Financial Advisory Service, Inc.

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# FAS Monthly Economic & Market Update

August 2019

As of July 31, 2019

# Contents

# Economic Conditions

The U.S. economy grew at an annual rate of 2.1% in the second quarter of 2019 according to the advance estimate released by the U.S. Department of Commerce – a slowdown from first quarter GDP growth of 3.1%. Slowdown in global growth continues to be a drag on the economy. Consumption continues to bolster the now longest recovery in post-WWII history as residential investment, including housing which declined for a sixth consecutive quarter, falling exports and declining business investment have been a drag on growth.

The fear of a slowdown was one of the primary reasons the Fed saw fit to cut interest rates by 0.25% in late July which came at no surprise to the markets. The surprise came after the announcement when during his speech Fed Chair Jerome Powell indicated this rate cut was not the start of a trend, but more of a "mid-cycle adjustment" citing "implications of global developments for the economic outlook as well as muted inflation pressures" as their reasoning for approving the cut. Powell also announced the Fed would end its balance sheet normalization – a strategy used for tightening monetary policy – earlier than anticipated which would allow the cash from maturing securities to be reinvested and remain in the economy. The 25 basis point cut was apparently not enough for the President as he continued his scrutiny of Powell and the Fed, calling for more rate cuts and easier monetary policy to combat the effects of a stronger dollar.

# Market Update – Yield Curve Inversion

| Index Returns | Jul '19 | YTD |
|---|---|---|
| S&P 500 | 1.31% | 18.89% |
| DJIA | 0.99% | 15.16% |
| NASDAQ | 2.11% | 23.21% |
| MSCI EAFE | (1.31%) | 10.31% |
| Barclays Aggregate | 0.22% | 6.35% |

July was another record breaking month as all three major US indexes hit fresh highs mid and late month. The Dow Jones Industrial Average and S&P 500 breached 27,000 and 3,000, respectively, for the first time. The NASDAQ surpassed 8,200 and 8,300 last month marking an all time high. The three indexes were up 0.99%, 1.31% and 2.11%, respectively. At the original time of writing this update we initially waited a few days to see how the rate cut on July 31 was going to affect the markets as they dipped slightly leading up to the Fed's decision. There was an initial drop due to the Fed's "hawkish" language as the markets were expecting them to express more eagerness for further rate cuts in 2019, which did not happen. Then the wheels began to fall off.

Earlier this month China allowed the yuan to breach the psychological level of 7 per dollar following the President's announcement of his plans to impose an additional 10% tariff beginning on Sep 1 on $300B worth of Chinese goods on top of the 25% on $250B. This spooked the markets causing further declines over the next several days including the worst single day for the Dow in 2019 – soon to be surpassed within a week. After a short-lived reprieve over the following week markets again fell with the protests in Hong Kong, a major financial hub, beginning to heat up as the Hong Kong airport was forced to cancel flights due to protesters overrunning the airport. Unexpected election results in the Argentinian primary presidential elections caused the Argentine peso

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# Market Update – Yield Curve Inversion

and their stock market to fall 25% and 35%, respectively, adding more fuel to the fire of worry over slowing global growth.

On August 13, not two weeks after announcing the next round of tariffs to go into effect, the President announced he would delay the additional tariffs until Dec 15 "in case some of the tariffs would have an impact on U.S. customers [for the Christmas season]." Investors found this statement somewhat puzzling considering the President's claim that the tariffs have had no impact on prices thus far. All of this news coming in at once gave investors pause when assessing the outlook for global growth. When that happens money will tend to pour into long and intermediate-term bonds causing rates to fall as investors flood into safe assets in anticipation of slowing growth or economic decline. The interest rate on the 10-year treasury fell from 1.62% on Aug 13 to a three-year low, slightly below 1.5% the morning of Aug 14 putting the 10-year Treasury rate below the 2-year Treasury rate for a brief period that day for the first time since 2007; otherwise known as a yield curve inversion. The 10-2 year spread – the difference between the 10-year and 2-year Treasury yield – is a key metric in economic analysis often referenced as a signal to the markets that a recession is coming. This caused the markets to fall nearly 3% with the Dow falling 800 points and registering its worst day of 2019 on Aug 14 – surpassing its previous worst day in early August.

The dreaded yield curve inversion has been widely discussed in market circles for years now, but on

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# Market Update – Yield Curve Inversion

Wednesday morning those discussions spread like wildfire into the mainstream media, warning viewers of a looming recession in the U.S. While this is a concerning indicator, we have to remember a few things; the first being that it is only one indicator and one indicator alone is not the end-all-be-all for signaling a recession. Additionally, if we are going to use historical trends to make assumptions about the future we must analyze several other trends that go in tandem with a yield curve inversion.

Over the last 50 years the 10-2 Treasury yield spread has preceded all seven recessions over that time period. That being said there are a few items to point out before screaming "fire" in a crowded room. While a recession has eventually followed a yield curve inversion over the last seven instances, each came as few as seven months to as long as two years following the inversion of the 10-2 spread with a recession beginning an average of 15 months after an inversion. In the last five occurrences since 1978, the S&P 500 has returned an average of 13.5% over the following year and 14.7% and 16.4% over the following two and three years, respectively. However, the ranges of those returns have been fairly wide, ranging from 3% to 13.5% over the following year, -8% to 26% over the following two years and -28% to 36% over the following three years (the -28% being the global financial crisis that followed the 2007 inversion). Near-term returns have historically been a little choppier as the S&P has averaged a 2.5% return over the following three months of a 10-2 inversion with the range falling between -10% and 13%. Since 1978 the S&P 500 hit its peak anywhere from one to 22 months

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# Market Update – Yield Curve Inversion

following a yield curve inversion for an average of just over 13 months before going into decline.

We are currently in the midst of the longest bull market and longest economic expansion in post-WWII history and we will eventually see another recession. And while this indicator is frequently used as a talking point for signaling a coming recession there is still no way of knowing when that may come and it wouldn't be prudent to sell out of equities and take the risk of missing out on what could potentially be nearly two more years of gains in the markets. This is why it is important to remember to stay the course and ensure your risk tolerance is properly aligned with your long-term goals. There is no way of calling the next recession and while we have certainly been in a slowing economic environment there are still potential bright spots such as a trade deal with China, looser monetary policy from central banks, and increasing consumption as a byproduct of lower rates that could fuel the global economy into further growth, at least in the intermediate-term.

# 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 July 31, 2019 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.