EMSTONE ADVISERS, LLC

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Numbers in the News

Indicator	9/30 Value	Versus 6/30
2-yr T-note yield	2.82%	+29bps
10-yr T-note yield	3.05%	+20bps
Yield Curve (2-10yr)	23bps	-9bps
ICE BofAML High Yield (YTW)	6.28%	-25bps
S&P 500	2,914.0	+7.2%
Dow Jones Index	26,458.3	+9.0%
NFIB Optimism Index	107.9	+0.7
Industrial Production Last 12 months (Aug)	+4.8%	+1.3pp
New Home Sales (Aug)	629,000	+11.1%AR
Payroll Employment (000)	149,500	+570
CPI last 12 months (Sep)	+2.3%	-0.6pp
Core CPI last 12 months (Sep)	+2.2%	-0.1pp
Personal Consumption Deflator (PCD) last 12 months (Aug)	+2.2%	-0.1pp
Core PCD Last 12 months (Aug)	+2.0%	NC

Bloomberg Barclays Bond Index Returns

	Third Quarter	12 Months
Aggregate	+0.02%	-1.22%
Government/Credit	+0.06%	-1.37%
Intermediate G/C	+0.21%	-0.96%
Intermediate A+ G/C	+0.06%	-1.05%
1-3 Year Govt	+0.20%	-0.01%
Municipal Bond	-0.15%	+0.35%

bps = basis points (0.01%)
pp = percentage points
AR = annual rate
NC = no change

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After clocking 4.2% growth in the second quarter, the pace of economic growth likely cooled a bit in the third quarter. The slowdown is due to the reversal of a temporary surge in exports that boosted second quarter growth. Nevertheless, personal consumption, supported by strength in industrial production and business investments, helped propel the economy at a pace above its long-term potential growth rate. According to the consensus forecast, growth in the third quarter was likely above 3%. The uptrend in economic activity that began in the fourth quarter of 2016, remains strong. Consumer confidence touched a new high for the current cycle. Small business owners have never been more optimistic. The National Federation of Independent Business Optimism Index reached the highest level on record in August. Consumer spending continues to remain the main driver of growth.

The Bright Spots: Manufacturing and Investments ❖ Industrial Production has been on a tear since 2017. Manufacturing activity continued to expand at a solid pace despite labor and material shortages. As of September 2018, the ISM PMI Manufacturing Index has sustained above 57 for fourteen straight months. The on-going cyclical recovery in the advanced economies provided a favorable backdrop for the US manufacturing sector. An additional boost to GDP growth came from inventory building. Wholesale and retail inventories spiked in the third quarter as businesses sought to restock warehouses and shelves.

In addition to restocking, business investments in capital goods also gathered strength. The tax cuts likely provided impetus for capital investments by businesses. Private non-residential fixed investment has been on a strong uptrend since 2017, prior to the tax cuts. In 2018, it has accelerated a bit, but could slow in 2019 as the effect of the tax cuts diminishes.

The Not So Bright Spots: Housing and Auto Sales ❖ The housing sector remains subdued. Existing home sales appear to have peaked for this cycle and is presently on a weakening trend. Housing starts, which has been on a very slow and gradual recovery path since 2011, has stalled. New home sales are also on a downward trend. Besides housing, auto sales also appear to have peaked in December 2016. Except for a temporary hurricane-related spike in September 2017, motor vehicle sales have been in a downtrend since early 2017. Looking forward, rising borrowing costs and a potential increase in purchase cost related to trade frictions could weigh on sales.

The Impact of Trade Wars ❖ Speaking of trade frictions, there were some signs of impact on the economy from the US-China trade war. Export orders have been slowing in recent months. Disruptions occurred in the supply of certain commodities, such as steel and lumber that have been subject to tariffs, causing a rise in input prices for manufacturers. The trade war is also distorting the net export figures. A temporary surge in exports helped narrow the trade deficit, and boosted GDP growth in the second quarter. This was due to a surge in US agricultural exports to China, ahead of retaliatory tariffs imposed by China. During the third quarter, this dynamic played out in reverse, as Chinese exporters frontloaded shipments ahead of the next round of US tariffs. Consequently, the trade deficit worsened sharply in July and August.

The Near-Term Outlook ❖ Trade-related headwinds notwithstanding, backlogs have been piling up for US manufacturers. Suppliers were struggling to fulfill orders due to tightness in the labor market and transportation issues. While at first glance, this may appear to bode well for continued strength in the fourth quarter, the storm clouds from the US-China trade war are looming large. The next round of tariffs imposed by the US is expected to hit consumers. At present, consumer optimism remains high as the job-creation engine keeps chugging along averaging 208,000 new jobs per month through the end of September. Personal consumption showed slight acceleration during the quarter, even as personal income remained stagnant. Most retailers reported robust sales in the second quarter, however, this optimism could fade when the collateral damage from the trade wars start hitting consumers.

Fed Policy ❖ Real disposable income has remained stagnant, growing less than 3% since the second quarter of 2017. Still, inflation has been showing some signs of life, giving cover for the Fed to hike rates three times so far this year. Core inflation measures have been on an upward trajectory during the first half of the year, but now appear to have stabilized. Nevertheless, given the underlying strength in the economy, the Fed's own projections suggest one more hike to 2.25% to 2.50% in December and three additional hikes in 2019. Market participants seem to agree and are currently discounting at least three of those four additional rate hikes. Trudging further along the hiking trail is likely to create headwinds in the form of higher borrowing costs for consumers and businesses. There are global repercussions as well. Higher rates in the US are stoking capital outflows from emerging markets. Countries with weaker fundamentals, such as Turkey and Argentina, are cracking under stress; and the contagion is spreading to other emerging economies. In addition, further increases in oil prices or a hard BREXIT could cause some turbulence. Consequently, market participants see a likelihood of only two hikes in 2019. The yield curve continued to flatten in the third quarter, albeit at a slower pace. The 2- to 10-year yield spread was 24 basis points (0.24%) as of September 30. However, as we enter the fourth quarter, upbeat economic data is exerting upward pressure on long-term yields, and the 2-10 spread steepened to 35 basis points (bps) as of October 10.

Fixed Income Markets ❖ Strong economic growth and inflation fears pushed Interest rates higher in the third quarter. Two-year Treasury notes rose 29 bps ending the quarter yielding 2.82%. Ten-year notes rose at a more moderate pace ending the quarter at 3.05%, a gain of only 20 bps, flattening the yield curve in the process. Going into year-end we would expect the 10-year Treasury yield to find support at 3.25%.

Investment grade (IG) credit had a positive third quarter with a total return of 0.89% and excess return of 1.57%. Year-to-date excess returns across the curve were flat while total returns declined 2.12%. Credit outperformed US Treasuries, as the latter continued to be pressured by the inevitable move higher in short-term rates. Since December 2015, the Fed has raised rates a total of seven times. As we have seen for much of the year, higher coupon bonds continue to buffer price declines at the front of the curve. The one- to three-year area returned 0.19% while intermediate and long Treasuries lost 0.12% and 2.88%, respectively. Excess return was generally positive across the curve given the negative price action in Treasury notes.

In general, lower rated credits performed best (see table). Baa's returned 1.35%, while A-rated securities gained 0.68%. Top rated utility bonds, a known defensive play, produced some of the weakest returns by having both a negative total and excess return of -2.54% and -1.96%, respectively. The "risk on" environment, supported by strength in equity markets, contributed to the strong performance of high yield corporates relative to IG credit returning 2.40% versus 0.89%, respectively. Emerging market debt, on the other hand, performed poorly on the double whammy of a strong US dollar and higher rates.

Bloomberg Barclays Index Third Quarter, 2018	Total Return	Excess Return[1]
Investment Grade Corporate	+0.89%	+1.57%
AAA-rated	+0.07%	+0.34%
AA-rated	+0.36%	+0.96%
A-rated	+0.68%	+1.41%
BBB-rated	+1.35%	+2.09%

The contraction in corporate yield spreads was influenced by well-received supply and a snapback from June's weakness. Issuers rushed to market early in September to get ahead of the anticipated September 26th FOMC rate hike. Much of the new issuance was merger related: Cigna for Express Scripts, UTX, Nestle, and AbbVie. Total issuance last quarter was just shy of $300 billion, $57 billion less than in the second quarter, and $60 billion less than the same quarter in 2017. Nevertheless, corporate bond issuance remains surprisingly strong.

[1] *Curve-adjusted excess return over US Treasuries*