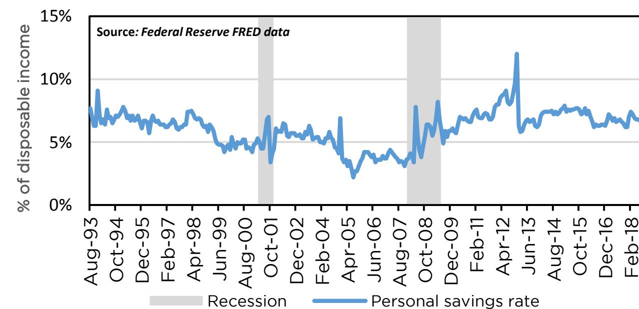
Economic Review

PAVILION

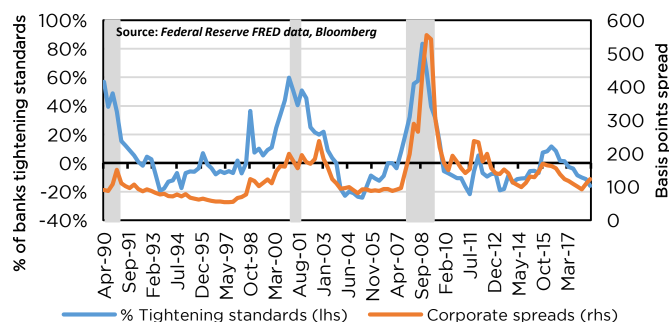
AUGUST 2018

In August, heightened uncertainty once again weighed on investor sentiment. Political events and trade policy conflicts were the primary drivers. Uncertainty was elevated further by the fact that global growth, still strong at an estimated annual rate of 4%, is unbalanced. International equities gave back most of July's gains, with emerging markets bearing the brunt of the reversal. Strong fundamentals allowed U.S. markets to avoid the fate of the international markets. U.S. data released during the month suggests the strong above-trend growth of the past few quarters should continue – and possibly accelerate. This growth, combined with moderate inflation, steady interest rates and extremely strong earnings allowed U.S. equities to overcome policy headwinds and produce another month of strong performance. Despite the positive performance, trade turmoil, turbulence in emerging markets, and flattening of the U.S. Treasury yield curve have caused many to question the sustainability of the bull market. While each of these factors should give investors pause, underlying fundamentals do not yet point toward a deterioration in financial conditions. Although interest rates are expected to continue rising, with another policy rate increase in September, the Federal Reserve is closer to the end of policy normalization than the beginning. Markets expect two more rate increases this year (September and December) with two more next year. It is the expectation that policy rate increases are near completion, rather than an expectation of a recession, that has caused the Treasury yield curve to flatten. Growth likely will slow through 2019 as rate increases continue and the stimulus of tax cuts fades. A recession is not yet apparent.

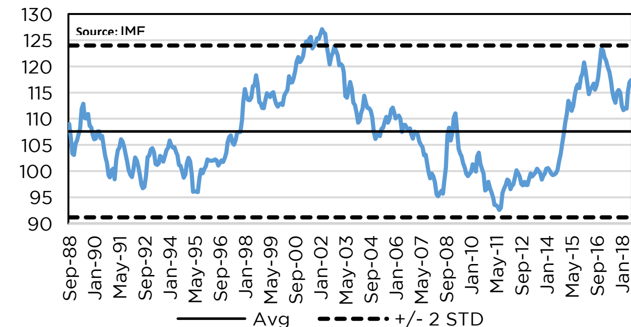
1. "A penny saved is a penny earned"



2. Lending standards continue to ease



3. Real effective exchange rate of U.S. dollar



Market returns

	August	QTD	YTD
S&P 500	3.3%	7.1%	9.9%
Russell 1000 Value	1.5%	5.5%	3.7%
Russell 1000 Growth	5.5%	8.6%	16.4%
Russell 2000	4.3%	6.1%	14.3%
MSCI EAFE	-1.9%	0.5%	-2.3%
MSCI Emerging Markets	-2.7%	-0.6%	-7.2%
Bloomberg Barclays Agg	0.6%	0.7%	-1.0%
3-Month T-Bills	0.2%	0.3%	1.1%

No house of cards: Regardless of the particular catalyst, recessions always begin with a decline in demand. U.S. households constitute almost 70% of the economy's demand, so household incomes and balance sheets can hold important clues as to the relative strength of the economy and the potential for a downturn. On the income side, wage growth has been stagnant relative to past recoveries (August's payroll report showed year-over-year gains of 2.9%), but employment growth and hours worked (determinants of the job market overall rather than household income) have been strong with unemployment claims falling to near record lows. This income growth has supported consumer spending on discretionary items, such as autos and retail products. During its recent earnings call, Target executives announced the "best sales in 13 years," with CEO Brian Cornell calling the consumer environment "the best I've ever seen." Another factor benefiting consumers is low interest rates. While rates have risen, household debt service costs as a percentage of disposable income remain near record lows at just 10.25%, as of the end of the second quarter. This compares to 13.25% prior to the crisis. Combined, all of these factors allowed households to improve their balance sheets by increasing their savings rate. As Figure 1 shows, households have almost doubled their savings rate since prior to the crisis. The bottom line is that households appear able to maintain current consumption levels and appear to have built a modest savings buffer.

Giving credit where credit is due: Another segment of demand in the economy is the business sector. One factor significantly impacting demand from this segment is the cost and availability of credit. Whether it is for funding the expansion of plant and equipment or the maintenance of inventory levels, credit availability serves as the lubricant for growth. When times are good, credit is readily available. As growth wanes, however, credit can become difficult to obtain. By virtue of the insights they hold into their borrowers' activities as well as the covenants in place for most bank loans, bankers typically have in-depth understanding into anticipated loan performance and, as a result, can provide early warnings of any potential deterioration in credit markets. Figure 2 takes data from the Federal Reserve's Quarterly Survey of Senior Loan Officers to highlight this point. The figure plots the percentage of banks tightening lending standards, with a negative percentage reflecting easing in standards, versus corporate bond spreads as represented by Bloomberg Barclays U.S. Aggregate Corporate Bond Index. As can be seen, it has been the case historically that lending standards cease easing and tighten in advance of credit spreads widening, and well in advance of recessions. This suggests business sector demand should remain sound for the foreseeable future, further reducing the prospect of a near-term recession.

Is it contagious? Recent turmoil in emerging markets has created concern of contagion. Some blame for the turmoil has been attributed to an appreciating dollar and the threat of a funding crisis. While this may be playing a role, the most significant factors appear to be uncertainty over trade policies and country-specific vulnerabilities in Turkey, Argentina, and, to a lesser extent, South Africa and Brazil. Figure 3 shows a time series for the real effective exchange rate for the U.S. dollar. Recently, the dollar has experienced modest appreciation, but it has remained in a narrow range during the past two years, close to its 30-year high. Recent moves are in stark contrast to movements in the late 1990s preceding the Asian financial crisis or 2014's +20% move, bringing the dollar from under to overvalued. As a result, this does not yet appear to be a repeat of past dollar funding crises. In the event that the most extreme trade threats are implemented, things could change.

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Market Review

August 2018

Overview

Dispersion in equity markets widened in August, as the S&P 500 reached new highs and international markets declined. Amid trade uncertainty, domestic fundamentals continued to provide support for U.S. equities. Outside the U.S., political and regional crises overshadowed steady global growth. In Europe, Italy's Eurosceptic government budget debate and bridge collapse along with ongoing Brexit negotiations weighed on the region. For emerging markets, tariff tensions loomed over China while Turkey, Argentina, and South African currencies fell, as economic crises appeared to escalate. While NAFTA negotiations with Mexico drew close to a conclusion, the dialogue with Canada remains incomplete. These political uncertainties and regional crises spurred a general sense of risk aversion, driving the U.S. 10-year treasury down 10 basis points and slightly widening credit spreads. Although headwinds are likely to persist, global growth appears sufficiently resilient to endure the current shocks.

Index Total Returns (%)

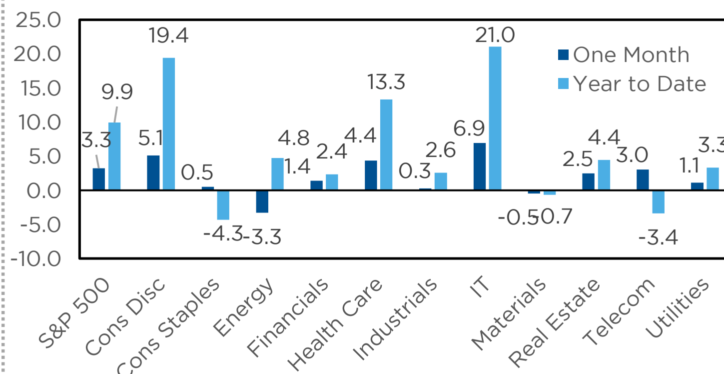
As of August 31, 2018

Domestic Equity Indices	Month	Quarter to Date	One Year
Dow Jones Wilshire 5000	3.5	7.1	20.2
S&P 500 Index	3.3	7.1	19.7
Russell 1000 Index	3.4	7.0	19.8
Russell 1000 Growth Index	5.5	8.6	27.2
Russell 1000 Value Index	1.5	5.5	12.5
Russell Midcap Index	3.1	5.7	17.9
Russell Midcap Growth Index	5.8	8.0	25.1
Russell Midcap Value Index	1.4	4.1	12.7
Russell 2000 Index	4.3	6.1	25.4
Russell 2000 Growth Index	6.2	8.1	30.7
Russell 2000 Value Index	2.4	4.2	20.0
International Equity Indices			
MSCI EAFE Index	-1.9	0.5	4.4
MSCI EAFE Growth Index	-0.3	1.8	8.1
MSCI EAFE Value Index	-3.6	-0.9	0.6
MSCI EAFE Small Cap Index	-0.8	-0.2	7.5
MSCI AC World Index	0.8	3.8	11.4
MSCI AC World Index ex U.S.	-2.1	0.2	3.2
MSCI Emerging Markets Index	-2.7	-0.6	-0.7
Fixed Income Indices			
Bloomberg Barclays Aggregate	0.6	0.7	-1.0
Bloomberg Barclays U.S. Int. Gov/Credit	0.6	0.6	-1.0
Bloomberg Barclays U.S. Long Gov/Credit	0.9	1.1	-2.1
Bloomberg Barclays U.S. Corp: High Yield	0.7	1.8	3.4
Bloomberg Barclays U.S. Treasury: U.S. TIPS	0.7	0.2	0.8
Citigroup Non-U.S. World Government	-0.7	-1.1	-1.9
JPM EMBI Global Div (external currency)	-1.7	0.8	-3.4
JPM GBI-EM Global Div (local currency)	-6.1	-4.3	-10.0
Real Asset Indices			
Bloomberg Commodity Index	-1.8	-3.9	0.5
Dow Jones Wilshire REIT	3.0	3.6	6.8

- U.S. equities again led the global equity universe, as international market headline risks eclipsed fundamentals.
- Intermediate- and long-term bonds were buoyed by yield declines but held back by spread moves.
- Emerging market crises sparked fear across currency markets, hurting local denominated debt.

S&P 500 Sector Total Returns (%)

August 31, 2018



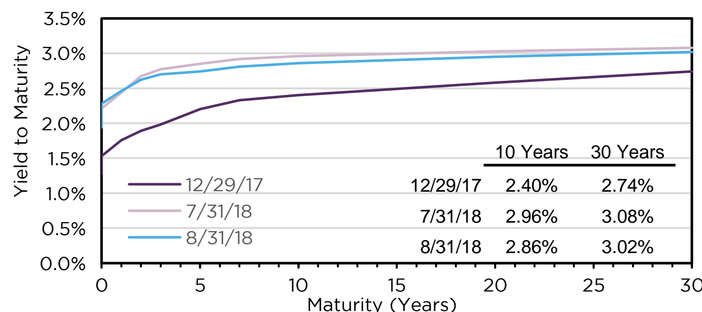
- The S&P 500's quarter-to-date return rose to +7.1%. After dipping at the end of July, the IT sector rebounded and climbed +6.9% in August.
- International tensions again challenged global supply chains within the industrials and materials sectors.

Duration-Matched Excess Returns to Treasuries

	Month to Date (bps)	Year to Date (bps)
Barclays Aggregate	-15	-26
Agency	-4	-15
MBS	-14	-17
ABS	8	17
CMBS	18	39
Corporate	-43	-90
High Yield	14	222
Emerging	-216	-277

- July's optimism was soured by international turmoil, as uncertainty pushed corporate spreads wider.
- Regional crises, in particular, hurt emerging market currencies, producing indiscriminate selling.

Treasury Rates



- The yield curve flattened, rising in the front-end and declining beyond 2-years.
- The FOMC is expected to continue its normalization process with two more rate increases this year with markets placing a 95% probability of an increase in September.

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