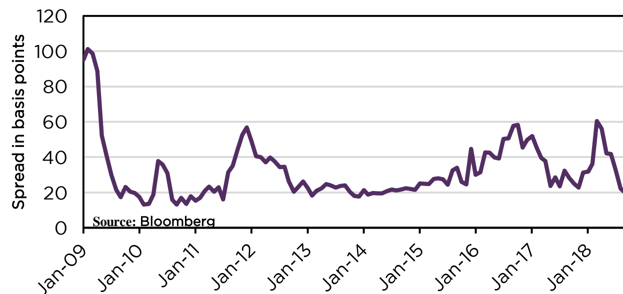
Economic Review

PAVILION

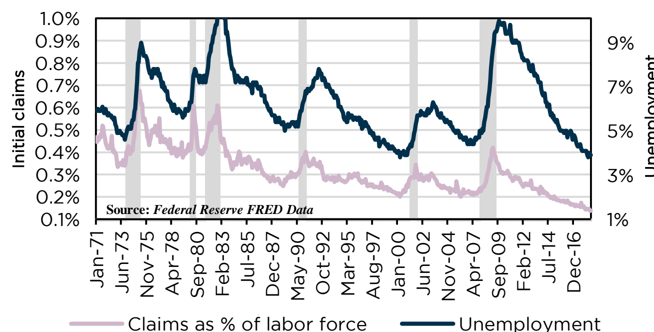
SEPTEMBER 2018

September marked the 10-year anniversary of Lehman Brothers' fall, considered by many to be the formal demarcation point for the Great Financial Crisis (GFC). Despite almost a full decade of recovery, with U.S. equity markets providing annualized returns of +15% (while ex-U.S. developed equities posted +8% annualized returns), U.S. investor confidence remains scarred. In the decade preceding the GFC, a decade including the Tech Bubble and near zero or negative annualized returns across equity markets, bullish sentiment averaged 43%, as measured by the American Association of Individual Investors' weekly survey (AAII). This contrasts with the post-GFC period during which AAII bullish sentiment averaged only 36.5% (currently 36.2%) – lower by almost a full standard deviation. The lower confidence level has not been unwarranted, as gun-shy investors have been buffeted by one potential crisis after another. Time may not heal all wounds. The 10-year anniversary of the GFC serves as a reminder of not only the length of the recovery but the fact that bull markets do not go on forever – hardly a foundation for improving confidence. Fortunately, bull markets are driven by conditions, not the calendar, and current conditions suggest the recovery should continue into the foreseeable future. Data during the month was consistent with U.S. economic growth remaining above trend in the third quarter at a likely annualized pace of between 3.0% and 3.5%. Although global growth has slowed from the pace earlier in the year, it remains near trend though less balanced. These conditions allowed the Federal Reserve to raise rates another 25 basis points at its September meeting). How long can the current cycle continue? It is difficult to gauge at this juncture as nothing yet is apparent in the data, certainly not "irrational exuberance."

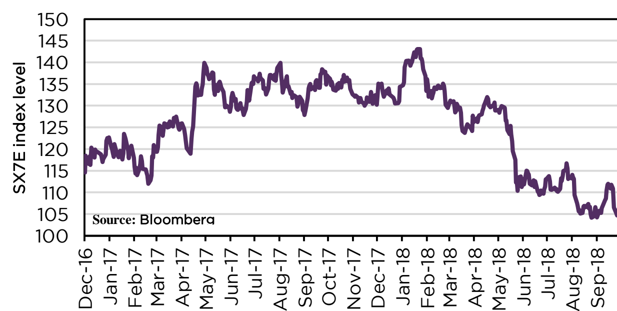
1. The 3 month TED spread



2. Labor market indicators



3. EU Bank Stocks (SX7E index)



Market returns

	September	QTD	YTD
S&P 500	0.6%	7.7%	10.6%
Russell 1000 Value	0.2%	5.7%	3.9%
Russell 1000 Growth	0.6%	9.2%	17.1%
Russell 2000	-2.4%	3.6%	11.5%
MSCI EAFE	0.9%	1.4%	-1.4%
MSCI Emerging Markets	-0.5%	-1.1%	-7.7%
Bloomberg Barclays Agg	-0.6%	0.0%	-1.6%
3-Month T-Bills	0.2%	0.5%	1.3%

Source: Factset

What about Ted? The Ted Spread measures the yield spread between Treasury Bills (T-bills) and the interest rate on dollar denominated time deposits in foreign banks, known as Eurodollars (T-bill vs Eurodollar hence Ted spread). The T-bill rate represents the rate the U.S. government pays to borrow, the so called riskless rate, while the Eurodollar rate (also known as LIBOR) represents the rate foreign banks pay to borrow dollar deposits. When liquidity is high, banks can borrow at rates only 15 or 20 basis points higher than the T-bill rate. As liquidity declines, banks pay an increasing premium to borrow funds, causing the Ted-spread to widen. As this premium increases, banks are more likely to limit outflows by tightening lending standards. Figure 1 shows a time series of the spread since the GFC. Historically, spreads materially in excess of 40 basis points have been viewed as a signal of deteriorating liquidity or credit quality across credit markets. Note the recovery from the GFC (2009), the European banking crisis (2012), tightening financial conditions from an appreciating U.S. dollar (2015 – 2016) and the liquidity squeeze earlier this year resulting from, among other things, a brief surge in government borrowing. In the past, cycle downturns have been preceded by a deterioration in short-dated funding markets. Currently, the spread is at 18 basis points, suggesting ample liquidity in funding markets. This suggests that Fed rate hikes have not begun to squeeze short-term funding markets, the Ted spread is not signaling any near-term turn in the cycle.

It is what they claim it is: Tightening financial conditions have implications beyond credit conditions. As financial conditions tighten, economic demand slows, eventually causing businesses to reduce output and pare capacity. This in turn leads employers to reduce payrolls. If payroll reductions become sufficiently widespread, the unemployment rate will increase. Figure 2 shows the four-week average of weekly initial unemployment claims as a percentage of the total labor force, the unemployment rate, and periods of recession (gray bars). Over the past 30 years, weekly initial unemployment claims typically have bottomed near 0.2% of the labor force, reflecting the fact that regardless of how good the economy is, there is always some labor market turn-over. Currently, the percentage stands at 0.14%, a record low. This extremely low level reflects in part employers' difficulties in replacing employees – so they are reluctant to fire them. Additionally, weekly claims tend to bottom and then turn up several months prior to any rise in the unemployment rate. Initial claims have yet to bottom for this cycle and remain at record lows suggesting the labor market remains healthy. This was further reflected by September's unemployment rate which, at 3.7%, is the lowest level in almost 50 years. Like the Ted-spread, labor markets have yet to signal any turn in the cycle.

But don't bank on it: Although the Fed has been raising rates gradually, Fed policy is not the only factor impacting financial conditions. Throughout this recovery, European banks have struggled to recapitalize and repair bank balance sheets, something accomplished early on and with greater speed in the United States. The sluggish pace of recovery among European banks has weighed on lending activity creating additional headwinds for recovery. Last year, recovery in the banking sector appeared be taking hold as banks began to relax lending standards, but that may have changed. As seen in Figure 3, European bank stocks have given up all of their 2017 gains and then some – with the bank stock index (SX7E) down almost 20% on the year. The source of the most recent challenges has been a renewal of concerns over European sovereign credits, most notably Italy. While there is no evidence yet, the concern is that this lack of confidence will result in tightening credit conditions. These are circumstances worthy of careful monitoring.

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Market Review

September 2018

Overview

Risk assets climbed the wall of worry in September, benefiting from slight alleviation of trade tensions, economic growth, and gradual normalization of monetary policy; however, trade discourse and regional headwinds continue to restrain investors. Trade uncertainty declined slightly, as NAFTA, now USMCA, negotiations closed and the South Korean Trade Agreement was signed. Both should produce little disruption to existing supply chains. These resolutions coupled with the potential for tightening oil supply supported energy and industrials while remaining trade and regional uncertainties weighed on emerging markets. Further economic expansion within corporate and household sectors allowed global monetary policy to reduce accommodation, driving rates higher. The wall of worry remains, but risks thus far have not derailed global growth or investment, paving the way for risk assets.

Index Total Returns (%)

As of September 30, 2018

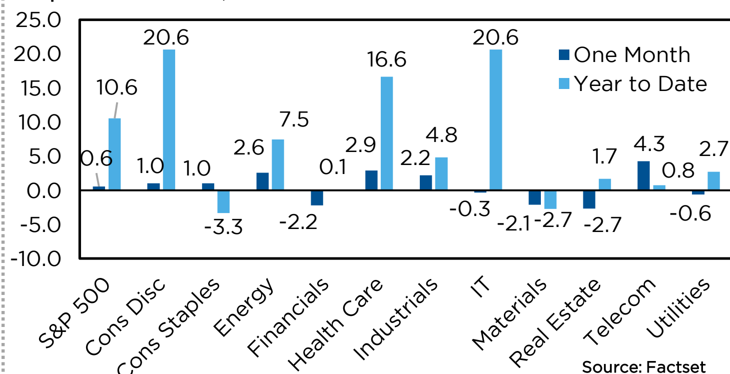
Domestic Equity Indices	Month	Quarter to Date	One Year
Dow Jones Wilshire 5000	0.2	7.3	17.6
S&P 500 Index	0.6	7.7	17.9
Russell 1000 Index	0.4	7.4	17.8
Russell 1000 Growth Index	0.6	9.2	26.3
Russell 1000 Value Index	0.2	5.7	9.5
Russell Midcap Index	-0.6	5.0	14.0
Russell Midcap Growth Index	-0.4	7.6	21.1
Russell Midcap Value Index	-0.8	3.3	8.8
Russell 2000 Index	-2.4	3.6	15.2
Russell 2000 Growth Index	-2.3	5.5	21.1
Russell 2000 Value Index	-2.5	1.6	9.3
International Equity Indices			
MSCI EAFE Index	0.9	1.4	2.7
MSCI EAFE Growth Index	-0.3	1.5	5.9
MSCI EAFE Value Index	2.1	1.2	-0.4
MSCI EAFE Small Cap Index	-0.7	-0.9	3.7
MSCI AC World Index	0.4	4.3	9.8
MSCI AC World Index ex U.S.	0.5	0.7	1.8
MSCI Emerging Markets Index	-0.5	-1.1	-0.8
Fixed Income Indices			
Bloomberg Barclays Aggregate	-0.6	0.0	-1.2
Bloomberg Barclays U.S. Int. Gov/Credit	-0.4	0.2	-1.0
Bloomberg Barclays U.S. Long Gov/Credit	-1.6	-0.5	-2.7
Bloomberg Barclays U.S. Corp: High Yield	0.6	2.4	3.1
Bloomberg Barclays U.S. Treasury: U.S. TIPS	-1.1	-0.8	0.4
Citigroup Non-U.S. World Government	-1.1	-2.2	-1.6
JPM EMBI Global Div (external currency)	1.5	2.3	-1.9
JPM GBI-EM Global Div (local currency)	2.6	-1.8	-7.4
Real Asset Indices			
Bloomberg Commodity Index	1.9	-2.0	2.6
Dow Jones Wilshire REIT	-2.8	0.7	4.0

Source: Factset

- International developed equities outpaced their domestic and emerging market counterparts, buoyed by global growth and heavier weights in energy and industrial sectors.
- Rising yields held back fixed income returns across the spectrum, but tightening spreads buttressed performance with high yield and emerging market debt generating positive returns.

S&P 500 Sector Total Returns (%)

September 30, 2018



Source: Factset

- The S&P 500's quarter-to-date return rose to +7.7%. After third quarter's strong performance, only two sectors remain negative year-to-date.
- Continued economic strength and rising prices of oil from potential supply constrains due to Iranian sanctions and OPEC production uncertainty supported energy.

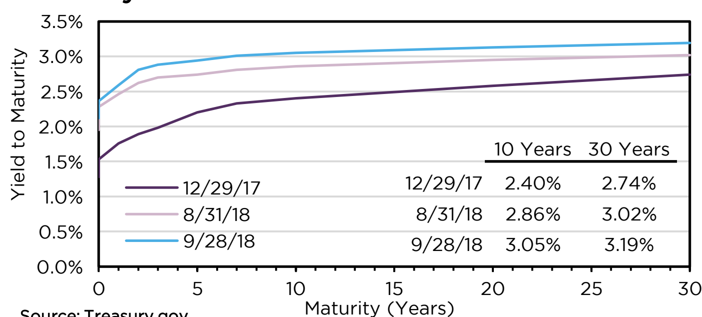
Duration-Matched Excess Returns to Treasuries

	Month to Date (bps)	Year to Date (bps)
Barclays Aggregate	26	0
Agency	37	22
MBS	11	-6
ABS	11	28
CMBS	29	68
Corporate	78	-12
High Yield	104	327
Emerging	222	-61

Source: Bloomberg

- Minor reductions of trade concerns helped spur positive sentiment and tighter spreads across most sectors. Additionally, a partial rebound of hard hit emerging economies bolstered the broad index.
- Year-to-date, regional crises and trade risks remain key factors in weak emerging market performance.

Treasury Rates



	10 Years	30 Years
12/29/17	2.40%	2.74%
8/31/18	2.86%	3.02%
9/28/18	3.05%	3.19%

Source: Treasury.gov

- The yield curve rose across all maturities and approached year-to-date highs.
- The FOMC is expected to continue its normalization process with markets, placing a 71% probability of another increase by year-end.

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