Market Insights

Economy | Capital Markets

Q3 2018

Economy

Although the United States economy and foreign economies around the world are experiencing a somewhat synchronized and multidimensional pickup in growth, there are ample signs of potential change in the wind for investors. For nearly a decade, the world's major central banks have given new meaning to the term "monetary accommodation" as interest rates fell to zero in the wake of the global financial crisis. Today, the Federal Reserve is on a campaign to raise short-term interest rates back toward normal and inflation is on target for the first time since 2012. Further, the global trade order that has existed for decades is being disrupted amidst contentious trade wars and potential tariffs. Finally, as the U.S. expansion enters its tenth year, it received a somewhat unprecedented boost from corporate and individual tax cuts. Because of these events, there exists the potential for higher interest rates, higher market volatility and additional economic uncertainty around the world.

On the economic front, the U.S. economy grew at a 4.2 percent pace in the second quarter, the fastest pace since 2014. Passage of the Tax Cuts and Jobs Act of 2017 has put more cash in companies' coffers and ramped up business spending at the fastest pace in years. For instance, capital expenditures, such as spending on factories, equipment and other capital goods, totaled about $167 billion in the first quarter for S&P 500 companies. That is the fastest pace in seven years and a record for a first quarter. Add in a solid job market, rising corporate profits and healthy industrial production, all signs point to the U.S. economy growing throughout this year and into next.

As the domestic economy produces solid growth numbers, global trade tensions between the U.S. and its major trade partners have festered and could potentially derail this sanguine economic environment. Already, it appears the U.S. has reached a tentative agreement with Mexico to revamp the North American Free Trade Agreement (NAFTA) with updates to provisions surrounding the digital economy, automobiles, agriculture and labor unions. In late July, the U.S. and European Union agreed to work toward lower tariffs and trade barriers, and the Europeans agreed to buy billions of dollars' worth of soybeans and natural gas. Yet an agreement with China, one of our largest trade partners, is still elusive and complicated. In short, the president has threatened to impose tariffs on virtually all $505 billion that the U.S. imports from China. So far, China has responded in kind to our tariffs, mostly in the agricultural sector. These threatened and imposed tariffs are viewed as punishment for China's policies that have resulted in intellectual property theft or mandated technology transfers on U.S. companies doing business there. It is still unclear what the long-term outcome will be of this trade war. A quick resolution should benefit domestic growth and employment, while a prolonged and severe trade war will serve to hurt U.S. farmers, families and businesses.

Amidst these events, several central banks around the world have started the long, slow process of reversing their decade-long accommodative monetary policy agendas. The Federal Reserve began raising interest rates in 2015 and then began selling assets in 2017. The benchmark interest rate has moved from about 0.25 percent to 2.0 percent over the past three years. Further, the European Central Bank and Bank of Japan are reining in asset purchases, although neither has begun raising rates or reducing balance sheet assets. The Bank of England, meanwhile, hiked interest rates for the first time in a decade last November. The accommodative monetary policies of the last decade have provided significant tailwind for asset prices. Now that those policies are tightening, the global economy is in uncharted territory. How much of a headwind will financial markets face in this new environment? The answer to this question will likely influence markets for years to come.

Looking ahead to the remainder of this year and into 2019, the economy appears poised for modest growth, sustained employment gains and an increase in corporate activity and earnings. However, amidst these positives are expected higher interest rates by the Federal Reserve and elevated trade tensions between our trading partners, which could disrupt world economies if not contained. As these events play out, we expect capital markets to respond accordingly. Core fixed-income securities will likely suffer as interest rates continue to trend higher. Domestic equities should produce solid, albeit more modest, gains moving forward, while we expect many of the international markets to bounce back from their slump of the past six months.

As always, investing in capital markets comes with some risk and uncertainty. We thank you for your continued support of our investment process as we work hard to deliver positive risk-adjusted portfolio returns to our clients. Should you have any questions, please do not hesitate to reach out to your financial adviser.

Capital Markets

The yield on the U.S. 10-year Treasury bond drifted higher during the quarter, which negatively impacted returns across most sectors of the bond market. Domestic equities bounced higher during the quarter as trade tensions eased and earnings grew above average. Foreign markets continued to struggle amidst trade tensions and a rising dollar during the quarter.

Disclosure: It is not possible to invest directly into an index. The indices listed above are unmanaged and are not affiliated with the Advance Capital Companies.

Market Index Performance(%)
As of September 28, 2018

	3rd QTR	YTD	1 Year	Annualized 3 Year
S&P500	7.71	10.56	17.90	17.32
Dow Jones Industrial	9.63	8.83	20.76	20.51
Nasdaq Composite	7.42	17.49	25.22	21.81
Barclays Aggregate Bond	0.02	-1.60	-1.22	1.31
FTSE USBIG Corporate	0.87	-2.40	-1.19	3.15
MSCI World	5.10	5.89	11.85	14.22

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	3.90%	6.11%	**Represents the number of unemployed persons as a percent of the labor force**	Near historic lows
Consumer Price Index	2.70%	4.10%	**Represents changes in prices of all goods and services purchased for consumption**	Trending modestly higher
U.S. Capacity Utilization	78.10%	80.26%	**The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime**	Trending higher
Gross Domestic Product+	2.90%	2.80%	**Total value of all goods and services produced indicates strength or weakness of the economy**	Trending higher
10 Year Treasury Yield	3.08%	6.37%	**Yield on the current 10 year treasury bond**	Has increased over the past year
Annual Housing Starts	1,282,000	1,435,000	**New privately owned housing unit starts annualized rate**	Steadily rising

*Average from 1966 to Present   + Annualized   *Source: Bloomberg*