MarketPoint

Third Quarter 2018 | Issue No. 23

TRUSTPOINT
Investments • Trust • Since 1913

YOU'RE INVITED!

CHARTS 'N CHATTER

Join our team as they present the economic and market outlook for 2019 and discuss topics such as the upcoming midterm election, tax briefs and more.

October 30 at 12pm
Trust Point Minneapolis

November 1 at 8am
The Radisson La Crosse

November 2 at 12pm
Trust Point Eau Claire

RSVP by calling 608-782-1148 or email at info@trustpointinc.com

In This Issue:

Economic And Market Update
Equity Market Update
Fixed Income Market Update

An Economic & Market Commentary from Trust Point

An Economic and Market Update from Trust Point

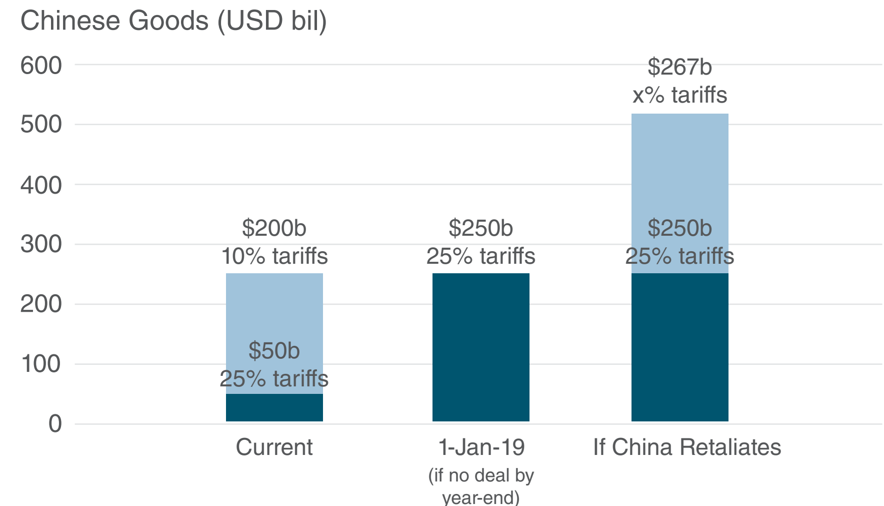
Geopolitics dominated the headline news once again over the past three months. Think of Brexit, Turkey, U.S. vs. Mexico, and U.S. vs. Canada, not to mention U.S. vs. China. Despite temporary, negative short-term market movements associated with those headlines throughout the quarter, the trend was clearly on the upside for both equities and interest rates. Investors certainly have become increasingly comfortable with the strength and longevity of this economic cycle.

Tariffs, Tariffs, and More Tariffs

While a newly revamped trade agreement with Mexico and Canada is currently on the table, the trade dispute with China only intensified over the quarter. Goods imported from China totaling $250 billion are now subject to tariffs, a sum amounting to about half of the total amount of goods the U.S. imports from China annually (Chart 1). While the measurable economic effects of these tariffs have so far been limited, over time we would expect reduced trade flows between the two countries. This could lead to slightly lower economic growth for China while putting upward pressure on U.S. prices. Unfortunately, trade shocks are very difficult to model, and their full impact can't be understood until after the fact. The issues at stake remain deep and complex; only time will tell if a negotiated solution between President Trump and President Xi Jinping can be found. The structure and timing of any deal are highly uncertain. The Trump administration believes that China ultimately will capitulate. For now, however, the Chinese seem willing to wait it out until the U.S. midterm election in November to see if the tone in Washington might change. Interestingly, it appears that the political payoff for "standing up" to trading partners may not be as favorable for Republicans as originally believed; the announcement of new tariffs has recently been greeted by rising odds that the Democrats could win the House in the midterms (Chart 2).

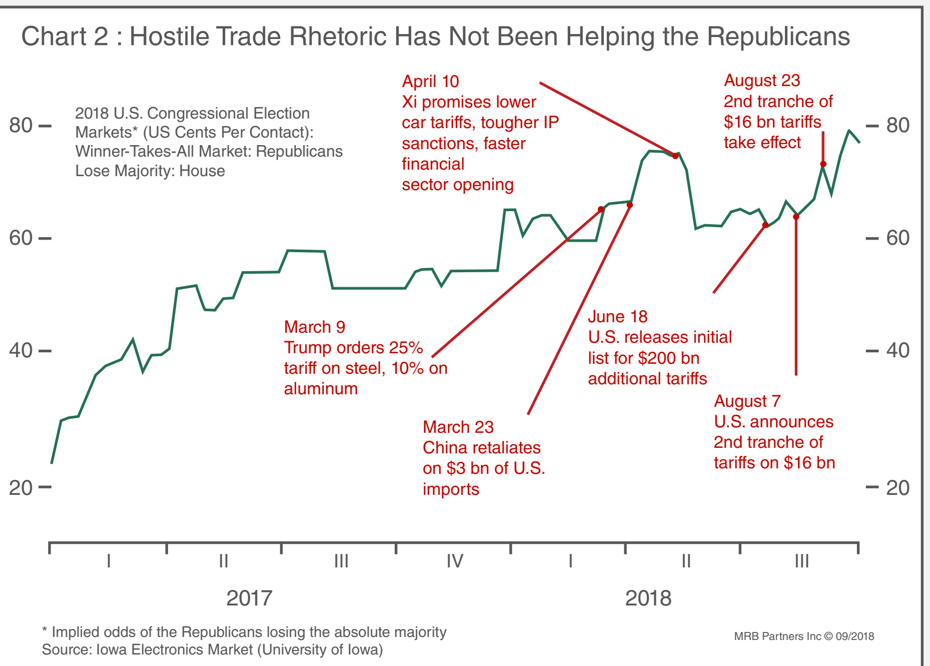
KEY ECONOMIC DATA	As of	Actual	3 Mos. Ago	1 Year Ago
Dollar Index Level	Sept	95.1	94.5	93.1
US Economic Activity				
ISM Manufacturing (>50 = Expansion)	Sept	59.8	60.2	60.2
ISM Non-Manufacturing (>50 = Expansion)	Sept	61.6	59.1	59.4
Non-Farm Payrolls	Sept	134K	208k	14k
Unemployment Rate	Sept	3.7%	3.9%	4.3%
CPI Ex-Food & Energy (yoy)	Aug	2.2%	2.2%	1.7%
Global Economic Activity				
JP Morgan Global Manufacturing Index (>50 = Expansion)	Sept	52.2	53.0	53.2
JP Morgan Global Services Index (>50 = Expansion)	Sept	53.0	54.6	53.8

Source: Bloomberg



Is the World Economy Growing or Slowing?

Despite ongoing trade tension, the world economy is still growing nicely, with global GDP growth of at least 3.5% expected in 2018. The pace of growth so far this year, however, has been uneven among countries (Chart 3). Economic strength has been most noticeable in the United States, as deregulation, tax reform, and a budget deal approved earlier this year have injected fresh blood into our economy, helping U.S. corporations post strong sales and earnings growth. Internationally, developed markets have experienced slower growth in 2018. As for emerging markets, Turkey recently received some media attention as decades of overconsumption, financed by cheap foreign money, hit a wall. To add fuel to the fire, a general decline in emerging-market currencies and slower Chinese growth acted as negative catalysts for what was a difficult quarter for emerging-market assets in general. As the rest of the world is slowly starting to feel the pressure from tighter monetary conditions in the U.S., we are closely watching our models and indicators to ensure that these "one-offs" don't become a source of contagion globally.



Weak Links in the Global Economy?

In the past, when the U.S. sneezed, the rest of the world caught a cold. Given the size of the U.S. economy, it made sense to look at the domestic economic climate first in order to assess the likelihood of a global economic downturn. We think this time may be different. Following the great recession of 2008-09, U.S. households and banks went through a very deep and painful deleveraging process. Internationally however, some non-U. S. economies took advantage of years of depressed yields resulting from the great recession to do the exact opposite leverage up. As a result, countries such as Canada and Australia are now dealing with household imbalances, while others, including Japan and Italy, face government imbalances. In our opinion, these economies are now the potential weak links of the global economy. In fact, we think that the biggest surprise this cycle may be that the U.S. economy does not provide the usual warning signs that the next global downturn is coming. How many of these countries need to experience contractionary forces before they become contagion risks for the U.S. or the global economy? That is a question we are looking at very closely.

An Equity Market Update from Trust Point

The third quarter was yet another good period for global equities. The MSCI EAFE index was up 1.4%, while the S&P 500 increased 7.7%. Although U.S. equity valuations are off their highs, international stocks are earlier in their market cycles, with more attractive valuations.

EQUITY BENCHMARK TABLE

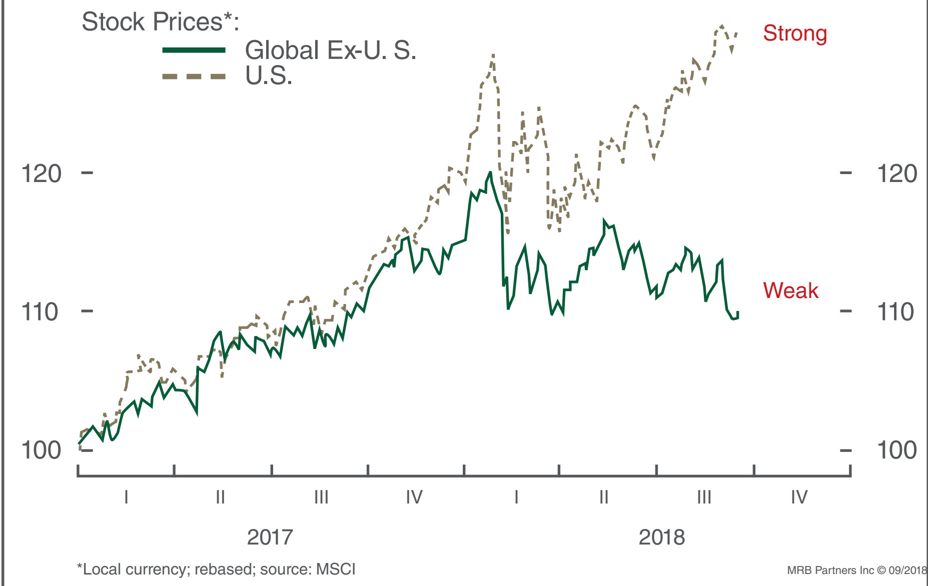
US Economic Activity	Quarter-End	3 Mos. Ago	1 Year Ago	3 years Ago	5 Years Ago
S&P 500	2,914	2,718	2,519	1,920	1,682
Dow Jones Industrial Average	26,458	24,271	22,405	16,285	15,130
NASDAQ	8,046	7,510	6,496	4,620	3,771

Equity Returns (%)	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Large Cap Growth	9.2%	17.1%	26.3%	20.6%	16.6%
US Large Cap Value	5.7%	3.9%	9.5%	13.6%	10.7%
US Mid Cap Growth	7.6%	13.4%	21.1%	16.7%	13.0%
US Mid Cap Value	3.3%	3.1%	8.8%	13.1%	10.7%
US Small Cap Growth	5.5%	15.8%	21.1%	18.0%	12.1%
US Small Cap Value	1.6%	7.1%	9.3%	16.1%	9.9%
International Large Cap Developed (US Dollar)	1.4%	-1.4%	2.7%	9.2%	4.4%
International Small/Mid Cap Developed (US Dollar)	-0.9%	-2.2%	3.7%	12.4%	8.0%
Emerging Market (US Dollar)	-1.1%	-7.7%	-0.8%	12.4%	3.6%

Source: Bloomberg, Morningstar

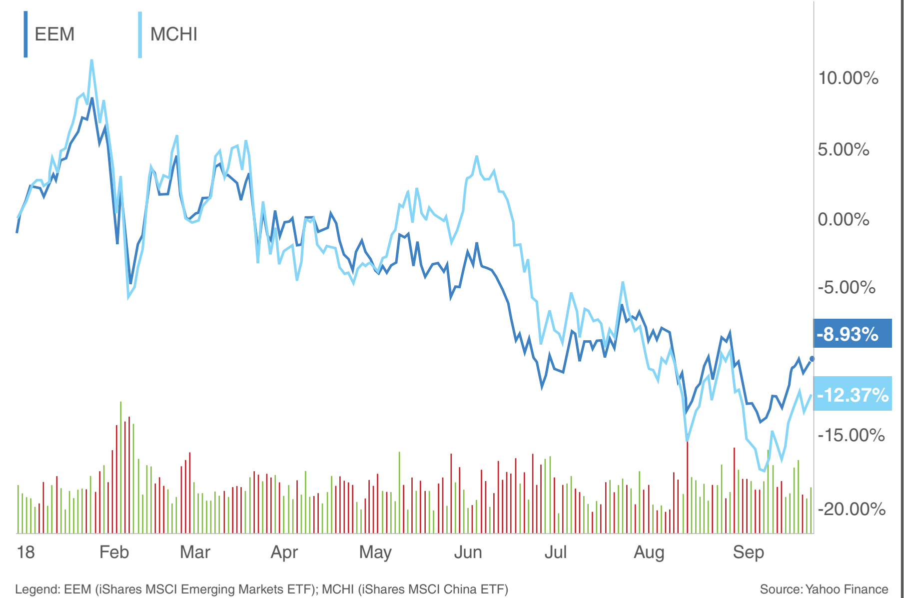
U.S. and International Equity Returns Diverge

Domestic equities have produced solid returns this year. Outside the U.S. it has been a different story, as the S&P 500 has outperformed the MSCI EAFE Index by 12 percentage points year-to-date (Chart 4). U.S. GDP growth surged to 4.2% in Q2, while economic growth in regions such as the Eurozone has come down from peak highs at the end of 2017. Additionally, very good U.S. corporate profits, combined with a rising U.S. interest-rate environment, attracted foreign investment flows into the country, while the trade war has penalized international companies that derive large portions of revenue from U.S. customers. We continue to be believers in diversified global investing. We think clients should view opportunities outside the U.S. as attractive, particularly since current U.S. economic growth is unlikely to be sustained, and equity valuations outside the U.S. are more attractive. We would not be surprised to see international equities experience a significant snapback once concerns about trade wars abate, although we admit that timing is the great unknown.



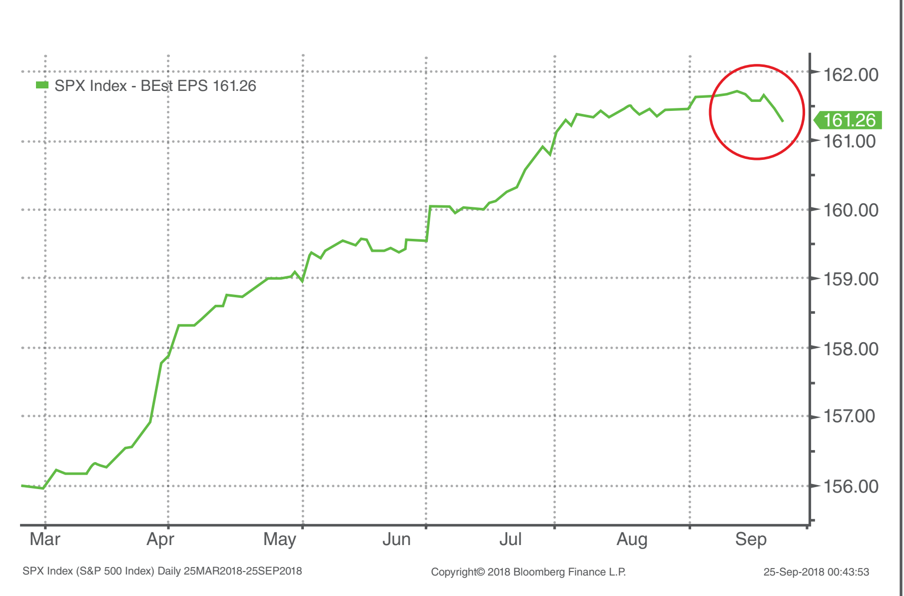
Headwinds for Emerging Markets

The term "emerging market" refers to a nation that is progressing toward becoming more advanced, usually by means of rapid growth and industrialization. Equities in emerging markets have seen broad price declines in 2018 due to trade tensions, a strengthening U.S. dollar, and interest-rate hikes in the United States. China, the world's second-largest economy and the largest emerging-markets economy, is in a bear market this year (Chart 5) for two main reasons: It has felt the brunt of the trade war, as the U.S. so far has slapped tariffs on $250B of Chinese imported goods, and its own domestic economy has slowed as well. The U.S. Federal Reserve is forecasting additional interest-rate hikes over the next year, as U.S. inflation currently shows signs of life and the domestic economy is operating at or near full capacity. Those rising interest rates should continue to make yields more attractive in the U.S. relative to emerging markets, which are still largely engaged in accommodative monetary policies. We would expect this to attract additional foreign investment into the U.S., hampering equity returns in emerging markets for the foreseeable future. As a result, for now we remain underweight emerging-market stocks in our modeled portfolios.



U.S. Corporate Earnings Growth Strong Again in Q2, But is it Sustainable?

Corporate earnings growth for the companies making up the S&P 500 grew an aggregate 25% year-over-year in Q2, repeating the strength seen in Q1. Revenue grew 9.5%, with particular strength showing up in technology, consumer discretionary, materials, and industrial companies, suggesting that both consumer and commercial demand is high. Another primary contributor to solid profit growth was the dramatic decrease in taxes paid by corporations stemming from the Tax Cuts and Jobs Act of 2017. The U.S. economy is, however, in the late stages of its expansion, which suggests that sales and earnings growth will start to slow. The unsustainable nature of tax cuts, higher costs from increasing employee wages, interest costs, and potentially higher costs from the trade war, among other signals, suggest that earnings growth may have peaked in Q2. Looking ahead to 2019, data collected by Thomson Reuters suggests that S&P 500 earnings are expected to grow only 10%, with year-over-year growth rate comparisons becoming more difficult as tax-cut benefits wind down. The data also points to the likelihood of a slowing economy as interest rates continue to shift higher. We will continue to monitor future earnings expectations (Chart 6), as they remain an important catalyst for equity markets.



A Fixed Income Market Update from Trust Point

Inflationary forces and the resilience of U.S. economic data have solidified the Fed's conviction in continued rate hikes. We expect the underlying trends in the U.S. economy will persist into the fourth quarter. These forces will continue to put upward pressure on bond yields and will remain a headwind for high-quality bonds.

FIXED INCOME BENCHMARK TABLE

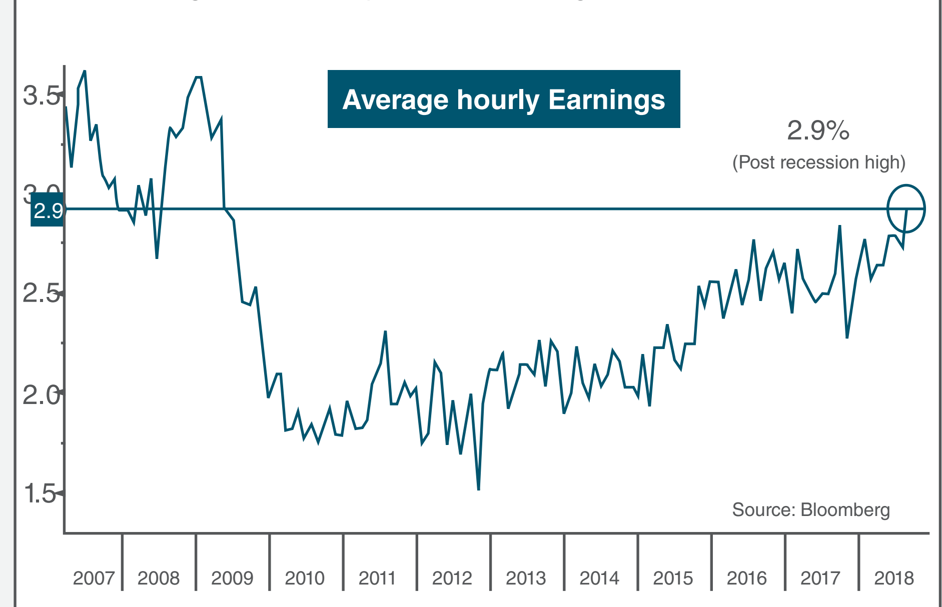
US Yields (%)	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
3 Month T-Bill	2.2%	1.9%	1.0%	0.0%	0.0%
2 Yr US Treasury	2.8%	2.5%	1.5%	0.6%	0.3%
10 Yr US Treasury	3.1%	2.9%	2.3%	2.0%	2.6%

Global Economic Activity	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Intermediate Treasuries	-0.5%	-2.1%	-2.5%	0.0%	1.6%
US Treasury Inflation Protected Sec.	-0.8%	-0.8%	0.4%	2.0%	1.4%
US Mortgages	-0.1%	-1.1%	-0.9%	1.0%	2.0%
US Short-Intermediate T/E Munis	-0.1%	0.2%	-0.6%	1.2%	1.8%
US Investment Grade Corporates	1.0%	-2.3%	-1.2%	3.1%	3.5%
US Senior Bank Loans	1.8%	4.0%	5.2%	5.3%	4.1%
US High Yield	2.4%	2.5%	2.9%	8.2%	5.5%
US Convertibles	3.9%	10.4%	12.2%	11.8%	9.3%
Int'l Bonds Ex-US (Hedged)	-0.6%	1.1%	2.3%	3.1%	4.1%
Int'l Bonds (Unhedged)	-0.9%	-2.4%	-1.3%	2.0%	0.8%
Emerging Market Debt (US Dollar)	1.9%	-3.5%	-2.9%	5.7%	4.6%

Source: Bloomberg, Morningstar

The Fed Digs In

The U.S. economy has chugged along for more than nine years as it recovers from the financial crisis of 2008-09. The recovery in labor markets, on the other hand, has been quite subdued. This dynamic started to shift in the third quarter. Nonfarm payrolls added 201,000 jobs in August (above the consensus estimate), while the unemployment rate remained at 3.9%-a level the Fed has predicted will put upward pressure on inflation. With good workers hard to come by, wage growth has picked up; average hourly earnings jumped .4% month over month and 2.9% year over year. Those are the highest levels since the great recession (Chart 7). A primary goal of the Fed is to keep inflation under control, so its attention has begun to focus on a tight labor market and rising wages, as opposed to supporting the economic recovery. With the U.S. economic backdrop strong, it would take a significant correction in equity markets—whether from continued trade disputes or contagion from recent emerging-market weakness—to cause the Fed to deviate from the path toward normalizing interest rates. In September, the Fed initiated its third rate hike of the year; it is forecasting another one in December, plus three more in 2019. Expect upward pressure on bond yields as the market's rate-hike expectations adjust higher to be more in line with the Fed.



Anchors on Global Yields May Soon Lift

The world is well aware that the U.S. Fed has been tightening policy, but the European Central Bank (ECB) may be flying under the radar a bit. We are watching ECB president Mario Draghi for further confirmation of a change in policy. While actions by the ECB are not likely to disrupt markets over the short term, a change in policy could have implications for global bond markets, as the U.S. 10-year treasury also responds to changes in overseas markets. The ECB is among the largest and most influential central banks in the world. It has announced an end to its asset-purchase program by the end of the year, and says it intends to hike interest rates next year, albeit no sooner than next fall. Although this may seem far off, markets tend to price in changes to monetary policy well before they actually happen. Our investment style focuses on long-term trends; shifts in policy tend to have long-term implications, as they can change the fundamentals of markets. Outside the U.S., the largest foreign bond-market yields have held well below 1% since 2014 and have acted as anchors on global yields (Chart 8). Central banks around the world are following the Fed's move toward higher rates, just at a slower pace. If this continues, global yields may finally begin drifting higher, as they did in the U.S. starting in the summer of 2016.

Positioning Highlights

Given the strength in third-quarter economic data highlighted by the latest U.S. GDP reading of 4.2%, the highest level in four years, we continue to think bonds tied to U.S. economic activity will outperform the U.S. Aggregate index, which is heavily invested in high-quality treasuries, mortgage-backed securities and investment-grade corporates. Credit-sensitive bonds remain supported by strong underlying fundamentals and positive effects from corporate tax cuts. We remain heavily defensive on duration (interest-rate sensitivity), given the outlook for further rate hikes and for inflationary pressures that would force rates higher. Our defensive stance on interest-rate risk added significant value over our benchmark, as the U.S. 10-year treasury yield has been steadily rising for most of the year and broke through the 3% technical and psychological barrier in September. We have reduced some overweight positions in credit sensitive bonds to capitalize on the recent upward shift in treasury yields. Although we have become a bit more defensive, our fixed-income portfolios remain nicely positioned to capitalize on higher inflation, higher interest rates, and continued strength in the U.S. economy.

Chart 8 : Bonds Yields Remain Low Outside the U.S.

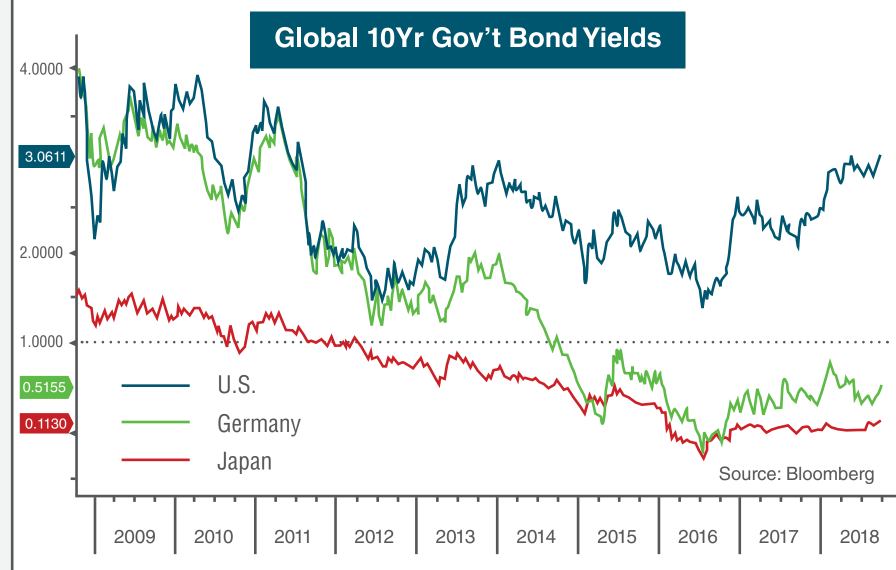
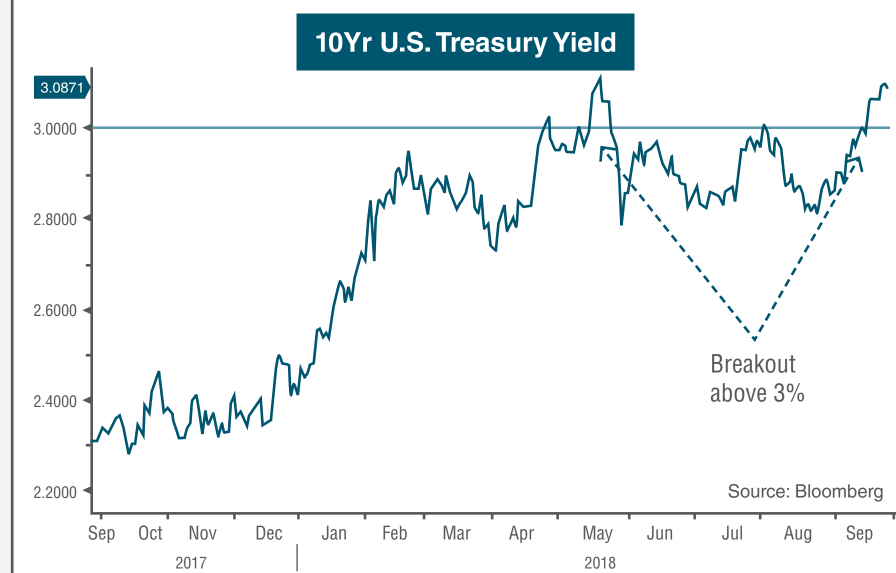


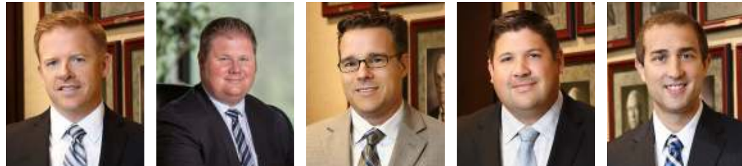
Chart 9 : 10-Year Treasury Yield Breaks Through 3% Resistance Levels



MarketPoint

Market Point is a quarterly market commentary designed to provide you with an overview of economic conditions, as well as equity and fixed income market summaries for the quarter.

This commentary is offered by the Investment management team. The individuals contributing to Market Point are Randy Van Rooyen, CFA®, Yan Arsenault, CFA®, CAIA, Brandon Hellenbrand, CFA®, Steve Brudos, and Ryan Bergan. Please feel free to contact any team member with questions.



Pictured left to right: Randy Van Rooyen, Ryan Bergan, Yan Arsenault, Steve Brudos and Brandon Hellenbrand.

The opinions herein are those of Trust Point Inc, are made as of the date of this material, and are subject to change without notice. Trust Point uses its best efforts to compile its data from reliable sources, however, it does not warrant the accuracy, completeness or timeliness of any of the information provided. This publication is prepared for general information only. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. Investors should seek advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. All investing involves the risk of loss, including principal, a reduction in earnings, and the loss of future earnings. Past performance is no guarantee of future results. Individual client portfolio performance and transactions therein can vary greatly based on factors including investment strategy, objective, limitations, risk tolerance, time horizon, asset composition, asset allocation and tax implications.

La Crosse, WI | P: 608-782-1148
Minneapolis, MN | P: 612-339-2343
Eau Claire, WI | P: 715-461-7018

www.trustpointinc.com

©Copyright Trust Point Inc. | La Crosse, WI | All Rights Reserved

230 FRONT STREET NORTH I PO BOX 489
LA CROSSE, WI 54602-0489

JOIN US!

CHARTS 'N CHATTER

Oct 30 at 12pm - Trust Point Minneapolis
Nov 1 at 8am - The Radisson La Crosse
Nov 2 at 12pm - Trust Point Eau Claire

RSVP by giving us a call at 608-782-1148
or email at info@trustpointinc.com

Standard
U.S. Postage PAID
Mailed from
Zip Code 54601
Permit No. 125