Market **Insights**

Economy | **Capital Markets**

Q3
2019

Economy

At times, the investing environment feels like the weather in Michigan. One day, it is cold and rainy; the next, hot and sunny. It can change quickly and unexpectedly, even by the hour. Perhaps this analogy best sums up the gyrations in the capital markets over the past year.

For a refresher, the S&P 500 Index fell around 20 percent during the fourth quarter of 2018 amidst heightened trade tensions and rising interest rates. The first quarter of 2019 witnessed a complete reversal when stock prices jumped considerably higher as investors anticipated a resolution to the trade wars and an interest rate cut by the Federal Reserve. Throughout the spring and summer, the markets remained volatile and whispers of recession fears began to spread among investors. Then interest rates fell to fresh new lows in early September, after spiking to cyclical highs this time last year. But like sudden changes in weather patterns, the markets did an about-face with stocks heading back to all-time highs and interest rates rising during mid-September. With so much volatility in the capital markets and global economies recently, investors are left scratching their heads and wondering what's next?

To help answer this question and gain some perspective, let's first analyze trends in the global economies and the support of central bankers, then focus on the capital markets. In the United States, second quarter economic growth came in at 2.3 percent annualized, after a solid 2.7 percent for the first quarter. Next year, growth is expected to moderate to around 1.9 percent because of softer manufacturing activity, trade wars and subdued growth in corporate capital expenditures. Yet, employment should remain robust with the lowest unemployment rate in about 50 years. Wage growth continues to increase, and the number of unfilled jobs is near an all-time high. In Europe, growth is expected to pick up over the remainder of this year and into 2020, as external demand is projected to recover, and temporary negative factors fade. Emerging economies, including Asia, are expected to grow at 6.2 percent in over the next year. This slightly reduced forecast largely reflects the impact of tariffs on trade and investment. In China, the negative effects of escalating tariffs and weakening external demand have added pressure to an economy already in the midst of a structural slowdown and needed regulations to rein in high dependence on debt. Policy stimulus is expected to support activity in the face of external pressures, with growth forecast at 6.2 percent for all of 2019 and 6.0 percent in 2020.

The combination of softer world growth, lower corporate earnings growth and heightened volatility in the capital markets prompted global central bankers to alter their monetary policies going forward. In the U.S. for instance, the Federal Reserve went from hiking to lowering interest rates in a matter of months. After raising interest rates nine times over the three-year period through December, they abruptly cut interest rates this past July and September when economic data disappointed. Investors appear to be pricing in the possibility of further rate cuts in the months ahead should growth and inflation underwhelm. The theme is similar in Europe, where central bankers lowered deposit rates to a record low of negative 0.5 percent and restarted their quantitative easing program in response to a weakening economic outlook and potential downside risks. Unlike the U.S. Federal Reserve, China's central bank doesn't have a single primary monetary policy tool. Instead, they use multiple methods to control money supply and interest rates in the world's second-largest economy. Amidst an ongoing trade war with the U.S. and slowing internal growth, they have pushed interest rates lower and adjusted their currency exchange rate to make their economy more competitive.

The combined effects of trade wars, lower corporate earnings, slowing global growth and aggressive global central bank policies have led to volatile returns in the capital markets over the past year. One-year results are quite underwhelming for most major indices, with returns for large-cap stocks modestly positive, while smaller capitalization names have returned flat or negative results. International and emerging market index returns are positive this year, but uninspiring over the one-year period. Meanwhile, most fixed-income sectors have benefitted from a decline in interest rates and investors' appetite for risk. Corporate investment-grade, high-yield and longer-dated U.S. Treasury bonds have performed well.

Looking forward, we expect that economic data could flirt with a recession over the next few quarters amidst slowing growth and subdued corporate earnings. Yet, with the Federal Reserve poised to lower rates, along with a stellar jobs picture and modest inflation, any weakness appears manageable. Considering most of this news is already priced into stocks, any surprises will have a corresponding impact on prices. We continue to expect modest returns for both stocks and bonds for the remainder of the year, although volatility could pick up. In this environment, we have positioned client portfolios slightly defensively with respect to bond duration and a slight overweight to credit. In stocks, we modestly favor domestic over international and growth over value. Rest assured, we are diligently working on your behalf and only make portfolio changes after thorough research and sound investment analysis.

As always, investing in capital markets comes with some risk and uncertainty. We thank you for your continued support of our investment process as we work hard to deliver positive risk-adjusted portfolio returns to our clients. Should you have any questions, please do not hesitate to reach out to your financial adviser.

Capital Markets

The yield on the U.S. 10-year Treasury bond declined during the quarter amidst a continued trade war and slowing global growth. Investment grade corporate bonds along with riskier high yield bonds produced solid returns for the quarter. Domestic large cap equities performed well and generally outpaced most international and emerging market equities.

Disclosure: It is not possible to invest directly into an index. The indices listed above are unmanaged and are not affiliated with the Advance Capital Companies.

Market Index Performance (%)
As of September 30, 2019

	3rd QTR	YTD	1 Year	Annualized 3 Year
S&P 500	1.70	20.55	4.25	13.39
Dow Jones Industrial	1.83	17.51	4.21	16.43
Nasdaq Composite	0.18	21.56	0.55	15.94
Barclays Aggregate Bond	2.27	8.52	10.30	2.92
FTSE USBIG Corporate	3.17	13.06	13.05	4.44
MSCI World	0.66	18.16	2.44	10.85

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	3.63%	6.04%	Represents the number of unemployed persons as a percent of the labor force	Near historic lows
Consumer Price Index	1.70%	4.00%	Represents changes in prices of all goods and services purchased for consumption	Trending modestly lower
U.S. Capacity Utilization	77.90%	80.24%	The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime	Slightly lower recently
Gross Domestic Product+	2.30%	2.90%	Total value of all goods and services produced indicates strength or weakness of the economy	Trending lower
10 Year Treasury Yield	1.73%	6.27%	Yield on the current 10 year treasury bond	Sharply lower recently
Annual Housing Starts	1,364,000	1,427,000	New privately owned housing unit starts annualized rate	Trending modestly higher

*Average from 1966 to Present   + Annualized   *Source: Bloomberg*