Quarterly Economic Update

December 4, 2018

MACROECONOMIC COMMENTARY

Fiscal Policy

By Michael McNair

The result of the recent midterm elections dim the odds of major legislation getting through Washington over the next couple of years. However, we caution the view of a complete gridlock scenario. In fact, the pieces appear to be in place to turn 2019 into a surprisingly productive legislative year.

Nancy Pelosi is likely to be elected Speaker of the House due to a lack of obvious alternatives. Many of our readers, including Strategas' Washington Policy Analyst, Dan Clifton, do not agree with her political views but even Clifton acknowledges that "She is a proven leader and an adult in the room when the extreme forces on both sides are pushing for extreme measures." It has become increasingly difficult to manage the divisions within the political parties. Therefore, Pelosi's experience and leadership might be necessary to reign in the fringe members of the Democratic Party. Ironically, Nancy Pelosi as Speaker of the House increases the odds of pushing through bipartisan legislation.

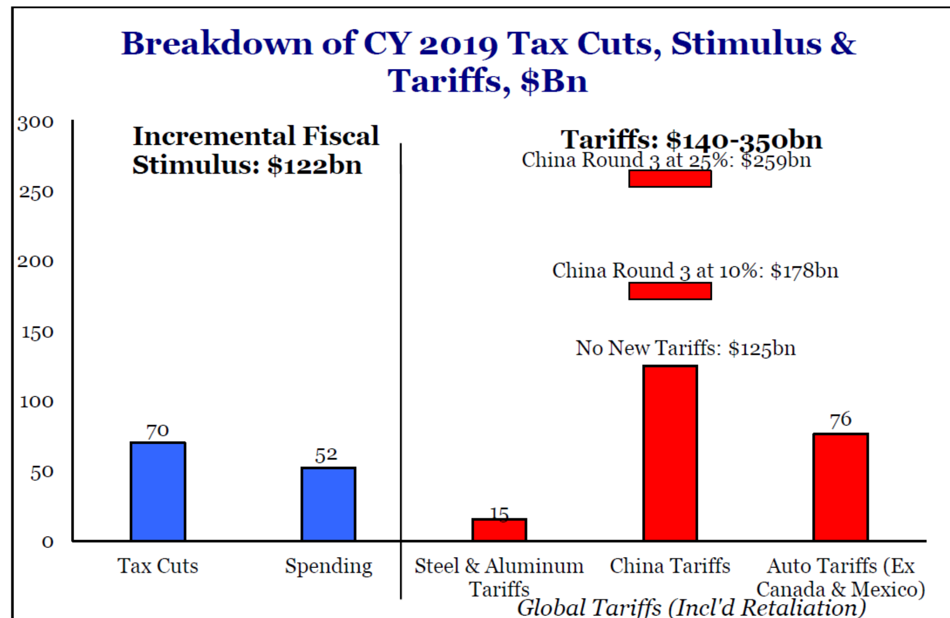
Despite President Trump's rhetoric leading up to the midterms, we believe the president is willing and able to work on a bipartisan deal.

> *In the nearly two weeks since the elections, Trump has abruptly changed tune – ditching the messages that advisers now acknowledge were crafted in a Hail Mary play to excite his base and stave off Republican loss…Now that Democrats have seized the House majority, the president has added to his repertoire happy talk about cutting deals with Pelosi, who is in line to become speaker. He pledged his support last week for bipartisan criminal justice reform legislation. And he is telling advisers that he wants an infrastructure package soon – and that he thinks Democrats will go along with one."*
>
> -*Washington Post* 11/19/2018

One of President Trump's original policy goals was to increase infrastructure spending. Yet, this is typically a policy goal for the Democrats due to their union support. Therefore, legislation to boost infrastructure spending is the most logical candidate for a successful bipartisan deal. However, we caution that any potential infrastructure bill is likely to be in $20 billion range, which doesn't provide much stimulus for the economy. Although, it will be impactful for the companies levered to infrastructure. Further, an increase in infrastructure spending is unlikely to increase the deficit and will need offsetting tax revenue to fund the spending. Senate Minority Leader, Chuck Schumer, recently said that he hopes President Trump will consider reducing some of the tax cuts for corporations and the wealthy to help pay for the infrastructure package. It is likely that the Democrats will attempt to roll back some of the tax cuts but the president's veto power ensures that any legislation on taxes will only survive if it is part of a larger bipartisan deal.

Trade Wars

Trade policy continues to be at the center of attention for investors. All eyes are on the upcoming G-20 summit where President Trump will meet with Chinese President Xi Jinping to discuss trade issues. If a trade deal is not reached by Jan. 1, 2019, the current 10% tariff on $200 billion of Chinese exports is scheduled to increase to 25% - a $134 billion increase. The proposed auto tariffs would add another $76 billion ($28 billion if only imposed on EU autos). The chart below shows the size of the tariffs in relation to 2019's estimated fiscal stimulus.



Source: Strategas

Comparing the tariffs to the fiscal stimulus provides some context to the size of the tariffs but we caution comparing the two numbers in terms of their impact on the economy. We have read numerous reports from Wall Street analysts improperly assessing the impact of the tariffs by only counting the headline "tax" and not incorporating the "subsidy". Therefore, it is import to explain how tariffs impact the economy.

A tariff is effectively a tax on domestic consumers, whose real incomes decline, and a subsidy to domestic producers, whose prices fall relative to their foreign competition. The impact of a tariff is similar to currency depreciation. Currency depreciation decreases domestic consumer's real incomes (the same dollar of income is worth less when the dollar's foreign exchange value falls) but increases the competitiveness of domestic producers (domestic prices fall relative to foreign prices as the dollar depreciates).

There are conditions under which tariffs, or currency depreciation, will increase growth and conditions in which it will decrease growth.

Tariffs, or any mercantilist policy, increase production relative to consumption by implicitly taxing consumers and subsidizing producers (i.e. increase savings: savings = production – consumption).

There are only two forms of demand: consumption and investment. Therefore, if consumption declines the economy can only grow if investment increases by a sufficient amount to offset the decline in consumption.

Should we expect investment to rise as consumption declines?

The purpose of investment is to meet future consumption. Then why would investment increase when consumption is falling?

This will only occur in economies that suffer from severe underinvestment so that even with falling consumption the new investment - made available by an increase in savings - will be profitable. This phenomenon only tends to occur in emerging market economies with low capital stock, but suffer from a lack of savings to fund necessary investment. Since a tax on consumption increases savings, investment will increase as savings increase in these scenarios. The best example is the United States during the 1800s.

All other investment is driven by changes in demand expectations. Therefore, investment is likely to decline in response to declining consumption. In other words, in economies were investment has not been constrained by lack of savings, falling consumption is unlikely to be offset by increased investment; therefore, production (GDP) will fall when consumption declines.[1]

Over the last several decades, investment has **not** been constrained by a lack of savings in all major economies around the world. Therefore, we should expect tariffs to cause a drop in both consumption and investment.

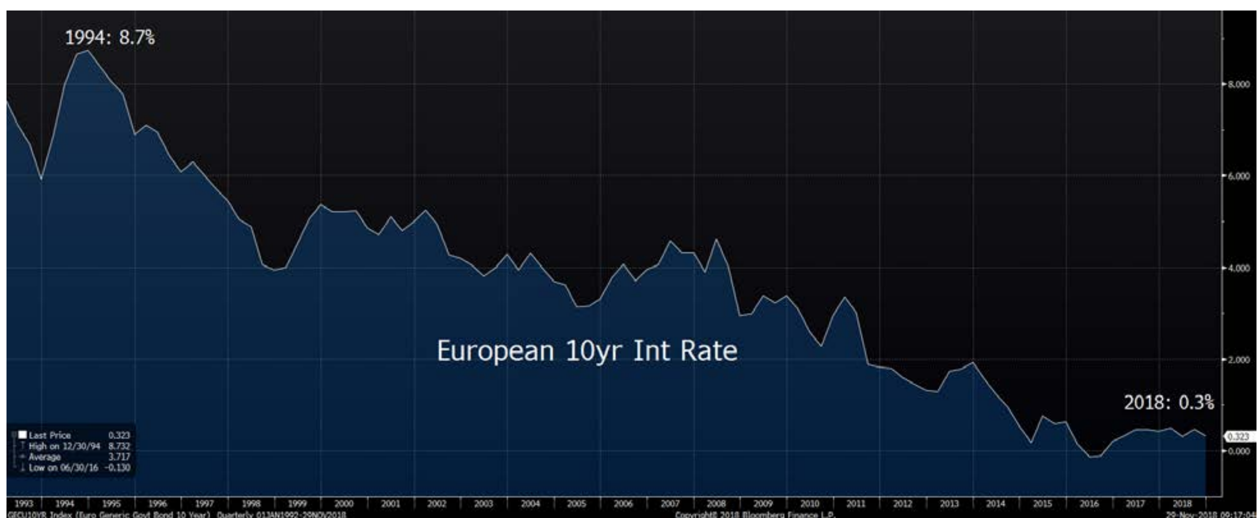
The savings glut hypothesis, most famously championed by former Fed Chairman, Ben Bernanke, states that we have been living in a world where the supply of savings has consistently exceeded the demand for investment. Critics incorrectly attack the savings glut hypothesis on the basis that savings must always exactly equal investment, which seemingly proves the hypothesis false. However, this only proves the critics understanding of the hypothesis to be incorrect and is easily refuted. The statement that savings must always equal investment is a tautology just as it is always true that there must be a buyer for every seller. Yet, there can still exist an oversupply of goods relative to demand. Price is the mechanism that adjusts in order to balance supply and demand. If there is an increase in the supply of oil but no change in the demand preference then the price of oil will fall until it reaches a level where demand equals supply (demand increases as prices fall, while supply decreases). Similarly, if the supply of savings increases but the demand to invest does not, then the price of savings (i.e. interest rates) must drop

[1] The exception is if a country can create a sudden increase in net exports to offset the decline in consumption and investment (beggar-thy-neighbor we will discuss later).

- reducing the desire for savings and increasing the desire for investment – until the supply of savings equals demand for investment.

Interest rates have been in decline for almost four decades and recently reached the lowest level in history. Therefore, it is difficult to disagree that we are living in a world awash with savings. But the question is: why has the supply savings consistently exceeded demand for investment?

The answer is that countries around the world have been implementing policies that are functionally equivalent to President Trump's "supply-side turned mercantilist policies".



When Supply-Side Policies become Mercantilist Policies

Supply-Side policies aim to increase investment, leading to an increase in the supply of goods and services in the economy. There are conditions under which supply-side policies will be effective in driving growth and times where they will fail. Supply-Side policies will be effective when demand runs near the limits of the

economy's ability to produce. As such, further increases in demand will not raise the output of the economy but only raise the PRICE of goods and services (i.e. create inflation).

In this case, supply-side policies tax/suppress consumption and subsidize/incentivize investment (remember that consumption and investment are the only two forms of demand). In other words, supply-side policies raise the domestic savings rate (savings = production – consumption) and because investment had been constrained by a lack of savings, investment increases enough to offset declining consumption and prevents production (i.e. GDP) from falling. The investment increases the supply and productivity of the economy, allowing for supply and demand to come back into balance.

Supply-Side policies will fail in a world in which investment has not been constrained by a lack of savings. In this case, taxing consumption and subsidizing investment will only cause aggregate demand to decline. If supply is already sufficient to meet demand then businesses will react to falling consumption by also reducing investment.

There are no sufficiently profitable investments that have been prevented due to a lack of access to capital. In fact, it is just the opposite. In today's economy, Trump's supply-side policies will not only fail but actually lead to lower growth.

When supply-side policies are implemented in a world awash with savings, then it becomes a mercantilist policy.

Attention to trade war might be a recent phenomenon but the trade war has been ongoing for at least 30 years. Countries have implemented policies which were designed to increase the competitiveness of their domestic industry but have instead only reduced global demand.

Strategies that tax consumption and subsidize production would not work in a closed economy because production would exceed demand. Falling consumption would cause businesses to reduce investment and GDP would drop (because production = consumption + investment). However, in a globalized economy **Production = Consumption + Investment + Net Exports.** Therefore, falling consumption and investment can be offset by a large enough increase in net exports (which can occur if tariffs or currency depreciation make domestic goods decrease in cost relative to foreign goods). Notice that this strategy only increases production domestically but leaves the world with less demand. This is why, contrary to popular opinion, tariffs are more likely to be deflationary than inflationary. Policies that suppress consumption – and likewise increase savings - are being repeated in economies around the world and it is the reason why the supply of savings has consistently exceeded demand for investment.

Rethinking Globalization

The reason for the dramatic increase in beggar-thy-neighbor policies, which are the cause of the global savings glut: the rise of globalization.

There are two ways for a country to increase competitiveness in international markets. The first is to invest in productivity increases, which lowers production costs by increasing the efficiency of the economy. The second strategy is to effectively tax domestic consumers and subsidize producers.

Whereas the first strategy increases the total pie (i.e. increases global growth) the second strategy works by increasing a country's slice of a shrinking pie. These are classic beggar-thy-neighbor policies.

The only way for the global economy to grow is through increases in productivity. Higher productivity leads to higher wages; however, in a globalized world, it is very difficult to raise wages because it is difficult to keep the benefits of higher wages – i.e. higher consumption – from bleeding out into the rest of the world in the form of a trade deficit.

For this reason, beggar-thy-neighbor policies have become an increasingly popular strategy as globalization has increased. It is also a major reason why global productivity growth has been on a downward trend over this time. The exact opposite result predicted by the conventional view of globalization.

Former Morgan Stanley chief economist Stephen Roach explains,

> *"While seemingly elegant in theory, globalization suffers in practice…Those who worship at the altar of free trade, including me, must come to grips with this glaring disconnect. Truth be known, there is no rigorous theory of globalization. The best that economists can offer is David Ricardo's early-19th century framework: If a country simply produces in accordance with its comparative advantage (in terms of resource endowments and workers' skills), presto, it will gain through increased cross-border trade. Trade liberalization — the elixir of globalization — promises benefits for all. That promise arguably holds in the long run, but a far tougher reality check invariably occurs in the short run."*

We are decades into the globalization cycle; yet, the global economy has become increasingly fragile. What today's free trade proponents fail to understand is that **globalization requires global coordination,** which has been almost non-existent. Today's globalization advocates failed to predict how countries would game the system in a way that creates economic distortions which easily overwhelm the benefits of globalization.

However, any respectable 19th century economist fully understood that global coordination was essential to ensure the functioning of a globalized world. This is not the first period of globalization. There have been numerous globalization cycles throughout history and there are important lessons we can learn from the previous

periods. As Jeffry Frieden explains in his excellent book, After the Fall: The Future of Global Cooperation:

> *"We can look to history for some guidance as to the problems the world economy is likely to face. Indeed, the world has been here before. For decades before 1914, the international economy was roughly as integrated as it is today…On a couple of dimensions the world economy was more "globalized" then than now. There was an international monetary order that tied almost all major countries together in something approaching a monetary union…By the same token, international migration was much freer then than it is today…There are at least two principal lessons of that previous age of international economic integration and its collapse after 1918. First, an open international economy requires the purposive collaboration of the major economic powers, especially during periods of economic stress. The 19th century fiction of self-equilibration international markets may have applied to particular markets; but it did not apply to the world economy as a whole."*

The gold standard was the monetary regime of the 19th century and it was well understood that sustained trade imbalances would lead to calamitous economic results.

Under the gold standard, a US trade deficit would have been met with a corresponding outflow of gold from the US to China. A loss of gold would be deflationary for the US while increased gold in China would be inflationary. As a result, Chinese prices would become expensive relative to the US and cause a reversal in the trade imbalance. However, the deflation necessary from the trade deficit country could be alleviated if the trade surplus countries allowed their gold inflows to fully flow through to their money supply, which would increase inflation and raise the surplus countries production costs. The important point is that the gold standard trading regime required global coordination and countries adherence to the "rules of the game". During the pre-war period, global coordination was high and the global trading system operated smoothly. However, during the inter-war period global coordination broke down and the system collapsed.

Under the gold standard global imbalances could not persist because the system contained a natural feedback loop to reverse the imbalances.

In today's trading regime countries can resist the appreciation of their real exchange values and prevent the reversal of their trade surplus. Rather than trading gold, countries trade financial assets (mostly debt). Therefore, a trade imbalance can continue for as long as one side is willing to continue trading financial assets for goods and services[2].

---

[2] We are not making an argument in favor of going back to the gold standard. The gold standard was a brutal system with its own set of flaws. We are only stating that the strength of the gold standard was its ability to reverse global trade imbalances in a self-organizing manner, while today's system lacks such a mechanism.

Former Fed Chairman Ben Bernanke explains that *"As currently constituted, the international monetary system has a structural flaw: It lacks a mechanism, market-based or otherwise, to induce needed adjustments by surplus countries, which can result in persistent imbalances."*

As a result, the mercantilist/beggar-thy-neighbor strategy is especially effective in today's global trading regime. As more countries implement these policies the global economy becomes even more distorted. Without global coordination, countries are likely to follow strategies that increase their share of the pie without increasing the size of the pie.

Beggar-Thy-Neighbor Policies around the World

Japan in the 1970s and 80's implemented their "investment growth model", which China later adopted. The Chinese, like the Japanese, investment growth model is a set of policies that taxed consumption and subsidized production in order to increase the competitiveness of Chinese industry. Of the policy distortions ("supply-side" policies), currency undervaluation receives most of the attention but financial repression is a far more important source of the transfer of wealth from households to the government and businesses. The source of financial repression in China is the incredibly low level of interest rates relative to nominal GDP. Through government control over the banking system China keeps interest rates well below the natural level. Over the last decade China nominal GDP grew by 15% annually, while interest rates averaged just 6%. Chinese households have very few options for savings but the majority of savings is in the form of deposits in the banking system. Therefore, the government forces Chinese households to accept a lower return on their savings while giving Chinese businesses a much lower borrowing rate. According to the IMF, this has led to a transfer of wealth from the private sector to producer's equivalent to 5% of GDP annually.[3]

As a result of China's policy distortions, the Chinese economy has become the most unbalanced in history. In 2011, Chinese consumption as a percentage of GDP reached the lowest level ever recorded, in any economy, at 34% (the global average is 65%). Chinese consumption is not low because of high household savings rates, it is low because it has the lowest income share of the economy ever recorded. The low-income share of the economy is a direct result of policies which effectively taxes workers income and subsidizes producers.

Another form of "supply-side turned mercantilist" policy is to suppress wages. Wage suppression is an obvious tax on domestic consumers and subsidy to domestic producers. The use of wage suppression as a mercantilist policy is exemplified in Germany. 2003-05 Hart Labor reforms were highly successful in

[3] We have heard commenters claim that the United States has financial repression; however, this is false. Over the past 30 years, US 10 year interest rates have been on average 0.5% below nominal GDP. Even today, 10 year interest rates, are less than 2.5% above nominal GDP, less the 3.5% average during the 1960s-80s. Further, unlike China, the US has an open capital account which prevents financial repression because households can take their money out of the country and invest in other countries with higher returns.

suppressing German wages. Germany, also benefits from an undervalued and fixed currency relative to their trading partners – in Southern Europe (much more so than China) as a result of the common Euro currency. As a reminder, an undervalued currency reduces real wages – which reduces real domestic consumption – subsidizes domestic producers – as goods produced domestically become cheaper relative to their foreign competitors.

Wage suppression and an undervalued currency resulted in a massive transfer of wealth from German consumers to German businesses in the form of soaring profits. German savings rose, as expected; however, investment actually declined. A country's trade balance is equal to savings minus investment; thus, increasing German savings and declining investment lead to a dramatic improvement in Germany's trade balance.

Just prior to the introduction of the Euro, Germany was running a trade **deficit** of almost 2% of GDP and had not run a trade surplus in a decade. Today, Germany's trade surplus of 8% of GDP – one of largest trade surplus ever recorded from a major economy.

Over the past two decades German GDP has soared despite weak domestic demand. Their growth has come as a result of siphoning demand from the rest of the world.

A recent report from Breugel, a Belgian economic think tank, showed that the real difference in competitiveness between Germany and Southern European countries, like Italy, was not in what we think of as labor costs but in the share of national income going to the corporate sector. The fact is that countries that run large trade surplus almost always do so because of domestic distortions in the distribution of income.

The important point is that policies such as financial repression, wage suppression, and tariffs will increase domestic competitiveness but reduce global growth. Any benefit a country, like Germany, receives from these policies is always at the expense of another. When these policies are enacted around the world it becomes a race to the bottom. The defining characteristics of today's economy - deflation, depressed return on investment, falling interest rates, low productivity growth, weak demand, and financial asset bubbles – are all a direct result of these supply-side turned beggar-thy-neighbor policies that have escalated around the globe.

The Inevitable Decline of Globalization

It is assumed by most that the move to a more globalized economy is the inevitable evolution of an increasingly "shrinking" world. But history shows us that globalization is a cycle which rises and falls despite the continued advancements in technology. And just as it has many times before, globalization will decline. In

fact, we are almost certainly at the start of a long period in which the United States will increasingly pullback from the world.
The only hope to save globalization is for a sudden increase in global coordination. However, we find this scenario highly unlikely for a number of reasons, least of which is the lesson of history. As Jeffry Frieden explains,

> *"The second lesson of the collapse of the classical version of globalization is that national governments will be unable to undertake the measures needed to sustain an open economy if they do not have the support of their constituents. Many of the major powers of the 19th century were at least partially undemocratic; they did not need to answer to the demands of the middle and working classes."*

By the end of the 1920s, almost every major power was democratic. It is not a coincidence that it coincides with the breakdown of the last globalization cycle.

President Trump's tariffs are not terribly significant from a purely economic perspective. The distortive effects pale in comparison to the policies that have been implemented around the world for decades. Trump's tariffs are significant because the rest of the world's beggar-thy-neighbor strategies required the United States to sit back and allow countries to steal US demand in the form of persistent, large trade deficits. After decades of shouldering the burden of the persistent trade deficits, the US middle and working class has finally had enough. Donald Trump is not the cause of the trade war, he is the result.

The motivation for Donald Trump's trade policy is that he correctly identified the opportunity to appeal to the discouraged American working class. However, nothing in his actions show that he understands the issue. From President Trump's perspective, the trade deficit is a result of bad trade deals. Thus, his attempts to rectify the situation have focused on renegotiating existing trade deals: China and the WTO, NAFTA and GATT.

The president fails to understand that "improved" trade deals will not reverse the US trade deficit because the trade deficit is a structural result of a flawed global monetary and trading system. Only a retreat from globalization or a complete restructuring of the global trading regime will reverse the United States' trade deficit.

Economic Outlook

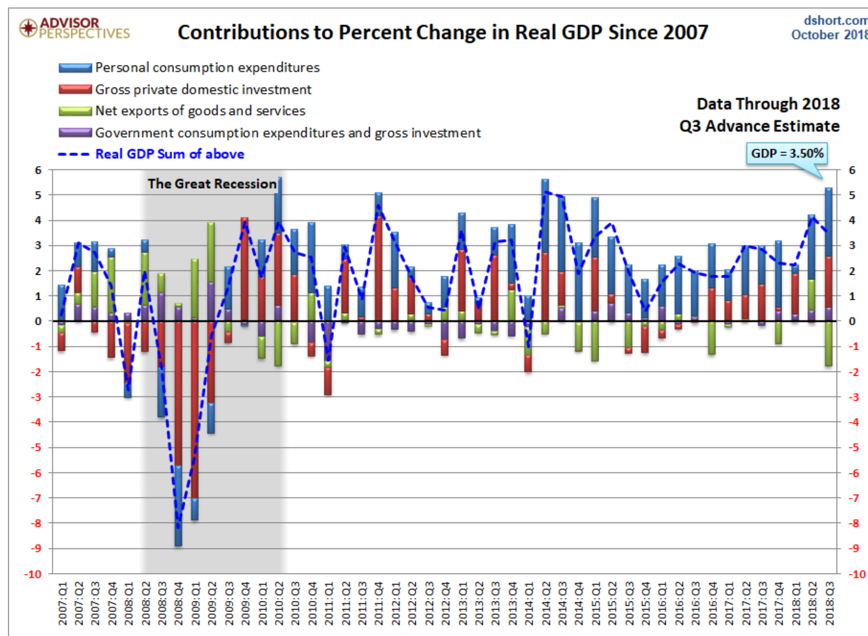
By Katie Richard

Despite market volatility and ominous headlines warning that the end is near, the U.S. economy has been exceedingly strong with healthy job & wage growth, low inflation, and high levels of business & consumer confidence. While there is a lot of conversation about when the next recession will begin, we believe the outlook for the next year is positive, but risks are rising. We remain vigilant at looking for indicators of a downturn. We lay out below why we feel cautiously optimistic that there is more room to run in this cycle; however, we feel that continued expansion will likely be more measured as we near the later stages.

As we have mentioned in previous updates, this cycle has been unique in that it is one of the longest recoveries in history, and we should not fear that a cycle will die from old age alone. In the past, there has been a trigger that leads to an economic shock, including commodity price spikes, overheating in cyclical sectors, and Fed mistakes on monetary policy. The economy has been able to persist in this expansionary period for so long because it has yet to experience a true boom/bust dynamic. We continue to monitor economic segments for what may become the culprit for the next recession, but at this time, there are no clear "excesses." With the economic data releases mentioned by segment below, we point out that none of the indicators that we follow are indicative of a looming recession at this point in time. While we are mindful of the slowdown facing global economies, we argue that the probability of a near term recession is low with the current solid U.S. economic climate.

GDP Growth

Figure 1: Contributions to Percentage Change in GDP



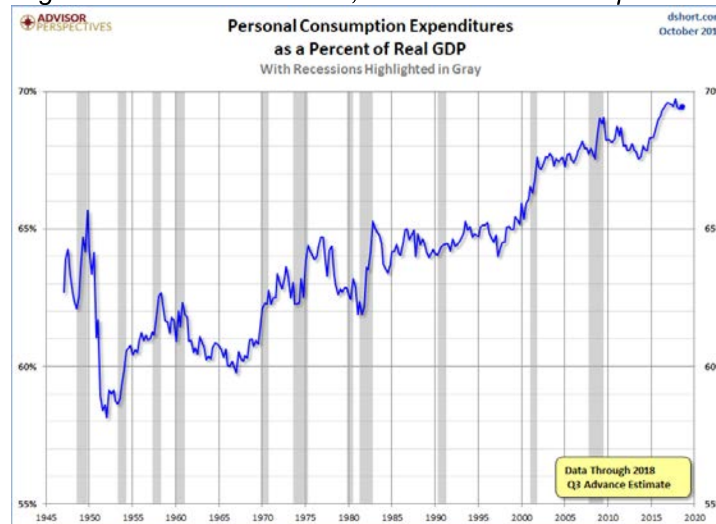
According to the second estimate by the Bureau of Economic Analysis (BEA), GDP increased 3.5% in the third quarter of 2018, which was down from the 4.2% growth in the second quarter but still ahead of expectations. In the last two quarters, the US economy has seen its strongest back-to-back quarters of growth in four years. As shown in Figure 1, personal consumption expenditures (PCE) continued to drive an increase in its percentage of GDP growth for the quarter coming in at 68% of GDP growth. Private inventory investment was strong this

quarter, and, continuing its gradual growth this year, government spending continues to modestly contribute to overall GDP. Residential investment continues to hamper growth while nonresidential investment struggles to offset housing's decline. While aiding results last quarter, trade was a drag on the economy in the third quarter amid trade disputes as we saw a downturn in net exports driven by a sharp increase in imports. We see the economy continuing on a steady path of growth moving into 2019, albeit at a slower pace than this past year.

The Consumer, Employment & Wage Growth

Consumer demand continues to be a key driver of the economy. As of October, the Conference Board's consumer confidence index, known for its leading qualities, was at cycle highs of 137.9. In November, it fell slightly to 135.7, although sentiment regarding current economic conditions actually rose. As mentioned above, consumer spending has continued to be strong and remains a solid contributor to the positive changes in GDP. A healthy job market, coupled with strong consumer confidence and the stimulus from the tax cuts, continues to support consumption despite market volatility and trade tensions. Real consumer spending came in at 4% in the third quarter, which drove an overall 3% increase year over year. Over time, the personal consumption expenditures component of GDP has been the most consistent correlation to real GDP growth. As shown in Figure 2 below, the PCE-to-GDP ratio continues its long term path upward, and the ratio of 68% is just off its recent high. Consumption drivers including real income growth and banks' willingness to make loans continue to remain supportive of consumer spending. With declining oil prices and prospects for higher tax refunds on the horizon, consumer spending should continue to trend upward as this year ends. However, we do expect consumer spending as a percent of real GDP to moderate into 2019, which in accordance with the above-mentioned correlation suggests overall real GDP growth could slow.

Figure 2: PCE-to-GDP Ratio; Source: Advisor Perspectives



The labor market remains tight as employment numbers continue to come in strong. The October employment report showed an increase of 250,000 in total nonfarm payrolls with unemployment remaining at 3.7%. As shown in Figure 3, nonfarm payroll growth has increased an average of 216,000 per month over the last six months with the twelve month moving average trending up slightly. Unemployment claims remain close to a five-decade low; however, in the week ending November 17, unemployment claims rose +3,000 to 224,000. The weekly indicator tends to be volatile due to holidays, natural disasters or weather, but we have also seen the four week moving average turn up to 218,500 as seen in Figure 4. With the volatility in claims, we use a three month average to look for any trends, which shows unemployment claims remain very low but have stopped declining.

Figure 3: U.S. Nonfarm Payroll Growth; Source: Cornerstone Macro

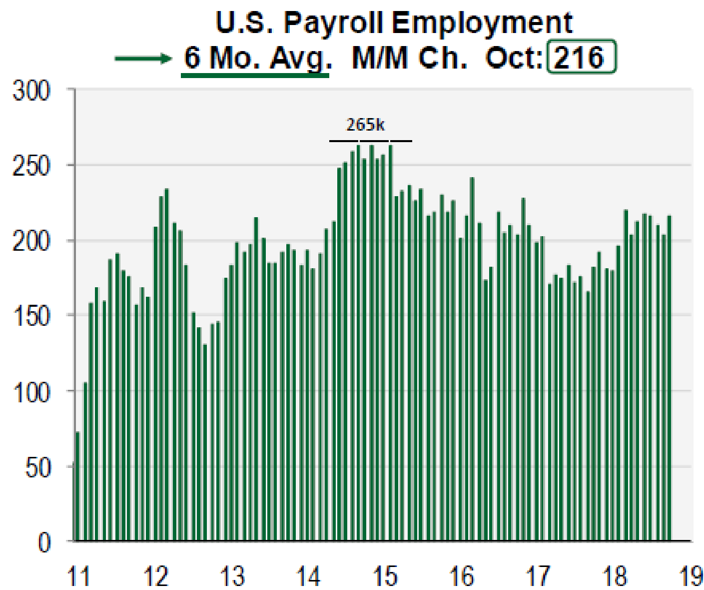
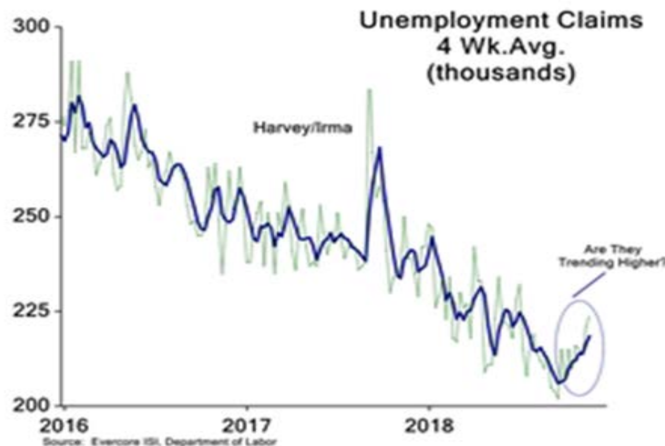
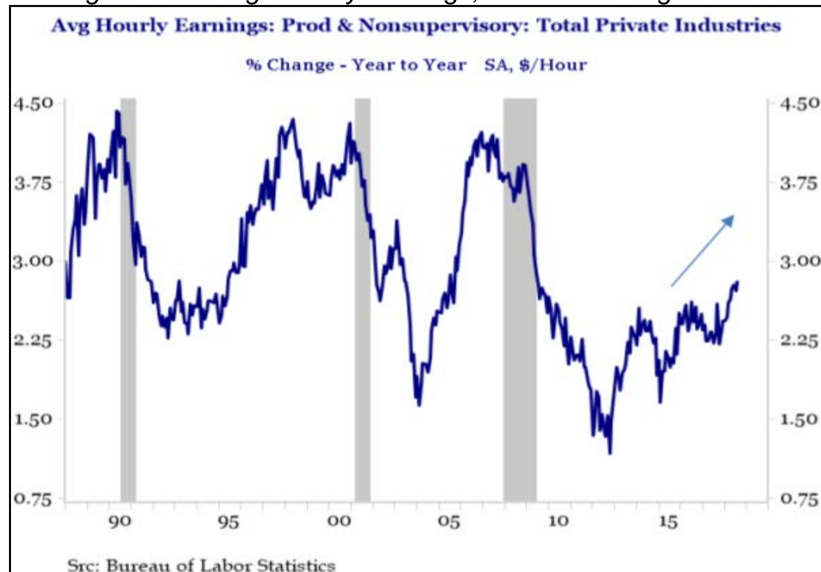


Figure 4: Weekly Unemployment Claims Report; Source: Evercore ISI



At these levels of employment, wage inflation was inevitable, and we continue to see the tightening labor market put upward pressure on wages. The Atlanta Fed wage tracker surged to 3.7% year over year in October, and the NFIB's wage survey remained in record high territory. While we need wage strength to support the continued health and momentum of the U.S. consumer, we monitor average hourly earnings (AHE) for overheating labor cost growth. As shown in Figure 5 below, historically when AHE growth crosses 4%, a recession is typically 2 years away. The hourly earnings increased in October 3.1%. While we are not close to 4% at this time, we caution that AHEs tend to accelerate quickly later in the cycle.

Figure 5: Average Hourly Earnings; Source: Strategas



Residential Investment

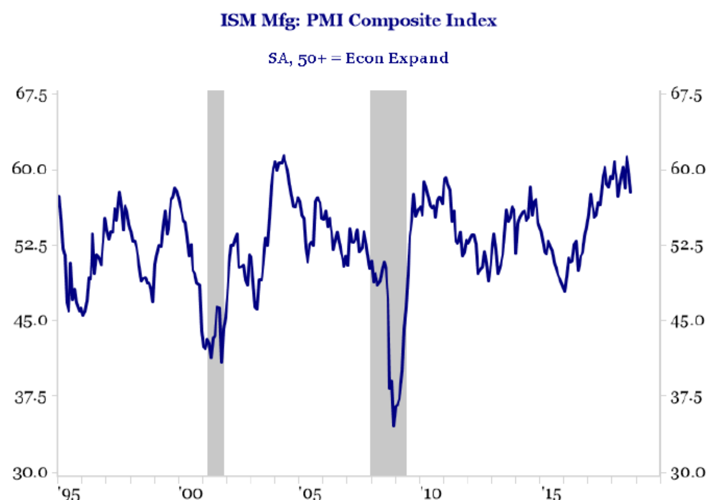
The housing sector continues to be an area of concern. The housing market remains tight and continues to put upward pressure on home prices. Housing investment fell 4% this quarter, which marked its third straight quarter of decline. Residential investment releases continue to come in weaker than expected with sluggish mortgage applications, falling demand in new & existing home sales, and a drop in October's National Association of Homebuilder's (NAHB) survey. While housing has been a laggard this year with affordability constraints and tight inventory, we don't expect housing to be a significant source of late cycle strife as households have largely de-levered since the housing crisis with mortgage debt as a percentage of GDP continuing to decelerate. While we do not expect housing to meaningfully boost GDP in the coming quarters, we are hopeful that housing demand and supply will eventually pick up and no longer be a detriment to growth. In fact, we saw a glimmer of hope in October's existing home sales numbers with an increase of 1.4% driven by both single family and condo sales. Further, while inventories are still tight, they are starting to tick higher. While this likely will not buck the declining trend permanently, it is encouraging to see a positive data point after seven months of declines. With housing inventory creeping back up, slowing house price inflation and continued solid wage growth, some buyers may be

stepping back into the market. However, we are mindful that rising rates and fear of the next recession will likely keep demand depressed. The gradual rate hike trajectory continues to be very important for any improvement here.

Corporations, Productivity and CAPEX

According to the ISM, economic activity in manufacturing and services slowed in October but is still directionally growing as demand remains strong. As shown in Figure 6, October PMI registered 57.7 percent, which was a decrease of 2.1 percentage points from September, but marks the twenty-sixth consecutive month of expansion according to the diffusion index.

Figure 6: ISM Manufacturing; Source: Strategas



With continuing tailwinds from tax relief and freedom from regulation, small business are thriving. As shown in Figure 7 on the next page, small business optimism has continued its two-year streak of highs with its October reading at 107.4. Small business owners have opined that they are using this current period to expand and invest more in inventory while seeing record high sales figures. While business confidence is up generally, we saw a loss of momentum in CEO confidence with the Chief Executive's Magazine's CEO confidence index down almost 9% year over year driven by concerns over the trade war and rising interest rates. Small businesses have been one of the driving forces behind growth and addition of new employees in the rapid expansion phase, and their continued success will be important in extending this cycle.

Figure 7: NFIB Small Business Optimism Index; Source: Evercore ISI

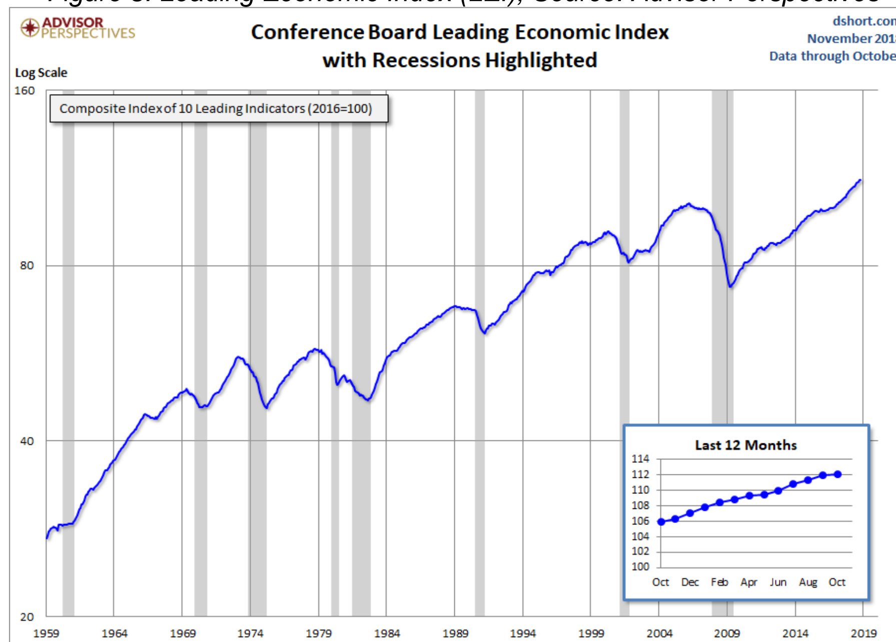
Corporate profits are a reliable leading indicator as they tend to peak an average of four quarters prior to that of GDP. Before the last two recessions began, corporate profits rolled over 2.5 years prior to the start of the recession. As of the third quarter, corporate profits were up ~19.4% year over year and show no signs of rolling over. We also saw productivity increase again for the third quarter 1.3% year over year. With profits and productivity up as well as continued stimulus from corporate tax relief, we saw that the CAPEX component of GDP increased just .99% q/q in the third quarter. While this sparked a fear of a broader decline in CAPEX spending moving forward, we believe it is too early to call an end to the CAPEX cycle and note that it was still up 6.4% year over year. We believe that many large cap companies in the S&P, notably the tech sector, increased their CAPEX dramatically earlier in the year and began favoring buybacks in this last quarter. However, we actually saw a pickup in smaller businesses, who use almost 100% of their excess capital for CAPEX. We expect these numbers to converge and see the slowed pace of growth in the third quarter as mostly noise. Leading drivers of growth, including after-tax profit growth and banks willingness to make C&I loans, continue to be supportive of a sustained CAPEX cycle. Further, we continue to see a secular move of global investment away from China into the U.S. and other countries as supportive. So far in the fourth quarter, October core durable goods orders were flat relative to September and indicate that CAPEX spending is off to a slow start. However, durable goods are prone to upwards revisions. BAA spreads, the dollar, and declining oil prices may continue to be incremental headwinds. However, we expect corporate tax cuts and full CAPEX expensing will support a CAPEX growth rebound, and we anticipate that CAPEX will be a meaningful percentage of GDP into 2019, which is crucial for sustained productivity gains and potential GDP.

LEI

The Conference Board Leading Economic Index (LEI) for October remained virtually unchanged, increasing only fractionally to 112.1 from 112.0. While the pace of improvement slowed this month, it is notable that the index still increased, further evidencing consumer expectations for business conditions are still high

offsetting the declines and volatility in the equity markets. For the six-month period ending October 2018, the LEI increased 2.6%, which is slower than the growth of 3.2% seen the prior six month period. The upward trajectory seen this year indicates continued growth into 2019. As shown in Figure 8, the reading would suggest no near-term recession risk with the LEI still advancing.

Figure 8: Leading Economic Index (LEI); Source: Advisor Perspectives



Inflation, Rates and the Yield Curve

The “inflation-is-coming” narrative is starting to fizzle as actual inflation, while moving up, remains muted. As seen in Figure 9 on the following page, the Consumer Price Index (CPI) increased .3% in October for a 2.5% increase over the last twelve months. With an increase in the gasoline index responsible for almost one-third of CPI, we saw the October core CPI was only up approximately .2% leaving the twelve-month change at 2.1%, and it is not accelerating as some had feared. As shown in Figure 10, core readings, including the core PCE index, the Fed’s preferred measure of inflation, have actually slowed down and will likely slow further in the last two months of the year. The effects of technology, competition and globalization continue to put downward pressure on inflation. With retail gasoline prices already declining 30 cents this month and futures indicating another 40 cent decline, we expect CPI numbers to be flat in the last couple of months of the year. We continue to monitor data releases for signs of higher costs from tariffs being fed into pricing; however, it seems like lower oil prices will continue to mostly offset price pressures form higher tariffs at this point.

Figure 9: Consumer Price Index (CPI); Source: Advisor Perspectives

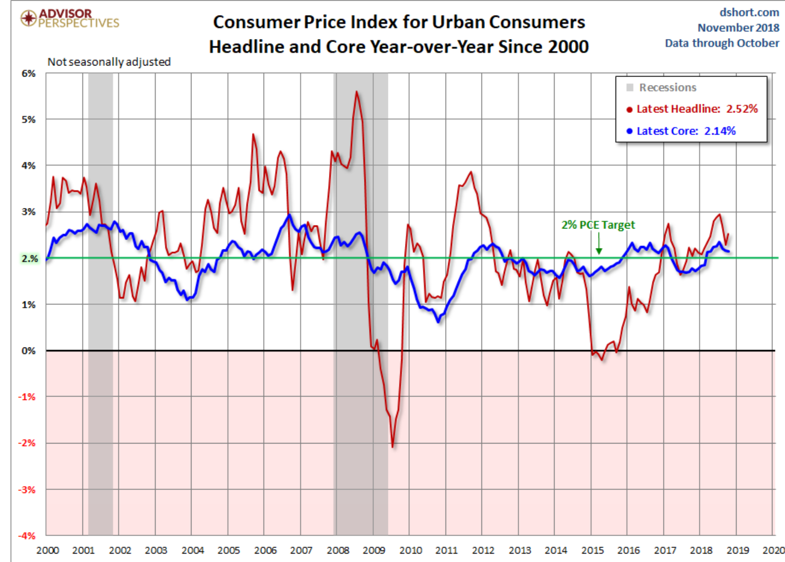


Figure 10: PCE Deflator; Source: Evercore ISI

In conjunction with inflation, investors often worry about missteps in monetary policy. When Fed Chair Jerome Powell made a comment in early October that we were far away from neutral, his seemingly hawkish stance sparked a scare in equity markets, which ignited a broader selloff. He has recently taken a step back in his language and maintains that the Fed's goal is to extend the economic expansion while maintaining stable inflation. They believe economic growth must slow, and unemployment needs to stabilize in order to maintain acceptable levels of inflation. With the current backdrop, most investors are increasingly building in a pause in the fed's previous rate trajectory expecting only two hikes in 2019 compared to the three that the Fed dots currently forecast. We are cautiously optimistic that the Fed is properly assessing all risks and will be careful not to overshoot.

In addition to inflation & monetary policy concerns, investors continue to watch the shape of the yield curve. As we have previously written, a negatively sloped or inverted yield curve can be another warning signal for declining future growth prospects. We have already seen the effects of low yields abroad weighing on the U.S. 10Y yield and have seen the 2-10 year spread narrowing. We are mindful to watch for signs of inversion and exactly what it will mean for the cycle this time around, but note that inversion does not mark the immediate end of the cycle.

In summary, despite high anxiety in capital markets, there is little evidence that we should be overly concerned with the economy at this time. We remind our readers that late stage doesn’t mean the end of the cycle, and the current expansion can still run for longer. We will continue to monitor any stress factors as they emerge but see nothing indicative of an imminent downturn, and we remain upbeat on the US economy heading into 2019.

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Nick Prillaman

At our previous meeting, risk assets were rising in tandem with interest rates. For the month of September, the S&P 500 rose 60 bps while the Dow Jones Industrial Average surged 2.0%. On the interest rate front, the yield on the 3-month Treasury bill popped 18 bps higher while the yield on the 30-year Treasury bond tallied a 12 bp rise. The across the board move higher was driven by "strong wage data, very healthy ISM numbers, higher oil prices, an escalating trade war with China, heavy corporate supply volumes, Fed QT(quantitative tightening), and we would add increase USD Libor in the second half of the month, which put upward pressure on the cost of dollar hedging for foreign investors" per BofA Merrill Lynch. On September 26th, the Federal Reserve hiked the target rate by a quarter point as expected. It also raised its longer-term dot plot projection to 3% which UBS's Seth Carpenter said, shows "an FOMC that plans to hike past neutral and send the funds rate into modestly restrictive territory." The Fed simultaneously dropped the "accommodative" language in its statement which some market participants viewed negatively.

Spread products outperformed in this risk-on environment. Agencies returned a negative 41 bps while mortgages posted a negative 59 bp total return versus the negative 98 bps for Treasuries. High yield corporates were stellar performers at 58 bps while high grade bonds at a negative 33 bps also beat Treasuries. High grade new issue volume was robust at $145.1 billion as this was up 8% year-over-year per BofA Merrill Lynch. Spreads compressed broadly over the ratings spectrum with CCC-rated bonds tightening 46 bps and AAA-rated credits coming in 8 bps according to CreditSights.

While investors were loving the risk-on trade in September, October proved to the complete opposite as upheavals occurred in numerous markets. For example, the S&P 500 dropped a precipitous 6.84%. BofA Merrill Lynch said, "The triggers included a jump in interest rates early in the month followed by weaker 3Q results and guidance from a few bellwether companies as well as soft foreign economic data and development in in various macro risks including trade war, Italy's fiscal challenges, Brexit and Saudi Arabia." The selloff in interest rates primarily occurred on October 3rd as the yield on 30-year Treasuries surged almost 12 bps and the 5-year yield rose 9 bps. These were large moves though a number of issues were able to retrace all or the bulk of the interest rate move by the end of the month as investors sought shelter from the storms in other markets.

Beyond Treasuries, most fixed-income securities saw material spread widening. The exception was agency sector where the Credit Suisse Agency 3-5 Year Index barely leaked wider by less than a basis point. The 30-year Fannie Mae mortage index versus the 5-year Treasury rose 16 bps. In investment grade corporates, Wells Fargo Securities said the sector widened by 12 bps and posted a total return of negative 1.5% as "industrial- and commodity-weighted sectors were under

notable pressure amid heighted trade concerns and declining oil prices." Oil Field Services was the worst with a negative excess return of 187 bps. In high yield bonds, spreads rose 55 bps and registered a negative 1.6% total return. Like their investment grade brethren, Oil Field Services was the standout laggard at a negative 4.76% total return per Wells Fargo. On the supply front, $96 billion was issued in the month among high grade names. This was down 25% year-over-year which Bank of America said was "driven partially by significant equity volatility."

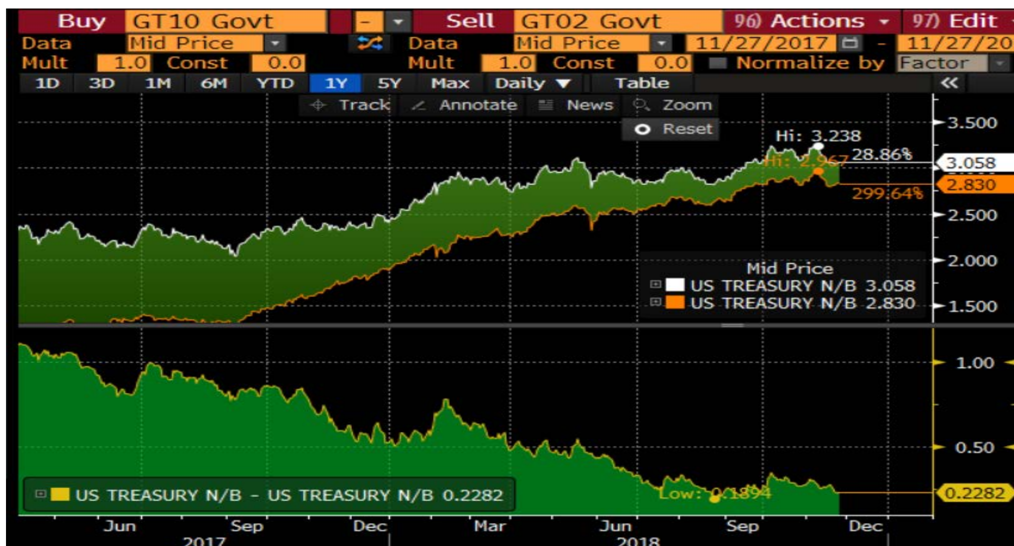
Volatility has continued in November for the financial markets. In the first part of the month, the S&P 500 staged a relief rally with Treasury yields rising as well. The biggest move came on November 7th when the S&P 500 surged 2 percentage points "as investors bet a split Congress dimmed chances President Trump's signature tax cuts will be reversed while reducing the possibility of major fiscal initiatives that might have pushed up interest rates" per Bloomberg News. After that day, pessimism began to reign and the S&P 500 tumbled 6-plus percent to the end of Thanksgiving week which CreditSights said was largely due to "the oil price slide and valuation concerns." The 2-year Treasury yield declined 15.5 bps while the 10-year yield fell almost 20 bps during that time.

Government-related bond performance has been mixed. The Credit Suisse Agency 3-5 Year Index has tightened by essentially one basis point while the 30-year mortgage index versus the 5-year Treasury has widened by 3 bps. Corporate bonds have been weaker. As of the end of Thanksgiving week, high grade bond spreads have risen by 13 bps with BBB-rated securities fairing the worst with 18 bps of spread expansion. So far, high grade has lost 28 bps in total return for the month while high yield has lost 1.62 percent per CreditSights.

Over the last few months, we have made a number of adjustments to the fixed income portfolio. In Treasuries, we added two new positions. We felt it was a prudent adjustment to increase our weighting in the asset class and raise our duration as we have been underweight Treasuries and short duration versus the index. In considering the next move in interest rates, one must wonder if a change in the trend of interest rates is in the offing given the wave of pessimism that is prevailing in the markets. The odds appears favorable for the Treasury market to experience either a large consolidation or a bigger relief rally. As seen in the chart on the next page, the uptrend in the 2-year Treasury has been robust over the past year. The strong economy which was boosted by Trump's $1.5 trillion tax cut combined with the Federal Reserve raising its target rate 3 times in 2018 to 2.25% has contributed to this surge. The Fed is expected to raise rates again in December with the probability of a December hike currently standing at 77% on Bloomberg.

Source: Bloomberg

Beyond December, the rate hike probabilities are worse than a coin flip. There is 38.8% chance of a raise in March to 2.75% on Fed Funds with a maximum probability of 40.9% by June. The market seems to be doubting the future pace of the Fed. This is not surprising as initially, rising interest rates were of somewhat little concern to market participants, but recently, the move seems to be causing problems for risk assets. The stock market has moved sideways for almost a year and is off 9% from the top. Credit spreads are starting to blow out, and commodities have struggled. This environment seems ripe for the Federal Reserve to reassess the durability of the economic expansion and slow the pace of its rate hikes. If the Fed does pause for a period of time and a recession is avoided, the 2s/10s Treasury curve should oscillate sideways. It has actually already started to do that as seen in the chart below. If the Fed ignores the current upheaval and continues with their interest rate normalization scheme, financial product returns could be further hampered.



Source: Bloomberg

In the agency sector, RSA completed various trades. One was a swap out of a 2-year Fannie Mae and purchased a 2.25-year Federal Home Loan Bank bond to pick up several basis points while only extending a quarter of a year. It also provided a much more attractive coupon. Another swap was performed where we sold an April 2026 Fannie Mae issue and bought a Federal Farm Credit note which added 9 bps in yield with a 5 month shorter maturity. Our view in this space is fairly benign as we don’t see major spread movements occurring. We will continue to maintain our weighting while always being on the lookout for attractive swap opportunities like the ones discussed above. Currently, our duration is on the short side, but are looking to tighten with that of the index on the account of Fed uncertainty.

Multiple mortgage trades were executed since our last meeting. RSA swapped out of two 10-year 3% coupon Fannie Mae mortgages and bought two 30-year 4% Fannie Maes. The trade was done to pick up yield, improve the carry of the mortgage portfolio, and to realign the types of securities within RSA’s mortgage portfolio to better match those of the benchmark. We estimated given various prepayment assumptions that the yield improvement was at least 33 bps for a less than 2.5 year extension in average life. Another trade with a similar rational plus a desire for more duration was also performed. In this case, 15-year 3% Fannie Maes were swapped into 30-year 4.0% Fannie Maes for an estimated pickup of 32 bps on a one year duration extension. The final trade was a swap out of a 15-year 2.5% Freddie Mac and into a 30-year 3.5% Ginnie Mae for the same reasons listed above but in a fairly duration neutral manner. The estimated yield pick was around 30 bps. From a total portfolio perspective, we remain underweight versus the index but long duration. We plan on being proactive in regards to duration management and will adjust depending on market conditions.

On the corporate bond front, we participated in multiple new issues including a Comcast 7-year at a spread of 95 bps, a Baidu 5.5-year at 133 bps over the 5-year Treasury, and a Consolidated Edison 10-year at 95 bps over. RSA is overweight corporate bonds versus the index and short duration. Investment grade corporates are currently at an OAS of 131 bps versus the 61 bps for agencies, the 37 bps for mortgages, and the 426 bps for high yield per Wells Fargo. From a long term investment standpoint, investment grade corporate securities offer more yield than government-related securities while not having the massive drawn-down risk of high yield which is why we prefer them. Since the market is in risk-off mode, the near term path of high grade bonds will be bumpy as evidenced by the 38 bps widening in OAS on a year-to-date basis. Overall, RSA should benefit over time by taking on investment grade credit risk.

Domestic Equity Strategy

By Allan Carr

After a slow grind higher over the summer, the S&P 500 hit an all-time closing high within days of our last update in late September. Since then, a confluence of worries resulted in more than a 10% selloff putting us in "correction" territory. The worries included midterm election uncertainty, continued trade disputes with China, slowing growth abroad, and oil price weakness. But the biggest factor in spooking investors was Fed Chairman Powell's hawkish tone on October 3rd in which he suggested interest rates were "a long way away from neutral at this point." The takeaway was that the Fed would be more aggressive than expected and could possibly go too far/too fast and choke out the decade long expansion. Was this the beginning of the end or just another bump in the road that typically occurs during the business cycle? After having time to digest it, we feels it's the latter.

Looking back, this time last year I wrote "we are wary of a pullback as we seem overdue for one, but trying to predict them is usually a fool's errand." At the time, it had been nearly a year and half since we'd witnessed even a 5% drawdown, much less a 10% correction. Since 1980, there was only one year that the S&P didn't suffer at least a 5% drawdown; 1995. Additionally, we were on a 13 month winning streak with the market up every month since November 2016 for a cumulative return of nearly 27.5%. Since 1980, that was the longest streak of positive returns in consecutive months since a 9 month streak back in 1982-83. Needless to say we were in unchartered territory.

Those streaks came to an end earlier this year, but not before the market had ripped another 10.5% to the January 26 all-time closing high. It was an impressive run that served as a reminder it was much more the exception than the norm. (EXHIBIT 1)

EXHIBIT 1

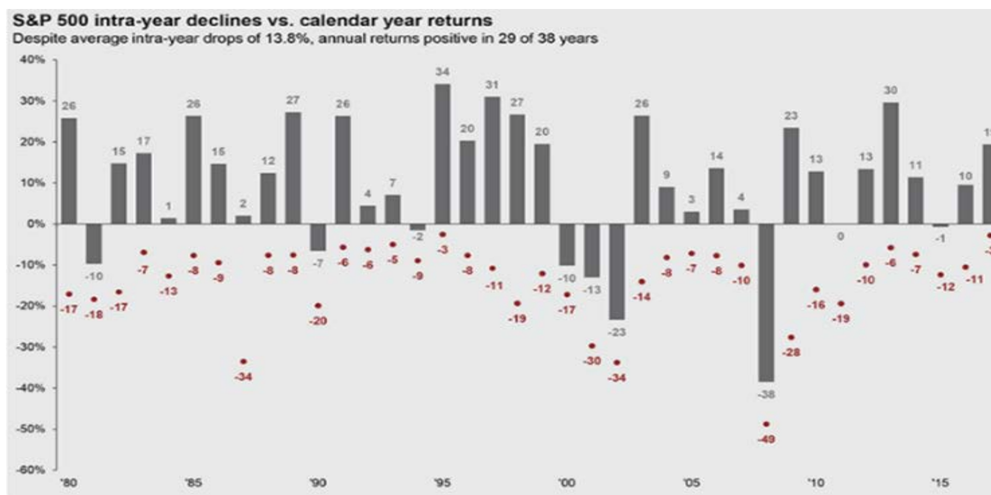


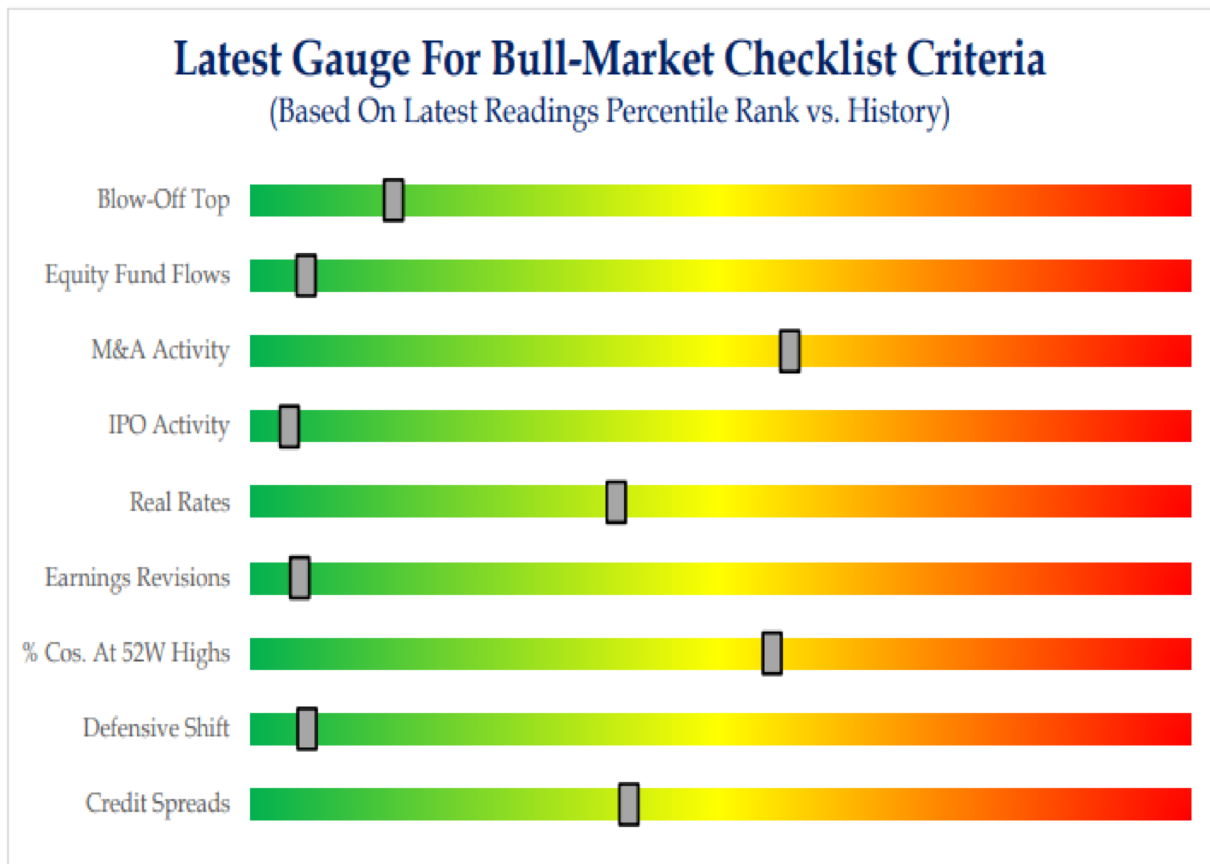
Exhibit 1 from JP Morgan shows the annual price return of the S&P 500 as well the largest intra-year price decline from 1980-2017. Last year joined 1995 as the only year to not experience at least a 5% drawdown. 29 of the 38 years witnessed an 8% or greater intra-year drawdown. The average drawdown was 13.8% with a median of 10.5%. Yet 29 of the 38 years experienced positive price returns. Inclusive of dividends, you could add 1994, 2011, and 2015 to make it 32 of 38 years of positive total returns.

During this 10 year bull-run we've witnessed more than 20 drawdowns of 5% or more. These fits and starts have not been fun, yet each time the market has resumed its march upwards. The conclusion is that while the media makes a huge to-do about them, drawdowns, and even corrections, are common in bull markets.

The U.S. economy still looks quite healthy despite some cooling off in areas. GDP is expected to slow going forward as we anniversary the boost from tax reform, as well as digest more interest rate hikes. This should not come as a surprise and slower growth does not equate to being on the cusp of recession necessarily.

As we have stated many times, economic cycles don't die of old age. They end in recession. As we take the temperature today, we still are not seeing the troubling signposts that typically point to a recession. (Exhibit 2, Strategas).

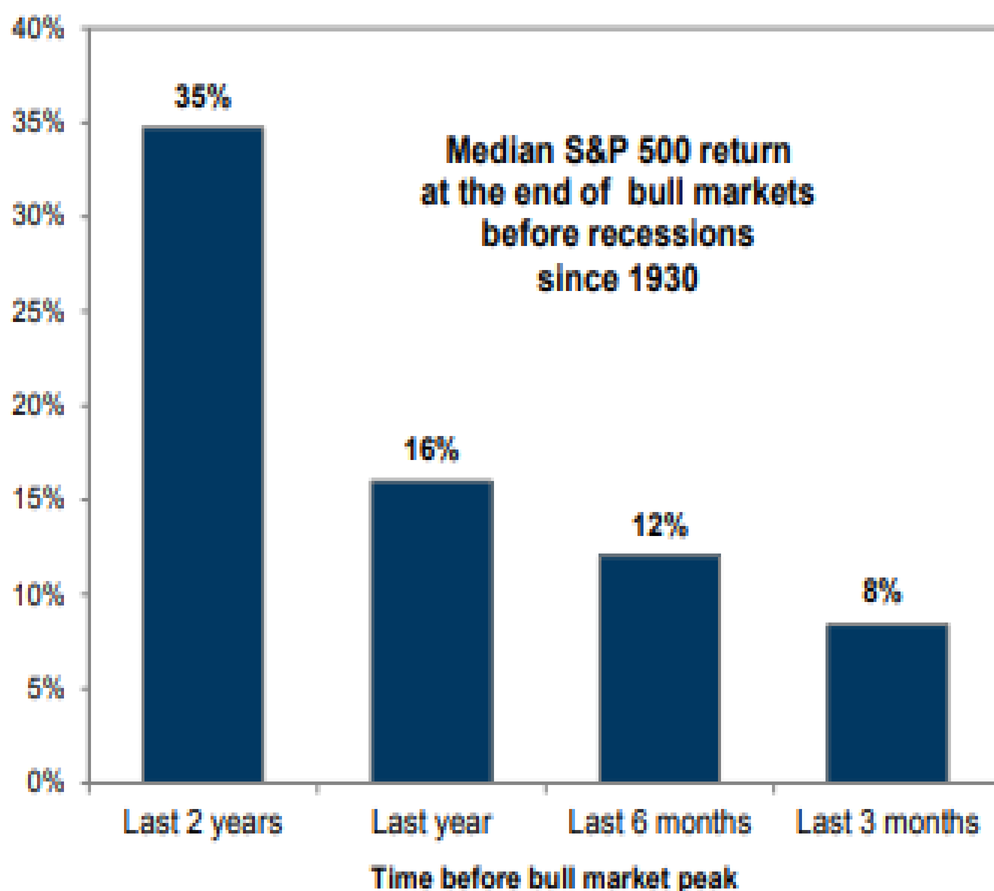
EXHIBIT 2



Goldman Sachs economic models put the odds of a recession in the next two years at 26% and only a 43% chance that one occurs in the next three years. This obviously can change but if a recession were to occur in the next 12-18 months we think it would come via some sort of exogenous shock.

It's worth noting for those calling for a recession that the market does not behave as most people think. Contrary to common belief and intuition, stocks do not slowly fizzle nor have a precipitous fall late in the cycle. Historically stocks have shown robust returns up until the bitter end (Exhibit 3, Goldman Sachs).

EXHIBIT 3



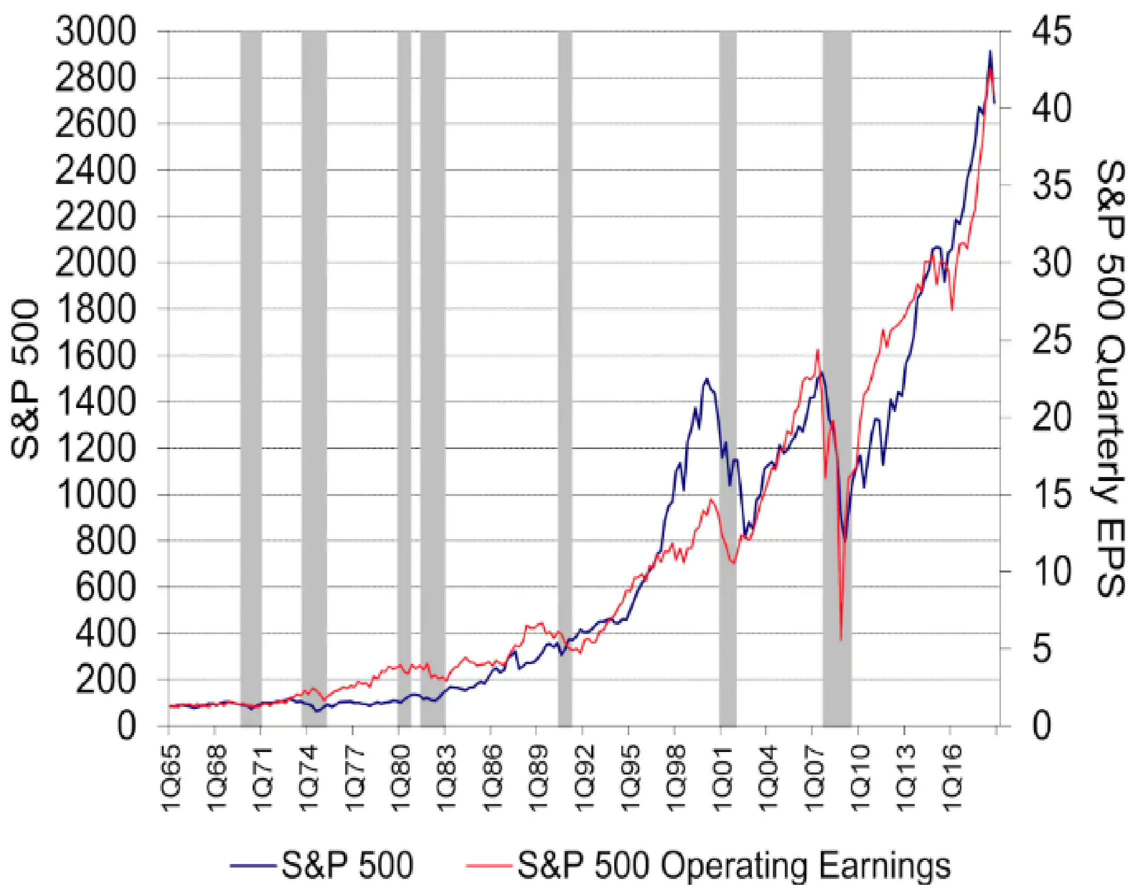
The list of possible culprits that could derail the economy remain much the same as it has been. Trade tension is still high atop the worry list. As we prepare this update, global leaders are assembling at the G20 Summit in Argentina where President Trump and President Xi of China are set to have a meeting. There is hope that they come to a truce, but with this President you never know. Other concerns include Brexit and other European dysfunction, slowing global growth, continued political wrangling, and the omnipresent geopolitical risk.

The latest addition to the anxiety list was not one that had been on many radars; the possibility of the Fed overshooting. A long eight weeks after his October 3rd speech sparked a correction, Chairman Powell delivered a much anticipated

speech to the Economic Club of New York on November 28th. There was some consternation leading up to it although many expected him to soften his tone given the reaction to his prior choice of words, not to mention some choice words from the President following it. In a relief to risk assets, he changed his tone from interest rates being “a long way from neutral” to “just-below” neutral. Markets rallied following the speech with the S&P up 2.3% on the day.

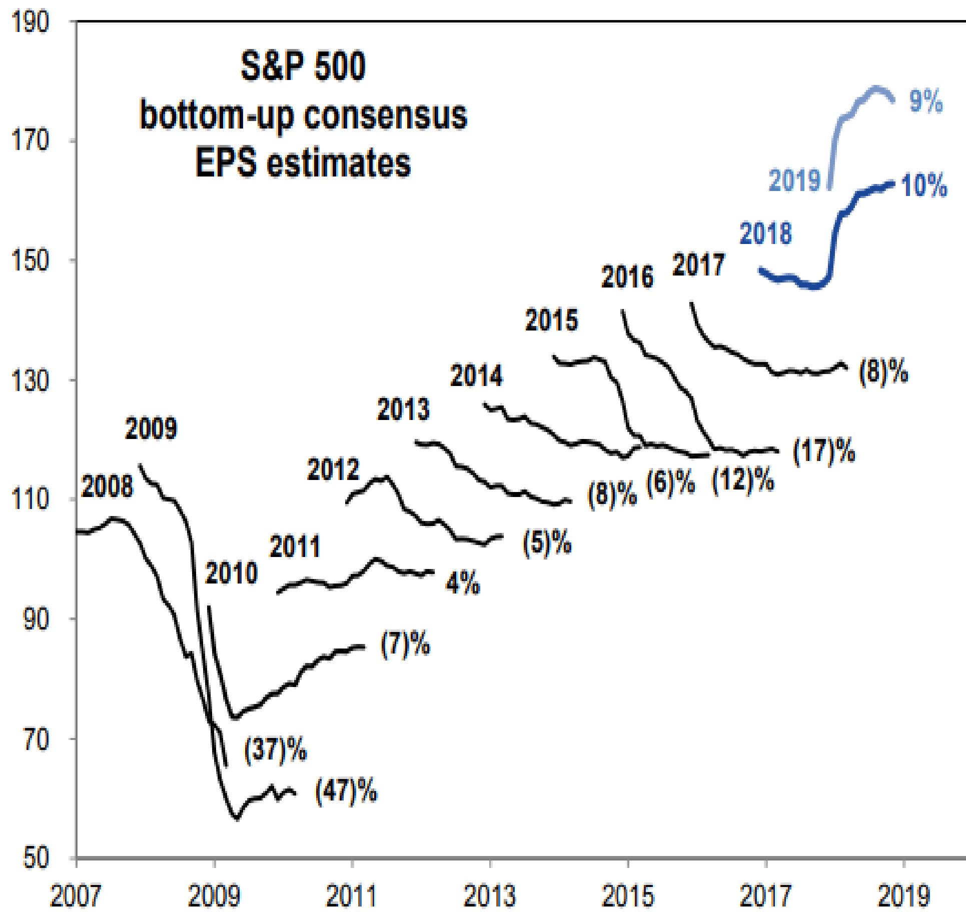
We are cognizant of the potential dangers, but absent one or more of them throwing us into recession, corporate profits are likely to grow. If that holds true, the historical correlation between corporate profits and the market is extremely strong (Exhibit 4, Citigroup).

EXHIBIT 4



2018 proved to be an outlier where bottom-up earnings estimates were actually revised upwards over the course of the year as analysts baked in tax reform. Looking to 2019, earnings estimates are starting to come down to a more reasonable level, following the historical revision pattern. (EXHIBIT 5, Goldman Sachs)

EXHIBIT 5



Top down estimates today are around $172-173 while bottom up estimates are closer to $176. Exhibit 6 from Strategas shows a matrix of earnings estimates and multiples.

EXHIBIT 6

S&P FAIR VALUE
VARIOUS MULTIPLES & EARNINGS

	\$165.00	\$167.50	\$170.00	\$172.50	\$175.00	\$177.50	\$180.00
15.0x	2,475	2,513	2,550	2,588	2,625	2,663	2,700
16.0x	2,640	2,680	2,720	2,760	2,800	2,840	2,880
17.0x	2,805	2,848	2,890	2,933	2,975	3,018	3,060
18.0x	2,970	3,015	3,060	3,105	3,150	3,195	3,240
19.0x	3,135	3,183	3,230	3,278	3,325	3,373	3,420
20.0x	3,300	3,350	3,400	3,450	3,500	3,550	3,600
21.0x	3,465	3,518	3,570	3,623	3,675	3,728	3,780

If earnings come in on the low end around \$170, a 17x multiple still yields more than 5.5% upside. If earnings come in closer to the bottom up estimate of \$176, a 17 multiple would result in 9.5% upside. In the event of investors paying higher multiples, the upside potential could be meaningfully higher.

As we weigh the current environment, we still see upside to stocks barring something unforeseen. 2018 has been a digestion phase after investors got a bit too complacent and optimistic as witnessed by the 15 consecutive months of positive returns. The correction has reset the bar to where valuations are more palatable and earnings revisions set up a scenario where estimates are now more likely to meet or beat than before. Crude is down to \$50, inflation has cooled, and the 10 year is now back to 3% following Powell's tempered remarks. In sum, many do not think the economy is so strong that rates overshoot, nor is it weak enough to think recession is upon us.

International Equity Strategy

By Steve Lambdin

Even though the global equity markets outside of the U.S. performed better in the third quarter vs. the previous period, we still characterize the period as being fairly weak. Investors were concerned with the growing trade tensions between the U.S. and China, rising interest rates in many regions, Brexit concerns, slower growth in Europe, and general fear that U.S. economic growth may have peaked for this cycle. Large cap developed markets stocks managed to post a small gain in the period, while emerging market equities continued their downward trend. These issues continued to push the U.S. dollar higher and wiped away -1% from local market returns in the period. However, at least it was not to the degree we saw in the second quarter. On the trade front, the U.S. has reached agreements with Mexico and Canada with a new version of the North American Free Trade Agreement (NAFTA). We find this agreement as most encouraging with better economics for the U.S. and keeps trade flow going with two of our most important trading partners. However, we have seen little progress on the Chinese trade agreements. Each side continues to propose new tariffs, and further escalation seems highly likely at this point. President Trump remains vigilant in the fight for better trade economics for the U.S. as well as limiting technology drain to the Chinese. Thus far, most U.S. companies have managed the tariff landscape surprisingly well, but the longer this goes on we see it as increasingly difficult to do so. As mentioned previously, the real risk is to supply chain management.

As far as central banks go, we continued to see the major central banks around the globe proceeding down divergent paths. This is nothing new from the last the few months, but still remains a major risk to the global equity markets if such actions result in a major misstep. On the Brexit front, Theresa May seems to have negotiated a deal with the European Union (EU) and is in the process of trying to sell the deal to the other regions and leaders of the country. However, we are not very optimistic this is going well. Many believe she “caved in” to the EU as terms seem to favor the EU over the U.K. A key vote is scheduled on December 11 on this deal.

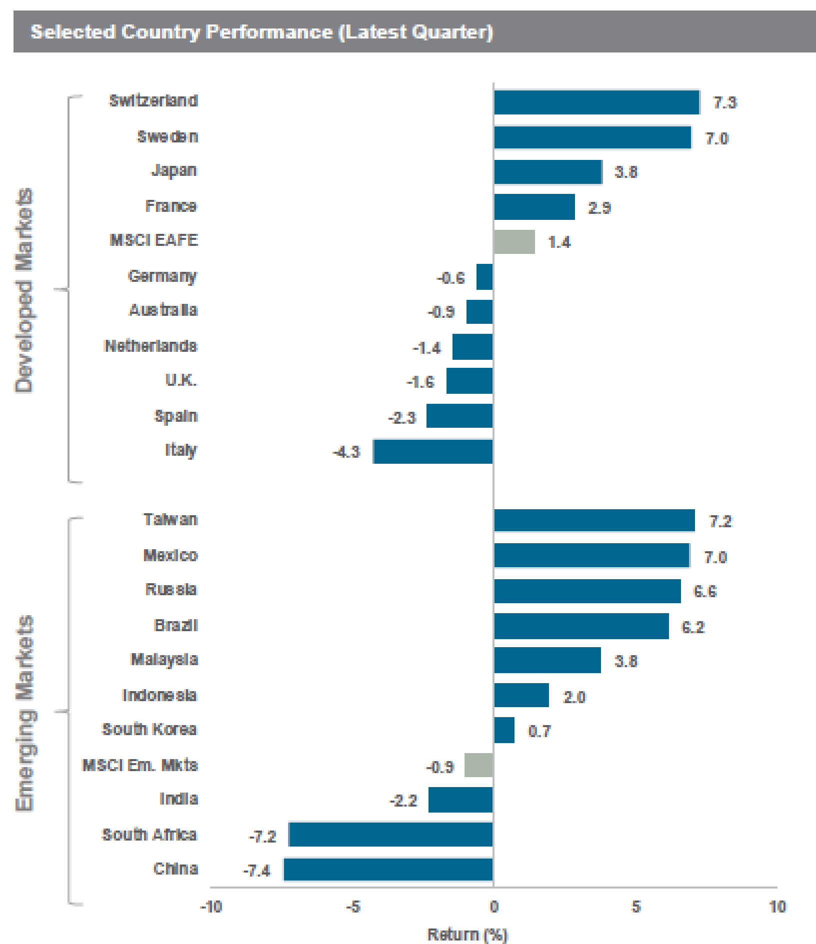
International Market Benchmarks

Equities	Representative Benchmark	Q3 Return	YTD Return
Developed	MSCI EAFE	1.4%	-1.4%
Europe	MSCI Europe	0.8%	-1.9%
Japan	MSCI Japan	3.8%	1.9%
Asia	MSCI Pacific ex-Japan	-0.5%	-2.5%
Emerging	MSCI Emerging Mkts	-1.1%	-7.7%

Performance returns as of 9/30/2018

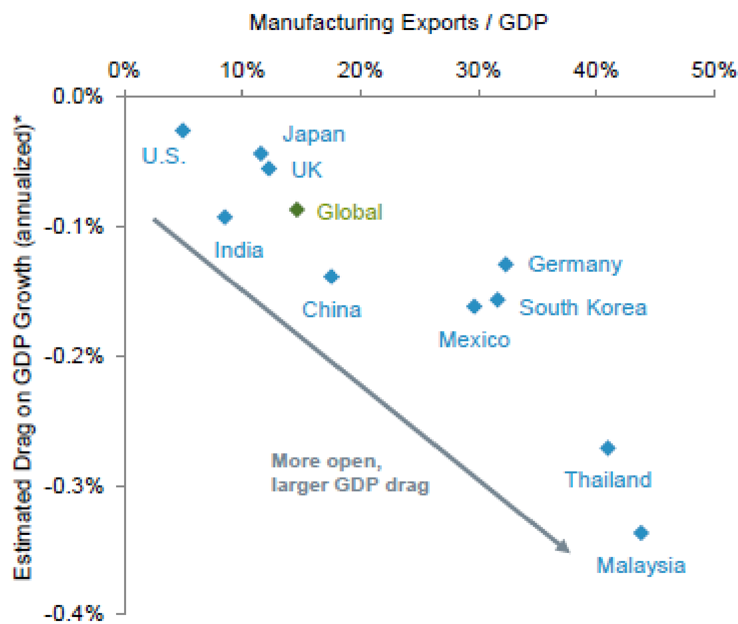
Source: Baird Market Update Q3 2018 Review and Outlook

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +1.4% and -1.1% respectively during the third quarter of 2018 vs. +7.7% for the S&P 500 Index. U.S. stocks significantly out-performed on the strength from quarterly earnings reports and U.S. economic growth. Also, a stronger U.S. dollar trimmed returns slightly for unhedged U.S. investors as mentioned earlier. For the third consecutive quarter, the Pacific region was stronger than the European region, as Japanese equities rallied on the re-election of Shinzo Abe to the ruling Liberal Democratic Party. From an economic sector standpoint, Energy and Health Care again provided the strength, while Consumer Discretionary and Technology were the weakest. Crude oil was somewhat volatile in the period, but rallied in September to finish nearly flat with the end of the previous quarter at $73/barrel.



Sources: Baird Market Chartbook; Morningstar Direct; MSCI

So far the fourth quarter of 2018, global equities have been extremely weak from a multitude of issues: U.S. mid-term elections; slowing growth in several parts of the world; rising interest rates; political issues in Europe; and increasing trade tensions with China. Investors have responded by selling risky assets such as stocks in favor of less risky short term fixed income type instruments. The MSCI EAFE Index is down about -8.3% and the MSCI Emerging Markets Index is down approximately -6.7% through late November, vs. -7.9% for the S&P 500 Index. There seems to be no place to hide in equities around the globe at the moment.

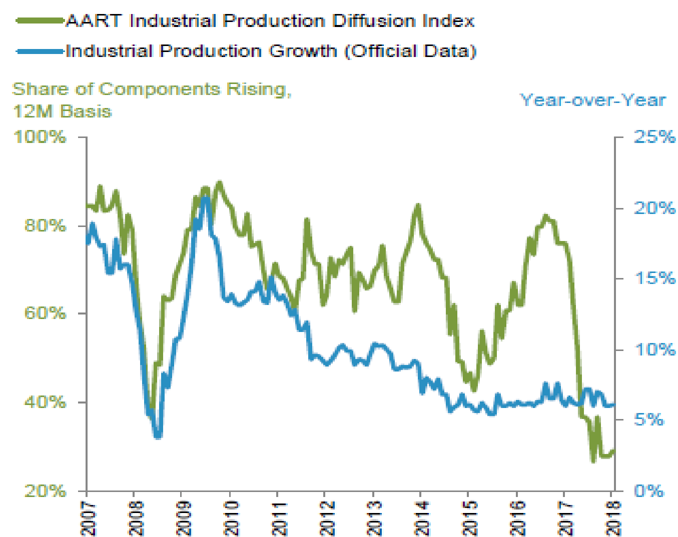


Sources: Fidelity Q4 2018 Market Update; IMF, Haver Analytics

Asia Update

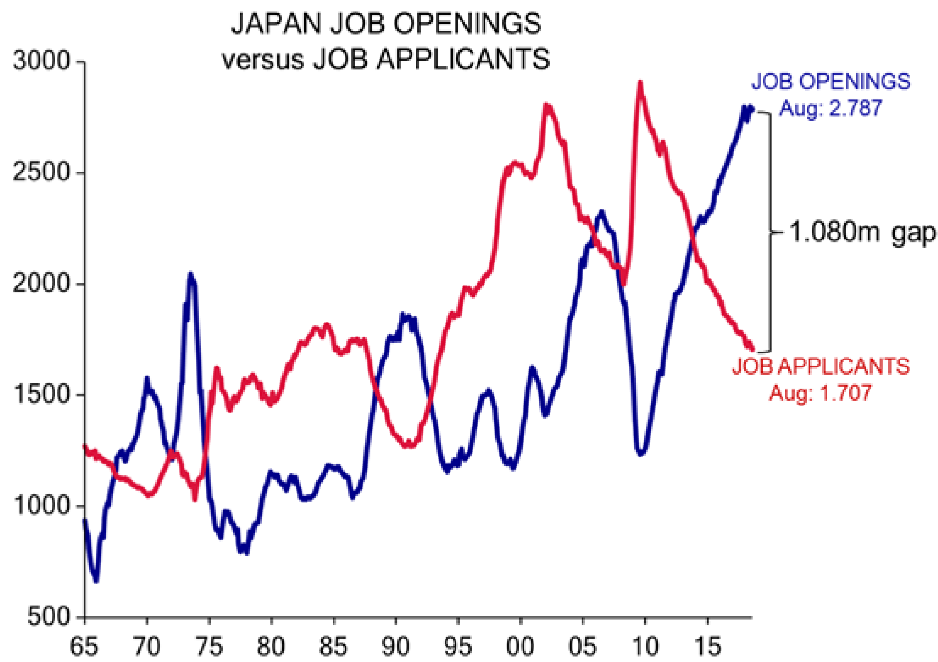
For the first time in three quarters, we finally saw some very marginal positive returns in large cap developed markets. The MSCI Pacific region rose +2.5% in the third quarter, as the Japanese equity market was strong in the period. Investors cheered the re-election of Shinzo Abe as Abenomics looks to stay in place. This brought a bit of business confidence to the region and investors responded accordingly. At the other extreme, Chinese equities were very weak from the negative trade rhetoric with the U.S. Chinese equities fell -7.4% in the third quarter and were one of the main reasons for dismal emerging market returns. No doubt that trade issues will dominate the investing landscape over the next weeks and months.

China's economic growth slowed a bit more than expected in the period as third quarter GDP rose +6.5% from a year earlier, which was the slowest pace of growth experienced since the great recession. Escalating trade tensions pressured industrial output in the period and all of this led to a lack of confidence and a weak market. It looks like trade tariffs are beginning to be felt in their economy, just as many have been expecting. Chinese leaders vow to increase stimulus measures and other means of support in order to counter these affects. But as we know, these measures take time to cycle into the economy. In the meantime, we would expect to see a further weakening of economic growth in the region, which is putting the government's official growth target of 6.5% for this year in jeopardy. We are seeing weakness in manufacturing, as growth slowed to +5.3% in the third quarter from +6% in the previous period. Looking at a few other key economic data points, fixed asset growth continues to fall as this climbed to only +5.4% in the first nine months of 2018, a significant deceleration from the six month statistic. Exports were very healthy in the quarter with +12.1% year-over-year growth. In addition, we continue to see record trade surpluses with the U.S. This is a testament of the overall strength in the global economy, not just the U.S. economy, as we would have thought this would have been somewhat weaker. Retail sales growth remained surprisingly steady in the period as third quarter sales were up +9.0% from a year earlier. Inflation continued to gravitate higher as September consumer prices rose +2.5% from the year earlier period. This is the highest level since earlier this year as food prices rose much more vs. non-food prices. Even though trade issues have not shown up too much thus far in economic data points, it is showing up in investor confidence and a declining equity market. Eventually it will push beyond this and into the data. President Trump has proposed a significant increase in tariffs starting in January in an effort to put pressure on the Chinese. Thus far, both sides seems far apart from a resolution. Developments on this front will probably set the direction of the Chinese equity markets over the next couple of months.



Sources: Fidelity Q4 Market Update; China Nat'l Bureau of Statistics; Bloomberg

After a surprisingly strong second quarter, the Japanese economy hit a growth pause in the third quarter, as GDP fell -.3% from the previous quarter, or -1.2% from a year earlier. It looks like a large part of the damage was done by a string of natural disasters that disrupted the economy here. Parts of Japan were hit by earthquakes and severe flooding from storms and that took its toll on production. These storms pushed exports lower in the quarter, which shaved -.1% from growth. Also contributing were lower shipments to China from the ongoing trade tensions with the U.S. This is an example of the peripheral effects that can happen the longer this goes on between the U.S. and China. As mentioned above, industrial production slipped in September from weather events, but should rebound in the following months and provide a boost to the outlook in this economy. However, Japan's leading economic index slip is a little troubling and remains at levels below the early part of this year. We need to see this pick up a bit from current levels to have a better feeling on a rebound here. At its October meeting nothing changed much at all as the Bank of Japan (BOJ) kept its short term rate at -.10% and is still targeting a 10-year government bond target yield at 0%. The BOJ still feels it is necessary to keep its stimulus flowing especially with everything happening right now with the trade issues in Asia. Consumer confidence continued to be rather lackluster, as September's reading only ticked up slightly to 43.4, which remains near yearly lows. However, we believe we are on the cusp of better readings with this key statistic. The labor market continues to be very tight here as the jobless rate fell to 2.3% in September, while the jobs-to-applicant ratio moved up to 1.64, which is yet another record going back decades. This is just starting to transpire into better wage growth, which could bring some much needed confidence to consumers. As we move into early 2019, we should see a rebound in the economy here as temporary weather related events are put in the rear view mirror. However, trade issues are a source of risk here as Chinese trade flows could be tough to overcome as substantial tariffs begin to be implemented between the U.S. and China. So far, Japan has escaped any full direct actions by the U.S. at its core manufacturing operations, which we believe is key for this economy. Investors will be watchful for any developments on this front.



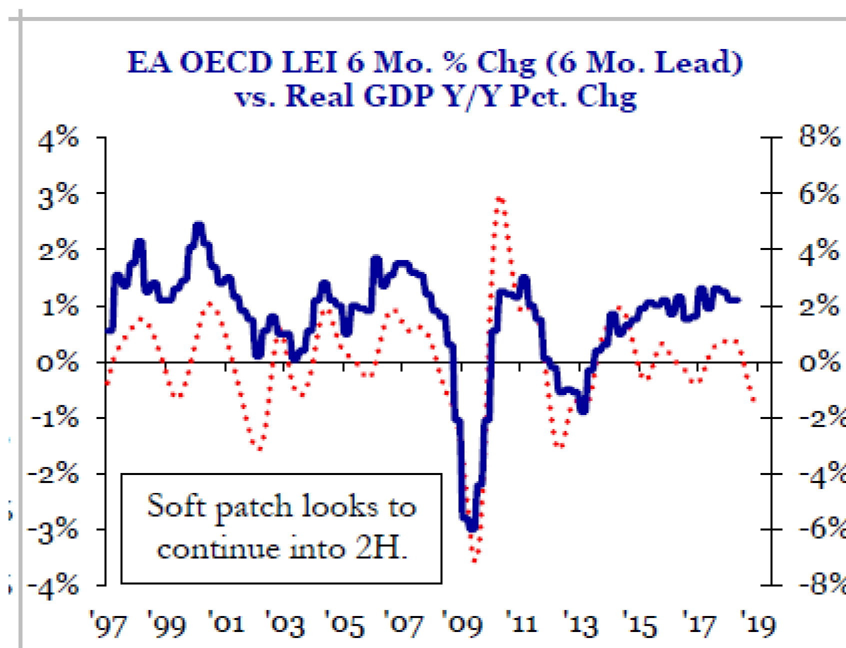
Sources: Evercore ISI; Nikkei News

Europe Update

European stocks managed to post a small gain in the third quarter as corporate earnings growth was fairly solid across the region, Italy's debt issues did not spread to other markets, and Brexit negotiations seemed to favor the EU over the U.K. These issues coupled with no unexpected surprises from the European Central Bank (ECB) gave some comfort to equity investors and markets moved higher as a result. This pushed the MSCI European Index (ex. U.K.) up +1.8% in the quarter, as currency movements by the Euro had little effect on returns in the period. The Italian equity market was the weakest as fiscal concerns spilled over to the bond markets and pushed interest rates higher. Italy could be dangerously close to breaching EU rules as its annual deficit to GDP could force credit downgrades of its sovereign debt. This is a very touchy issue at the moment and investors are scrutinizing every comment from the Italian government.

The European economy continued its recent trend in deceleration as third quarter GDP only rose by +.2% from the previous quarter, or +1.7% from the year earlier period. This just confirms what many have been seeing over the course of the last few months. Manufacturing is slowing as global trade tensions heat up, which increases pessimism for many corporate executives. The German economy fell into negative growth territory for the first time in over three years from its large export driven economy. The automobile industry took a leg down recently and was responsible for a large part of this economic shortfall. Confirming what we see in the German economy, the more broad Eurozone industrial production data point continued its recent struggles and fell -.3% in September from a month earlier. This is near the weakest levels of 2018. In another measure of the economy, the

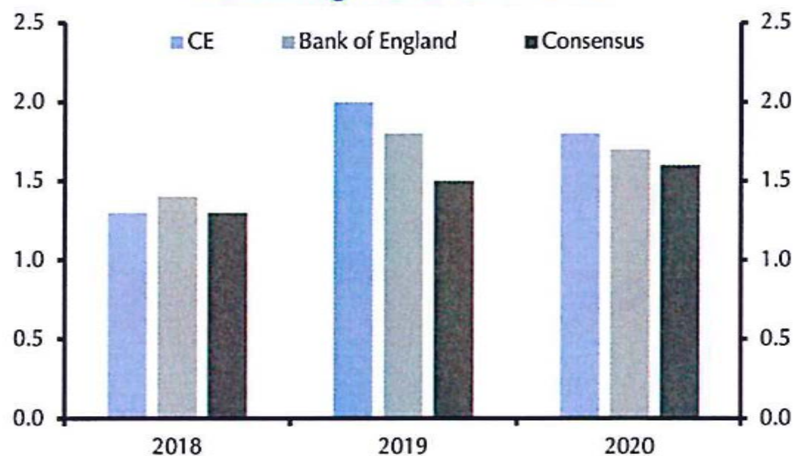
index of executive and consumer sentiment fell to 109.8 in September, which is the lowest reading since May 2017. Retail sales continue to struggle in the region, as sales in September were flat with the previous month, or up only +.8% from a year earlier. This goes right along with other weakening trends we see in the region. All of these weak readings have pushed Core CPI down to +.9% in September, with little to no signs of inflation at this time. The employment situation continues to be one of the few bright spots in the economy lately, as the September unemployment rate fell to 8.1%, which is another new low since the great recession. This remains one area in the Eurozone economy that is fundamentally improving with each passing period. At this point, it's quite clear to us the Eurozone economy is in a weakening trend. Growth in 2019 will probably be somewhat less than 2018, but still growing nonetheless. Trade data points need to be watched closely as we enter 2019 as the U.S./China trade situation could become much worse and have spillover effects on the Eurozone economy.



Source: Strategas

Brexit uncertainty led the U.K. equity market downward in the third quarter. While Theresa May has negotiated for a Brexit deal with the EU, many now believe it has little chance getting passed by Parliament. Investors seem to be growing more anxious ahead of a key vote scheduled in December. This uncertainty is creating an environment where planning is difficult and business is suffering as a result. The MSCI U.K. Index returned -1.7% in the third quarter on a U.S. dollar basis. The British Pound fell to a year low in August vs. the U.S. dollar as this uncertainty manifested itself into a frenzy. Surprisingly enough, the economy remained more resilient than we would have thought, as GDP grew by +.6% from the second quarter, or +1.5% from the year earlier period. This was the best quarter in two years and probably was helped by the World Cup, which is more of a "one-off"

special event. Net trade and household spending were strong parts of the economy in the quarter. Industrial production continued its recent difficulties as September posted no month-over-month or year over year growth. The only bright spot was manufacturing, as all other areas of industrial production posted negative growth. Retail sales have been weak lately as October sales fell by -.5% from the previous month, or up only +2.2% from a year earlier. This is the second month in a row of weaker sales and the weakest readings of the year thus far. Core CPI has been steady lately as October's reading of +1.9% from a year earlier is still well below the official Bank of England (BOE) targeted rate. At its recent November meeting, the Monetary Policy Committee (MPC) voted to maintain its benchmark interest rate at .75%, while maintaining its bond purchase target of 435 billion pounds, including 10 billion in corporate bonds. The MPC does not want to take any action at this time in front of a key Brexit ratification agreement vote by Parliament coming in December. The third quarter unemployment rate remained steady as the rate inched up to 4.1%, which still remains near multi-decade lows. Employment increased by 23,000 workers in the quarter with ending employment at yet another new record of 32.41 million workers. Wage growth continued to improve, as wages grew by +3.2% in the three month period ending in September. We find these employment readings very encouraging for the region.



Sources: Capital Economics, Bank of England, Thomson Reuters, Markit

Emerging Markets

Emerging market equities continued to decline in the third quarter as Chinese shares put heavy downside pressure on the index from trade issues and fresh geopolitical concerns from U.S sanctions engulfed the Turkish Lira. In addition, weaker currencies caused by tightening by the U.S. Fed has created an environment of poor investor sentiment, which is leading to weakness in emerging markets. The MSCI Emerging Markets Index fell nearly -1.1% in the quarter and finished down -.8% for our fiscal year. Chinese shares fell -7.4% from trade related issues and Indian shares fell -2.2% in the period from fresh concerns surrounding India's rising deficits along with rising inflation. On a brighter note, Brazilian shares rose +6.2% as markets here celebrated the recent election of Jair Bolsonaro and his plan to attack government waste. Over the next few months, we would expect to see a fair amount of market volatility in emerging market equities as trade barbs continue between the U.S. and China and a strong U.S. dollar continues to play havoc with these currencies. We still expect investors to proceed cautiously with regard to exposure here until we see some positive progress on the trade front, as China is a large percentage of the emerging markets index.

When the U.S. dollar rises, emerging markets tend to struggle

U.S. Dollar Index (DXY)

Sources: John Hancock Global Market Outlook; Factset

International Equity Activity/Strategy

As we end 2018 and look out into early 2019, we believe the global growth debate could wind up being the focal point for most investors. From recent data points and surveys, we get a feeling that growth is likely to decelerate through a good part of 2019. The divergence in growth between regions could well begin to move back toward mean reversion. As mentioned many times over, trade issues between China and the U.S. will remain center stage until some level of agreement takes place. In Europe, we remain watchful with regard to developments with Italy. Though issues remain manageable at the moment, this could be a source of a new crisis if things meltdown from here. Central banks remain another major source of

risk as many of these are withdrawing stimulus measures and embarking on a tightening cycle. Missteps here could severely harm the global economy. However, as we assess the areas of risk in the global economy, we still see a global economy that remains in growth mode, just at a slower pace. Employments trends continue to improve, inflation remains well in hand, and global PMI's remain positive.

We continue to remain active with our put writing on EEM since our last update and expect to continue to be going forward in an effort to bring in some current income and add further to this asset class after an extended period of under-performance lasting several years. Premiums for doing this strategy still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 2.5% of total assets and approximately 10.3% for MSCI EAFE equities. *(Credit is given to the following entities for charts provided: Capital Group, Euromonitor, Capital Economics, Bank of England, Bloomberg, WSJ, ACM, Thomson Reuters, Haver Analytics, Nikkei News, Barclay Research, Strategas, Markit, Fidelity Investments (AART), ISM, IMF, Baird Market Update, MSCI, Factset, Evercore ISI, John Hancock Global Market Outlook, China National Bureau of Statistics, and Morningstar Direct)*