Positives

Housing starts and permits hit cycle highs for the expansion

Personal income continues to advance late in the business cycle

Real personal spending remains steady as business expenditures soften

Negatives

ISM Manufacturing PMI (U.S. Domestic) at the lowest level since 2009

JP Morgan Global PMI readings in contraction territory for five straight months

Wholesale inventories increase more than expected impacting future production levels

EQUITY OUTLOOK

Summary

The S&P 500 rose 1.9% in September and markets calmed following a particularly volatile August. Value stocks outpaced growth during the month with the Russell 1000 Value Index climbing 3.6% vs. the Russell 1000 Growth Index which was unchanged. Financials (+4.6%) and utilities (+4.3%) were the top performers while health care (-0.2%) and communication services (+0.4%) were the laggards. Equity markets abroad also fared well as the developed market MSCI EAFE Index gained 2.9% and the MSCI Emerging Markets Index added 1.9%. Several headline risks continue to increase the potential for more volatility and market weakness. The political divisiveness in Washington has now spiraled into an impeachment inquiry which will undoubtedly leave some impression on the equity markets. The month of October also marks a heated Prime Minister election in Canada as well as the deadline for Great Britain's exit from the EU. Little progress has been made with China on trade and the Trump administration continues to open new fronts in the ongoing trade war.

Given all of these stresses, it is hard to imagine the markets gaining much upward momentum. Third quarter earnings season, which will heat up over the coming weeks, could provide a catalyst for the markets. However, many companies have already warned some impact is being felt by the global economic slowdown. It is therefore unlikely we'll see a broad upside surprise to corporate earnings.

Investors should brace for increased volatility in the near-term but should also feel reassured by the fact that equity valuations do not appear overly stretched at current levels. Valuation multiples could even be expected to expand given the prospects for lower interest rates.

Positives

Accommodative Federal Reserve

Resilient U.S. consumer

Negatives

Global economic slowdown

Impeachment inquiry

Unknowns

Stalled trade negotiations

Brexit path and impact

FIXED INCOME OUTLOOK

Summary

After plunging in August and leading the bond market to the best monthly bond returns in a decade, interest rates moved sharply higher during the first few weeks of September. Tracking the hope and despair cycle of the trade talks for months, an announcement that U.S.-China trade talks were back on led many to be optimistic that a thawing in the relationship was increasingly likely. The 10-year Treasury note increased nearly 45 basis points (bps) to close at 1.90% on September 13. Likewise the 2-year increased by 37 bps as investors reduced their expectation that the Fed would cut the overnight rate by 50 bps at the upcoming meeting of the Fed's Open Market Committee (FOMC).

However, the date on the calendar, Friday the 13th, should have been a signal that something more ominous might be on the horizon as on the very next day, a series of drone attacks severely damaged two state-owned Saudi Aramco oil processing facilities. The strike resulted in a 5% reduction in global oil output and sent global crude prices skyrocketing 15%. With tensions rising in the Middle East, yields reversed their upward trend and began to ease lower again. As expected, a few days later at their regularly scheduled FOMC meeting, the Fed stepped in and cut the overnight rate by 25 bps. Importantly, for the first time in a while they effectively communicated that more rate cuts will be provided if the economic environment weakens further. Across the curve, interest rates ended the month just 12 bps to 17 bps higher with the 2-year at 1.62% and the 10-year at 1.67%. Despite last month, this year has been terrific for bond investors of all varieties.

Looking forward, even with the strength in the labor market and consumer spending, there is enough weakness in the manufacturing sector that when combined with foreign weakness and trade uncertainties, we believe the trend is for slower economic growth in the next year or so. This should allow the Fed to

continue to cut rates at least one more time this year and at least two more times over the next six months. While the Fed is more open in stating they do not really know where the "neutral rate" actually is, they now appear willing to move to a more accommodative policy if need be. With the Fed's help to keep front-end rates anchored, we think the long end could grind a bit higher, but we are not concerned that they will shoot back to 2% anytime soon. A steepening curve would not only return optimism to stock investors but would deliver the opportunity for incremental returns to bond investors due to the "roll" which causes bonds to appreciate as they age toward maturity.

Positives

Germany and much of Europe are close to entering into a recession

European Central Bank lowered the overnight rate further into negative territory

U.S. rates continue to be much higher than other high-quality, safe markets

Negatives

The yield on 10-year inflation-adjusted treasury notes is near zero

Tariffs could lead to temporarily higher inflation

Unknowns

Outcome of trade negotiations with China
