Financial Advisory Service, Inc.

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FAS Monthly Economic & Market Update

December 2018

As of November 30, 2018

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Economic Conditions

Gross domestic product grew at an annual rate of 3.5% in the third quarter of 2018 according to the second estimate released by the US Department of Commerce, unchanged from the advance estimate released in late October. Despite no changes to Q3 GDP growth economists have lowered their estimates for Q4 GDP growth. Both the NY Fed's *Nowcast* and the Atlanta Fed's *GDP Now* estimate the economy to grow by 2.4% in the fourth quarter of 2018, down from their estimates of 2.7% and 2.9%, respectively, one month ago. The downgrades were the results of surprises to the downside in manufacturers' shipments and new orders and declines in exports which were primarily due to a continued strengthening of the US Dollar. Forecasts for Q4 GDP growth range from 2.2% to 3.3% according to data collected from the Blue Chip survey. Despite these small pockets of weakness, the economy continues to send signals of strength as consumption remains strong, inflation remains in check and unemployment continues to hover at its lowest level in nearly 50 years.

Market Conditions

After a brutal month in October with indexes posting their worst month of 2018, markets ended on a positive note in November. However, the market tested new lows late-month as the S&P 500 hit levels not seen since May. Both the S&P 500 and Dow Jones Industrial Average turned negative for the year before ending up 1.68% and 1.79% respectively for the month. Although the NASDAQ came less than 1% from turning negative, it joined the S&P and the Dow in correction territory at one point before rallying back to squeeze out a 0.34% gain in November. Once the markets dipped into "oversold" territory late-month, they quickly made an about face and began rising leading up to Fed Chair Jerome Powell's speech to the New York Economic Club. Stocks rose further following Powell's "dovish" remarks that implied the Federal Open Market Committee may not have many more rate hikes to go before reaching a "neutral" level (the interest rate level at which GDP is growing close to its trend rate without inflation running too high) and that the Fed was not on a pre-set path, indicating they could slow the pace of interest rate hikes in the future. These were backpedaling remarks from his comments in October when he said the Fed was "a long way from neutral." The change in rhetoric helped lift stocks into positive territory to end the month.

Index Returns

	Nov '18	YTD
S&P 500	1.79%	3.24%
DJIA	1.68%	3.31%
NASDAQ	0.34%	6.19%
MSCI EAFE	(0.31%)	(11.76%)
Barclays Aggregate	0.60%	(1.79%)

The Dreaded Yield Curve Inversion

The most recent buzzword/phrase being thrown around in the media lately has been the dreaded "inverted yield curve." As we all know, the media loves to throw around financial jargon and catchy phrases when it comes to the markets and market cycles. But what does it truly mean for the yield curve to invert and why is it meaningful for the markets? In order to understand what it means we need to understand what an inverted yield curve is. We've discussed the topic briefly in past updates but haven't provided much color around it.

A yield curve is an illustration of bonds of the same credit quality with different maturities ranging as short as one month to as long as 30 years. The most common yield curve referenced is the US Treasury yield curve and is the curve you should assume is being referenced when you hear anyone talk about "the yield curve." Naturally when an investor (buyer) lends money to a borrower (issuer) they expect a higher yield when agreeing to lock in a rate further out on the curve. For example, why should an investor agree to lock in a rate of 3% for a 10-year issue if they can get the same rate with less interest rate risk for a shorter-term issue yielding the same amount? For that reason yields are typically incrementally higher the further out you go (longer maturity) on the yield curve. If an investor is willing to purchase a bond further out on the yield curve they would anticipate rates (prices) to fall (rise). Likewise, issuers anticipate rates (prices) will increase (fall), making the debt they owe worth less than what they would be able to borrow in the future – everyone wants cheaper debt, after all.

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The Dreaded Yield Curve Inversion

Traditionally when the yield curve begins to flatten it means one of two things; long-term rates (prices) are *falling* (rising) faster than short-term rates or short-term rates (prices) are *rising* (falling) faster than long-term rates. It can often be a combination of the two. This is happening today because the Fed is currently doing two things – selling bonds in the open market in order to unload bonds from their balance sheet that were purchased during quantitative easing (causing prices to fall and rates to rise), as well as increasing the fed funds rate which plays a role in determining the rate banks use to lend money to each other. This in turn also determines the rates that banks set for lending money to borrowers and the rates that depositors receive in their accounts.

At the beginning of December we saw the two and five-year portion of the curve invert, which means that two-year treasuries were yielding more than five-year treasuries – panic ensued. This was the first time the yield curve has inverted since 2006, in which a recession followed roughly two years later. The last several recessions have been preceded by an inversion of the yield curve. The reasoning behind this is the idea that when the yield curve inverts, banks significantly pull back on their lending as the rates they pay on their deposits begin to exceed the rates they receive on loans extended to borrowers leading to what is called a negative net interest margin or negative lending margin. This tends to lead to credit freezes in which lending in the markets dries up and economic growth begins to slow. However it is important to realize that this is not an

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The Dreaded Yield Curve Inversion

immediate effect, which is why prior to the last six recessions the average timeframe between a yield curve inversion and a recession has been about 56 weeks – and that's when the 10-year treasury yield falls below the fed funds rate which has not yet occurred. Bank net interest margins have continued to increase even throughout the Fed's rate hiking cycle that began in 2015. Until banks begin to tighten their purse strings we don't necessarily see a yield curve inversion in the middle of the curve as a glaring indicator that a recession is right around the corner. That is not to say that the Fed couldn't decide to continue with their rate hike cycle as planned, pushing the yield curve flatter or even past the point of inversion. Until we begin to see higher rates on our deposits and/or lower rates on our mortgages, and therefore lower net interest margins for banks, we do not see the need to panic. If and when the day comes when the yield curve truly inverts, history tells us there is a significant lag time between inversion and a recession.

There is no surefire way to tell when a recession may hit and attempting to time a market top is a fool's errand. That being said, we are in the longest bull market in post-WWII history and a recession will come sooner or later which is why it's important to ensure you are comfortable with the level of risk you are taking in your portfolio and that those risks are aligned with your investment goals, time horizon and objectives. We are merely encouraging our clients to not jump to conclusions and believe everything they hear or read in the media. If you would like to reassess the risk in your portfolio we encourage you to reach out to your adviser.

Disclosures & Index Definitions

Under style performance boxes, indexes referenced in the equities section for large, mid and small reference the Russell 1000, Russell MidCap and Russell 2000 stock indices, respectively. The Barclays US Government, Barclays Credit and Barclays High Yield fixed income indices refer to Gov't, Corp, and HY, respectively. Short, Intermediate and Long refer to the time frame of the investments and their positions on the yield curve.

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All dates are as of November 30, 2018 unless stated otherwise.

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Index Definitions

The **S&P 500 Index** is based on the market capitalizations of 500 large companies whose stocks are listed on the NYSE and NASDAQ. This is widely regarded as the single best gauge of large cap US Equities.

The **Dow Jones Industrial Average** is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials. It is used as a barometer of how shares if the largest US companies are performing.

The **NASDAQ** is a market capitalization weighted index of the more than 3000 common equities listed on the NASDAQ Stock Exchange. These securities include American Depository Receipts, common stocks, real estate investment trusts, and tracking stocks.

The **MSCI EAFE (Europe, Australasia, Far East) Net Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America, Europe, Australia, and the Far East.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 822 countries, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **Barclays US Aggregate Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS, ABS, and CMBS.

All index information has been gathered from public sources who are assumed to be reliable, although we cannot guarantee the accuracy or completeness of those public sources.