Congress Asset Management Company

Economic and Market Outlook

Third Quarter 2019

The U.S. economy continues to grow and is likely stronger than recent headlines imply, providing a level of comfort for domestic investors. There are, however, two fault lines underneath the global economy: slowing momentum in Europe, China, and the United States; and rising trade tensions. The two lines are interdependent and in combination add an increasing level of uncertainty to economic prognosticators.

The financial markets felt the effects of increasing uncertainty in the second quarter. Bond yields fell to about 2% for the U. S. Treasury 10-year note, a level not seen since 2017. Stocks gyrated, particularly in May as trade tensions spiked, yet finished the quarter up about 3%. Oil prices collapsed only to stabilize late in the quarter. The most significant of these moves may be the bond yields themselves.

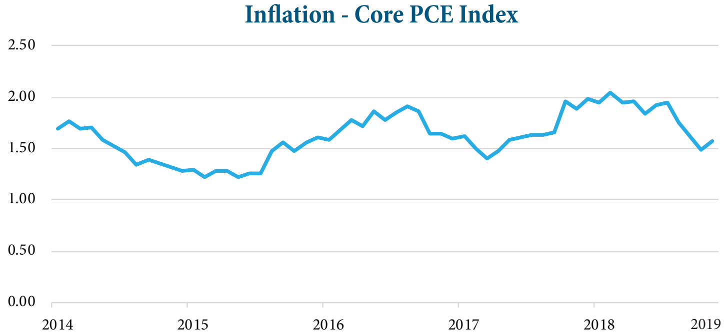
U.S. Ten Year Bond Yield 2018-2019

Source: Factset

A few months ago, it appeared that global central banks were set to end their decade long experiment in quantitative easing by decreasing their own balance sheets and raising rates. As recently as December, the Federal Reserve (Fed) hiked short-term rates in the U.S. As the quarter progressed, it became clear that both domestic and global momentum had slowed, precipitating a U-turn by central banks. Interest rate increases are now on hold and balance sheets are as likely to expand as they are to shrink.

The Fed and other central banks have the ability (and it appears the inclination) to react to weakening indicators because of subdued inflation readings. To be sure, developed economies world-wide remain in a systemically low inflation environment. Rarely have we experienced this phenomenon. The implications are far ranging and include negative interest rates in Europe and low rates elsewhere, adversely effecting both pensioners and investors.

Inflation - Core PCE Index



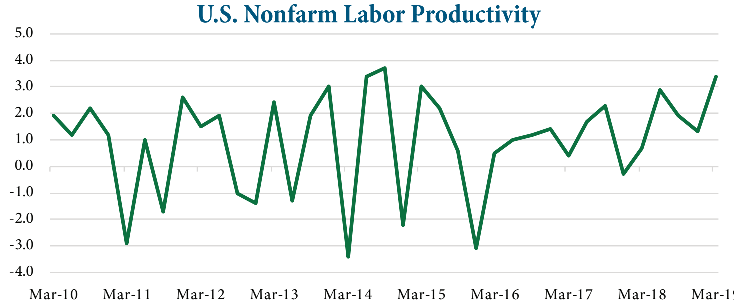
Source: Factset

The U.S. is not immune to economic lethargy. Spending on capital equipment has slowed and manufacturers are facing their own perfect storm: tariff-induced higher component costs, a strong dollar affecting overseas sales, and the anniversary of tax incentives, which pulled orders into 2018. Farmers in the corn belt are facing a trying year hindered by a wet planting season and curtailed exports. The bond market has noticed. While we do not face negative rates, part of the yield curve has inverted with some short-term bonds in the unusual position of yielding more than longer term bonds, indicating a recession could be in the offing. That inversion would likely disappear should the Fed lower rates as expected in July.

The current economic malaise represents more a pause in activity than a trend. Low interest rates act as both a warning to investors and a stimulant. The combined effect of low foreign rates and the Fed intimating a policy change has had the effect of lowering mortgage and loan rates. Lower rates will work through the economy over time and will increase home affordability and could foster investment in long lived assets, benefiting consumers and businesses.

May's headline job growth was weak, but it appears to be an outlier as other measures of employment remained strong and workers' compensation continues to improve. In a positive development, productivity rose over 3%, the highest level this cycle, with positive implications for efficiency, profitability, and inflation.

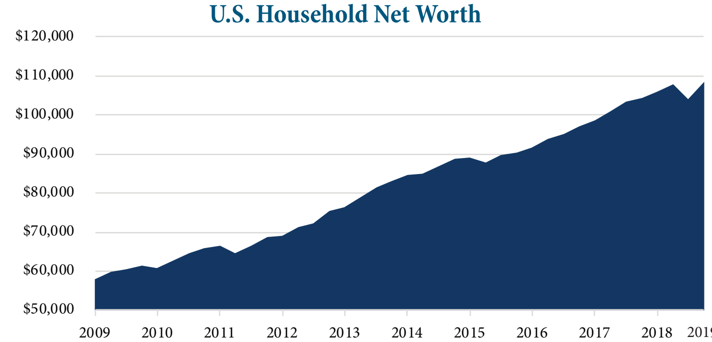
U.S. Nonfarm Labor Productivity



Source: U.S. Bureau of Labor

Whether consumer spending, backed by strong employment metrics, will be enough to offset sluggish business spending and keep the economy on a growth path remains to be seen. A decade of recovery after the financial crisis has left the consumer in a strong position, though. Consumer debt burden is very manageable, household net worth is at its highest level and continues to grow, and the savings rate at over 6% suggests that the consumer can support the economy in the face of business uncertainty.

U.S. Household Net Worth



Source: Board of Governors of the Federal Reserve System

To a large extent, the challenges facing the economy and markets now result from uncertainties caused by a significant change in our trade policies. Global trade has been espoused and endorsed by most countries for decades as a source of growth and the best method to improve their standards of living. Laws and business practices had adapted to encourage the flow of goods and services. Brexit and tariff concerns have changed this global view. Trade policies are in flux with no clear end game in sight. Stock markets are likely to react to every pronouncement, positive or negative, with the unintended effect of increased market volatility.

Restrictive trade policies will affect growth to some degree but are unlikely in themselves to cause a recession. By July, the U.S. expansion will have reached the ten-year mark and will have become the longest domestic expansion on record. More than 20 million jobs have been created in the last decade, unemployment is at 50-year lows, and inflation remains benign. Economic momentum is strong enough to withstand the current round of trade friction.

Financial markets are understandably jittery given the ever-changing trade environment. Bond yields are low by historical standards but provide an attractive return relative to other developed nations. Stocks are likely to be more volatile as investors digest how trade dynamics will affect future earnings. Longer term, stocks remain the preferred asset class.

Investment Oversight Committee
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