

ECONOMIC & MARKET REVIEW

Third Quarter 2019

Economy has slowed, fire trucks have left the station

The Federal Reserve cut short term rates twice in the third quarter, each time by 0.25%. Prior to these cuts, the Fed raised rates nine times from December 2015 through December 2018. The Fed's intent with rate hikes is to slow the economy and lower inflation or the potential for future inflation. Mission accomplished – the economy has slowed in response to higher short term rates. It is clear that in a slow or no-growth world with very low rates, it doesn't take

	Q3	YTD
S&P 500	+1.87%	+20.55%
Russell 2000	+2.08%	+14.18%
Barclays Aggregate	-0.53%	+8.52%
MSCI EAFE	+2.87%	+12.80%
MSCI EM	+1.91%	+5.89%



Source: Factset Research. As of 9/30/2019

much in the form of higher short term rates to impact the economy. Considering the lack of growth around the globe and the slowing of growth in the U.S., the Fed has moved in the opposite direction. Something as complex as the U.S. economy cannot turn on a dime, thus there is typically a lag of six months to a year between a rate change and the desired outcome. This means the Q3 rate cuts will not fully impact the economy until next summer, but help is on the way.

Central banks across the globe are on the quantitative easing bandwagon, but it may not be the long-term answer

One additional point regarding interest rates is that at no time in the past have global interest rates been this low. While they are reflective of little if any economic growth, especially in the developed world, low rates increase the need for investment income when the markets are stingy to oblige. Another important point: central banks have fallen in love with quantitative easing as a way to stimulate growth. This is where the central bank of a country or region prints money and uses it to buy securities. This has resulted in a jump in the demand for bonds by vast buying from a source that is not normally engaged in the market.

The U.S. Federal Reserve was the first to employ this strategy, and I think it was very effective at stabilizing our markets and economy after the 2008-2009 meltdown. We were also the first to call a halt to the experiment. The European Central Bank and the Bank of Japan have kept the program going to the point of driving interest rates in their economies into negative territory. Currently, more than \$15 trillion in government

debt globally has negative interest rates. Driving interest rates into negative yields is not a healthy outcome. Those central banks are intent on making the cost of capital cheap - even if it is negative – to induce borrowers to borrow more in the belief that the low cost of capital will lead to more economic growth. If the cost of capital is negative in Europe, why isn't their economy on fire right now? More effective strategies would include structural reforms, government spending programs especially in Europe, relaxing strict labor laws, cutting regulation and pension reforms, allowing their economy to breathe.

The U.S. consumer continues to be the economic growth locomotive at home

Our unemployment rate remains low and there are now more jobs available than there are unemployed workers to fill them. Despite all the distractions this year, consumer confidence remains strong. The consumer saving rate has increased and debt levels are modest relative to ten years ago. Also related to the consumer, the U.S. housing market is moving again after a decade of very modest home buying. Stocks of home builders have moved up and most all of the housing statistics are improving. It has taken a decade and very low mortgage rates to get this important component of the economy back on track.

Manufacturing at home and abroad is a casualty of the U.S./China trade war

Manufacturing numbers are contracting year over year in the U.S. but recession-like in Europe. The decline in manufacturing is a direct result of the U.S./China trade war. The tariffs create financial barriers, and the result is hurting manufacturing everywhere. Germany is particularly sensitive to this as they are both a major manufacturer and exporter. It is notable that the Chinese manufacturing numbers are now improving, after more than 100 easing moves over the last few years, including both rate cuts and regulatory efficiencies.

Q4 Outlook – expect a watered-down trade deal and potentially another rate cut

The setup as we enter the final quarter is the strength of the American consumer versus a worldwide slowdown in manufacturing. The U.S. consumer is 70% of GDP, thus the consumer matters most. However, if the slowdown in manufacturing leads to reduced job growth and rising unemployment, consumer confidence will take a hit.

I expect there to be a watered down trade deal. It will include the U.S. removing the threatened additional tariffs and some buying of soybeans and maybe natural gas by China. If all we get out of a small trade agreement is less tension, that would be helpful in the near term. Moving the trade war to the sideline would be a lift to both markets and the economy. The U.S. and the rest of the world have legitimate concerns about Chinese behavior. The next time we attempt to address our grievances with the Chinese, we should bring a collection of other developed countries with us – if we can get them to step up and help. I also expect the Fed to lower rates again before year-end. As to whether we're headed for another recession – it is a close call, with deteriorating manufacturing currently being offset by an upbeat consumer. My thought is that we will continue to see slower growth, but not a recession.



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