EMSTONE ADVISERS, LLC

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Anthony J Basile, *Portfolio Manager*
Gail M Habecker, *CFA, Economist*
Folu Abiona, *Portfolio Manager*
Sundar Kuttalingham, *CFA, CAIA, Sr. Analyst*

During the second quarter, the pace of economic growth cooled to 2.0% from 3.1% in the first quarter. Consumer spending accelerated during the second quarter while the trade war weighed down business investments. As we entered the third quarter, the current economic expansion became the longest business cycle in modern history.

Crossing a Historic Milestone ❖ As we crossed this historic milestone, the dashboard of the US economy was showing mixed signals. The pace of job creation remained robust, fueling continued strength in personal consumption. Confidence among consumers and small businesses held up. On the flip side, the trade war was extracting a toll on businesses. Exporters faced slowing sales and importers faced rising costs. Manufacturing exports fell, as the global economy deteriorated. During the quarterly earnings report season, manufacturers, such as Caterpillar, cited rising costs from tariffs and slowing sales to Asia. Some leading indicators were flashing warning signs. New orders for manufacturing and building permits were pointing to a slowdown. Reflecting expectations of a slowdown, market participants were betting that the Fed would start cutting rates soon.

Monetary Policy Reversal ❖ After maintaining a stance emphasizing patience, the Fed relented to the widespread expectations for easing. Despite a backdrop of a strong labor market and rising consumer spending, the FOMC cut its policy rate by 25 basis points (0.25%) in July. This was the first rate cut by the Fed in more than a decade. The action was justified as a precautionary move against potential domestic spillover from the global slowdown. The Fed labeled it a "mid-cycle adjustment to policy" and promised to act as necessary to sustain the current expansion.

Attributes of the Current Expansion ❖ The current expansion, though longest, has certainly not been the strongest. As of the third quarter, the US economy has expanded by a cumulative growth of 25% in the current cycle. By comparison, the economy grew by a cumulative 43% during the Clinton-era boom of the nineties; and 38% during the Reagan-era boom of the eighties. In the current cycle, the job market recovered slowly over a prolonged period from the depths of the Great Recession. Real wage growth has been anemic. Also, over the years, the US economy has become more service-oriented. About two-thirds of the value added during the current cycle came from services. Manufacturing contributed less than 10% of the total increase in value added.

Threat to the Current Expansion ❖ Though manufacturing is a smaller part of the US economy, it is a major cyclical driver. Since it is interlinked with global supply chains, the US manufacturing sector is sensitive to the global economy and trade. On August 1st, the US slapped new tariffs on the remaining tranche of imports, including consumer goods, from China. China responded by

Numbers in the News

Indicator	9/30 Value	Versus 6/30
3-month T-bill	1.81%	-28bps
2-yr T-note yield	1.62%	-13bps
10-yr T-note yield	1.66%	-35bps
Yield Curve (2-10yr)	25bps	+11bps
ICE BofAML High Yield (YTW)	6.06%	-42bps
S&P 500	2976.7	+1.2%
Dow Jones Index	26,916.8	+1.2%
ISM manufacturing	47.8	-7.5%
ISM nonmanufacturing	52.6	-4.5%
Payroll Employment (000)	151,722	+470
CPI last 12 months	+1.7%	+0.1pp
Core CPI last 12 months	+2.4%	+0.3pp
Personal Consumption Deflator (PCD) last 12 months (Aug/May)	+1.4%	NC
Core PCD Last 12 months (Aug/May)	+1.8%	+0.3pp

Bloomberg Barclays Bond Index Returns

	Third Quarter	12 Months
Aggregate	+2.27%	+10.30%
Government/Credit	+2.64%	+11.32%
Intermediate G/C	+1.37%	+8.17%
Intermediate A+ G/C	+1.25%	+7.78%
1-3 Year Govt	+0.59%	+4.42%
Municipal Bond	+1.58%	+8.55%

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

Data obtained from various market and government sources by Stoneridge PMG Advisors, LLC. For additional information , please contact our office.

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allowing its currency to weaken and imposing additional tariffs on US automobiles, agricultural products, and oil. No sooner were these Chinese retaliatory tariffs announced than the US upped the ante with another hike in existing tariff rates. As a result of worsening trade conflicts, manufacturing activity is declining in the US and the rest of the world. Slowing economic growth was creating disinflationary pressures causing major central banks, such as the ECB, to announce more quantitative easing.

Market Reaction ❖ In the aftermath of the latest round of trade salvos in August, the views of the equity and bond markets appeared to be divergent. Equities started selling off but rallied back toward all-time highs on any hint of a possible trade truce or even a temporary reprieve on new tariffs. The bond market clearly sounded the alarm bells that a global economic slowdown is currently underway, warranting more aggressive Fed action. Long-term Treasury yields plunged. The 30-year Treasury yield fell to a record low during the quarter. The spread between 10-year Treasuries and three-month Treasury bills moved deeper into inversion. The shape of the yield curve was signaling that more rate cuts are inevitable, as the Fed seeks to avert a recession. The Fed, for its part, delivered another 25 basis-point (bp) cut in September despite the data available at the time suggesting a relatively stable domestic service sector and firming inflation. With the benefit of hindsight, this move appears to have been prudent, as subsequent data points indicate that the service sector is slowing as well.

Economic Outlook ❖ The US economy likely decelerated during the third quarter to an annualized growth rate of 2.0% or less. As of the end of the third quarter, the service sector remained supported by robust, albeit cooling, consumer spending. Home sales activity is enjoying a modest bounce related to lower mortgage rates, but from the subdued level of last year. Manufacturing and business investments are weakening rapidly. The manufacturing slowdown appears to be spilling over into the services sector. The pace of job creation has significantly slowed. Consequently, personal consumption appears to be cooling from the brisk pace seen in the second quarter. Given the backdrop of weakening global growth and elevated geopolitical risks, the US expansion is expected to continue at an anemic pace, supported by further monetary easing.

Fixed Income Commentary ❖ For the quarter, the negative spread between the three-month Treasury bill and 10-year Treasury note further inverted to -15 basis points, seven basis points wider than the June level. Ten-year Treauries declined 35 bps during the quarter to 1.66% while the two-year Treasury fell 13 bps to yield 1.62%. By far the biggest determinant of total return in the third quarter was the move in US Treasury yields. Interest rates moved swiftly lower in August, particularly on the longer end of the curve. Corporate spreads widened in August, but the significantly lower level of rates precipitated a flood of new issuance immediately after Labor Day and continued at a fast clip into quarter-end. It was reminiscent of the issuers' rush to market a few years ago when the specter of Fed rate hikes hovered over the market. A wide range of issuers participated although the majority of new issuance was lower-rated BBB bonds. However, even companies flush with cash such as Apple, took advantage of "cheap" money. Investor appetite was strong given the alternative of significantly lower US Treasury rates and, for non-US investors, negative yields in many foreign bond markets.

September turned out to be one of the three highest issuance months on record, with $158.3 billion issued. Unlike other high-volume months which are driven by merger and acquisition financing, most debt was intended for refinancing and general corporate purposes. Of course, all that debt eventually produced a bit of market indigestion, resulting in modestly negative total returns for almost all sectors in September. On an excess return basis, however, higher yields in the Treasury curve contributed to positive credit returns.

The third quarter was replete with political tension at home and abroad. A drone attack on Saudi oil fields, opioid litigation, and publicly unfolding tariff negotiations all served to create a muddled picture of sector impacts. Some, like oil and health insurance, were clearly victims of the quarter's drama; others were less clear cut. Total returns were positive with most sectors rising between 1.5% and 4.0%. There were a few standouts like other transportation and natural gas which returned 7.42% and 5.13%, respectively. Excess returns on the other hand were more dispersed with both positive and negative returns. Positive returns were less than 0.95% except for Tier 1 subordinated bank debt with an excess return of 1.56%. The largest negative excess returns were in independent energy (-1.83%), transportation services, (-1.21%), and health insurance (-0.80%).

Bloomberg Barclays Index Third Quarter, 2019	Total Return	Excess Return[1]
Intermediate Treasury	+1.18%	0.00%
Intermediate Agency	+1.00%	+0.10%
Intermediate Credit	+1.70%	+0.36%
Intermediate High Yield Corporates	+1.98%	+0.55%
Securitized (MBS, ABS, CMBS)	+1.40%	-0.07%
Source: Bloomberg Finance L.P.		

With the bond market continuing to look for additional Fed easing during the fourth quarter, we expect shorter-term two-year rates to trade in the 1.25% to 1.50% range while 10-year Treasury yields should remain rangebound in the 1.25% to 1.75% area.

[1] Curve-adjusted excess return over US Treasuries