Economic Review & Outlook

Is the next recession right around the corner? It’s a question many market pundits are currently trying to answer. It’s a justifiable question given some of the current circumstances. The escalating trade war between the U.S. and China is reducing global trade and increasing economic uncertainty. Economies overseas such as Germany are noticeably slowing down. Manufacturing in the U.S. is also slowing. But a strong consumer seems to be keeping the U.S. economy growing so far.

One reason recession concerns are elevated is because of what is called the inversion of the yield curve. This happens when long-term interest rates fall below short-term interest rates. While various parts of the yield curve have been inverted off and on for some time, the 10-year Treasury yield dropped below the 2-year Treasury yield in mid-August. Historically inversions of the yield curve have been good indicators of oncoming recessions. But the lead time between an inverted yield curve and a recession has varied, ranging from a few quarters to a few years. So while an inverted yield curve may indicate a recession is likely ahead, it doesn’t help anyone know if it is a few months away or a few years away.

The Federal Reserve has taken notice of increased economic uncertainty, cutting interest rates by 0.25% at both their July and September meetings, while signaling more rate cuts may be coming. Highlights from the comments included an acknowledgement of above average economic uncertainties as well as “weakened” domestic capital spending forecasts. Now, before you read too much into the current Federal Reserve thinking, remember that last December, 15 of the 17 Federal Open Market Committee (FOMC) members were predicting interest rates would increase in 2019. Instead, interest rates have been lowered twice this year. Predicting where interest rates are headed is just as difficult as predicting where the stock market is going.

Usually before a recession the confidence of consumers and CEOs turns down. You can see from the chart that CEO confidence has waned.
over the past two years while consumer confidence remains high. For now, the divergence seems inconclusive. But if consumer confidence were to fall sharply, that would significantly increase the likelihood of recession in the near term.

One reason consumers remain confident is the strong labor market. The unemployment rate has remained in steady decline, currently registering at 3.7%. The job market is strong and clearly a sign of a healthy economy, at least in the present. A strong labor market and consumer confidence has led to solid consumer spending and US economic growth of 2.0% in the second quarter, with projections for similar growth in the third and fourth quarters.

Recessions have been notoriously hard to predict and the same is true today. While some indicators point to a potential upcoming recession, others show an economy continuing to grow at moderate levels. Eventually the US will have another recession but predicting exactly when is impossible. Since the stock market is a leading indicator, stocks will adjust long before economists have declared the next recession. So, while it is interesting to follow economic indicators, we heavily advise against using any of them to make predictions with your investment portfolio.

**Bond Market Review & Outlook**

It has been a great year for the bond market. Through the third quarter, core bonds as measured by the Barclays Aggregate Bond Index returned 8.5% for the year. This compares favorably to the current 1-2% yields offered by money market funds. Riskier bonds have also fared nicely this year, returning 11.5% as measured by the Bank of America High Yield Index. Lower yields throughout the world, combined with the previously discussed about-face changes to monetary policy by the FOMC, have put significant downward pressure on interest rates in the U.S. putting bonds on pace for their best annual performance in nearly a decade.

While the strong performance this year is certainly a reminder as to why one should continue to own bonds within the conservative portion of their portfolio, this performance does suggest returns may be muted going forward. The strong return for bonds this year is a result of a sharp drop in yields. While many U.S. investors may dismiss the possibility of yields dropping further, it is worth considering where interest rates are globally. At the close of the third quarter, the following countries all had negative 10-Year government yields: Switzerland, Germany, Denmark, Netherlands, Austria, Finland, France, Japan, Sweden, Slovakia, and Belgium. The 1.7% 10-Year U.S. Treasury yield looks very attractive if you live outside the U.S.
The difference in global interest rates is one reason why a further decline in U.S. interest rates is a distinct possibility. There isn’t a single country with a higher credit rating than the U.S. who has higher borrowing costs. This fact has not gone unnoticed by the current administration that has sought to encourage the Federal Reserve to lower U.S. interest rates. While it seems likely U.S. rates will decline more during the next recession, it remains to be seen if the U.S. will experience negative interest rates similar to other developed countries.

**Stock Market Review & Outlook**

Stocks cooled a bit in the third quarter after a blistering first half start to the year. Most markets were up in July and September but declined in August. The broad-based S&P 500 delivered a return of 1.7%, comparable to the Dow Jones Industrial Average 1.8%, return. Small caps lagged their large cap counterparts, falling 2.4%. The NASDAQ composite was roughly flat at 0.3%, as were international markets as measured by the -1.1% return from the MSCI EAFE. It really was a much ado about nothing quarter for the stock market in terms of returns, but it seems unlikely this period of lower volatility will continue.

Although stocks as a whole had a relatively lackluster third quarter, there was a bit of a leadership shift from growth to value, as shown by the Russell
Style Index chart. The top three performing sectors during the quarter were real estate, utilities and consumer staples. All three of these sectors tend to have above average dividend yields. Thus, you can make a case that the driving force behind this shift in sentiment was lower interest rates. As interest rates drop, stocks with dividend yields materially higher than traditional bonds become more appealing to income seeking investors. Only time will tell whether or not this trend will continue, but keep in mind growth stocks have outperformed their value counterparts by more than 4% per year over the last five years. This is an extremely large gap from a historical standpoint, and one would expect some type of reversion at some point. With economic growth likely to remain modest and interest rates possibly moving even lower, this trend is something to keep an eye on.

Conclusion

Given the recent headlines including the trade war with China, Brexit still playing out, the attacks on Saudi Arabia’s oil infrastructure, and the formal impeachment inquiry, is it surprising the S&P 500 is up over 20% year to date? Yes and no. We believe some of these issues do indeed represent real risks, but calm markets and easy investing only exist in hindsight. It can be easy to forget this when potential risks don’t materialize, but headlines and risks are always around. In that sense, the last nine months has been similar to many other periods when risks were prevalent, but stock returns were strong nonetheless. It’s a good reminder that most of the headlines and segments on the nightly news are simply noise that should be ignored by long-term investors. That can be hard to do so we thank you for entrusting us with helping you to navigate your financial future.

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