

Economic & Market Perspectives

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HALF FULL OR HALF EMPTY?

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Much of the extreme gloom of August has evaporated, and the market is once again seeing a “half-full” world. The saw-tooth pattern we’ve seen this year is typical of a late-cycle environment where uncertainty surrounding policy and mixed messages about the expansion’s sustainability cause market sentiment to swing strongly between pessimism and optimism.

KEY POINTS

We will continue to follow our late-cycle playbook of gradual risk reduction as valuations and risks of recession move higher.

As anticipated, the Federal Reserve Bank voted to cut interest rates by 0.25% to the median level of 1.875%.

There was some robust data in the labor report: stronger wage growth, rising labor force participation and a rebound in average workweek.

Inflation momentum has been growing across a broad set of subcomponents.

Recently, the ECB met and took unexpectedly aggressive dovish steps.

As we have always counseled, it's best not to react to specific data points or headlines. Instead, we recommend developing an investment strategy based on how one expects the economy and market to play out over the next 6-18 months, adjusting course only if the preponderance of the data indicates that it is necessary. While volatility is inevitable, the market should ultimately reconnect to the broader positive fundamentals over time.

Indeed, recent developments have had a more supportive tone to them, helping to return the S&P 500 to within 1% of all-time highs set in late July. Economic data, including the latest readings on jobs and consumer spending, have reduced fears of a looming recession. At the same time, trade tensions have come off a boil. Interest rates have also rebounded, calming concerns that the inverted yield curve was signaling imminent economic distress.

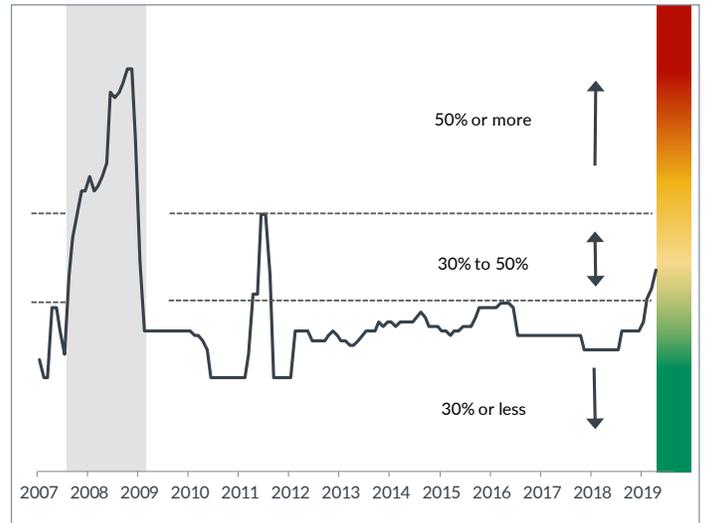
Still, the root causes of recent market concerns and volatility remain. So far, the U.S. economy has held up well in the face of global headwinds. Growth has slowed, but domestic demand continues to have strong foundational support, given low levels of unemployment, solid income gains and healthy overall household and corporate balance sheets.

However, the long-running economic expansion and equity bull market are not bulletproof. An aging business cycle is more vulnerable to policy missteps and other shocks. While the economy has shown great resilience to challenges from overseas, recent deterioration in business confidence and depressed investment is worrisome, and we remain on the lookout for broadening signs that this cautious behavior is spilling into hiring decisions and other domestic economic sectors. Should this occur, it would risk kicking the legs out from under the expansion.

The Fed will also be a leading actor in the story ahead, with officials standing ready to provide further cuts as insurance against downside risks. For the most part, we believe the central bank's shift to a more accommodative stance can help extend the economic expansion. Recessions are often brought on by overly tight monetary

FIGURE 1

Recession Risk Rising, But Sustainable Growth Still Likely Ahead



Source: City National Rochdale as of 9/2019. Gray column represents recessionary period.

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FIGURE 2

This Is What Late Cycle Looks Like: Harder Fought Gains S&P 500



Source: FactSet as of 9/19/2019.

policy, a concern we won't face in the near term, and, importantly for investors, bear markets outside of recessions are rare.

Given this, we're not surprised by the recent market rebound, and we expect stock prices to hold on to reasonable gains for 2019. A slowing but expanding economy, modest corporate profit growth and low interest rates still provide a good environment for equity investing.

This won't, however, spare the market from more bouts of overreaction in the months ahead. It's likely trade uncertainties and the ongoing manufacturing downturn will continue to stoke concerns of an impending recession from time to time. Add to that the potential for future Fed policy moves to diverge from investor expectations, and more episodic swings in market sentiment shouldn't be unexpected.

So is the glass half full or half empty? We think the economic reality lies somewhere between recent extreme perspectives, and we will continue to follow our late-cycle

playbook of gradual risk reduction as valuations and risks of recession move higher. We still believe maintaining a portfolio of high-quality durable assets will beat a bond or cash portfolio in the months ahead, so we want to stay highly invested to earn our yield and growth. But as the cycle matures and risks rise, we will continue to take steps to protect our clients' capital.

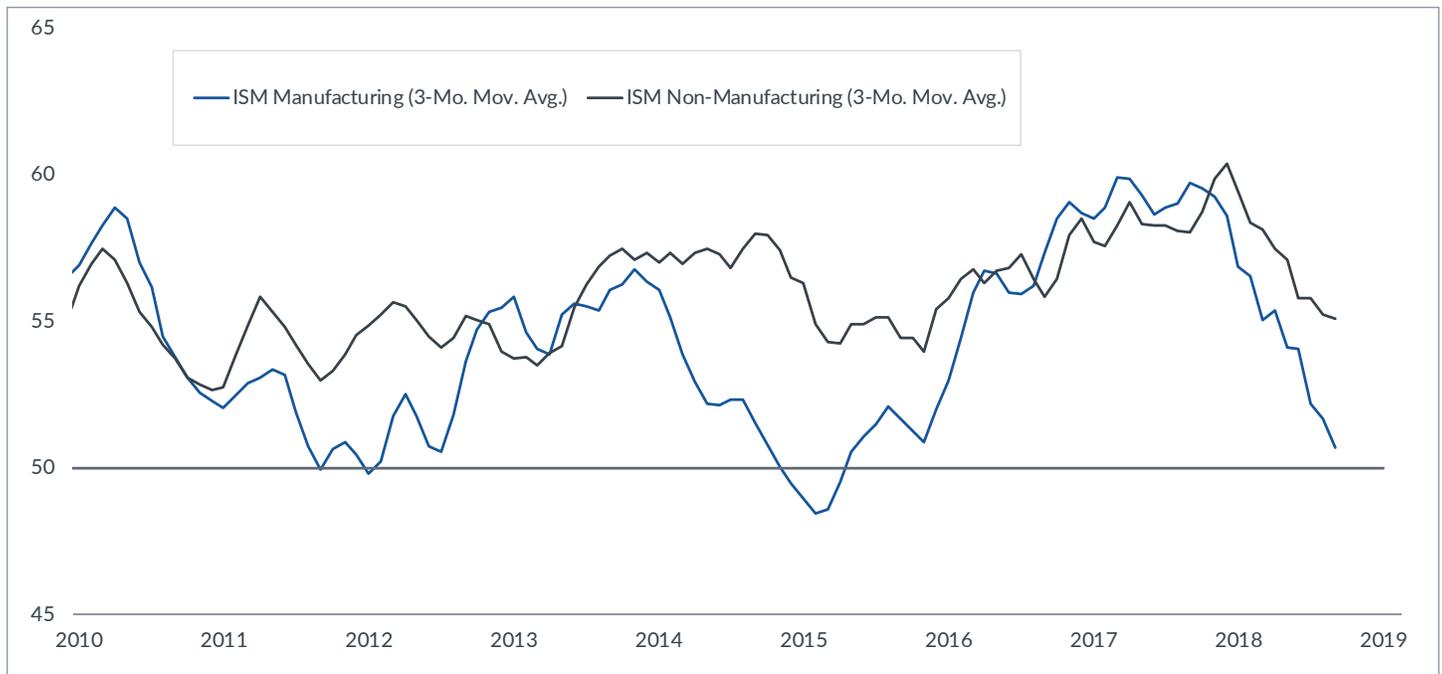
THE FED

As anticipated, the Federal Reserve Bank voted to cut interest rates by 0.25% to the median level of 1.875%. This move will help cushion the economy against the global economic slowdown brought on by rising trade policy uncertainty. This is the second reduction in the past two months, following a string of nine interest rate increases that began in 2015.

The Fed is trying to sustain the expansion. This is part of what it calls its "mid-cycle" policy adjustment, which is being interpreted as more than one cut but not an extended easing cycle. The question for the markets is: How much more easing is in store? The Fed does not plan

FIGURE 3

Service Side of the Economy Is Showing Resilience Against Manufacturing Headwinds
ISM (Diffusion Index, 3-Mo. Mov. Avg.)



Source: FactSet as of 9/2019.

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on any more interest rate cuts this year or next year. But that is the median of a range of forecasts from the 17 policymakers; underlying that median is a wide range of forecasts. The federal funds futures market expects one more cut this year. If the Fed does cut rates one more time, it would match the 75 bps in cuts that occurred in the previous “mid-cycle” easing periods that occurred in 1995 and 1998 (see Figure 4). Both of those were attributed to prolonging the expansion of the 1990s.

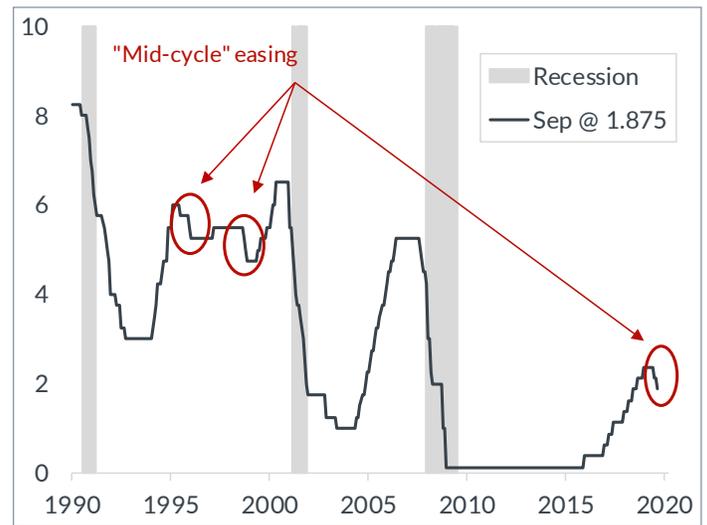
The Fed mentioned that the domestic economy continues to grow at a moderate pace, although the picture is mixed. Consumer spending has had solid growth, but the manufacturing sector has been weakening.

LABOR

Payroll growth continues its upward trend, albeit at a slower pace than last year. However, it is hard to draw conclusions from such comparisons. About a month ago, the Bureau of Labor Statistics announced that it plans to revise down past data. 2018 will drop by about 40,000 jobs per month. It appears that while hiring has slowed, the pace has not dropped as abruptly as current published figures indicate (see Figure 5). The revised data will be released next year. The unemployment rate is unchanged at 3.7% and is just above the 50-year low of 3.6%.

There was some robust data in the report: stronger wage growth, rising labor force participation and a rebound in average workweek. Wages have risen solidly; the annualized rate is up 4.2% in the past three months – the fastest growth since 2007 (compared to a 3.2% year-over-year rate). The accelerating wage growth suggests that the pool of idle qualified labor has shrunk. The labor force participation rate is at 63.2%, matching the highest level in the past five years.

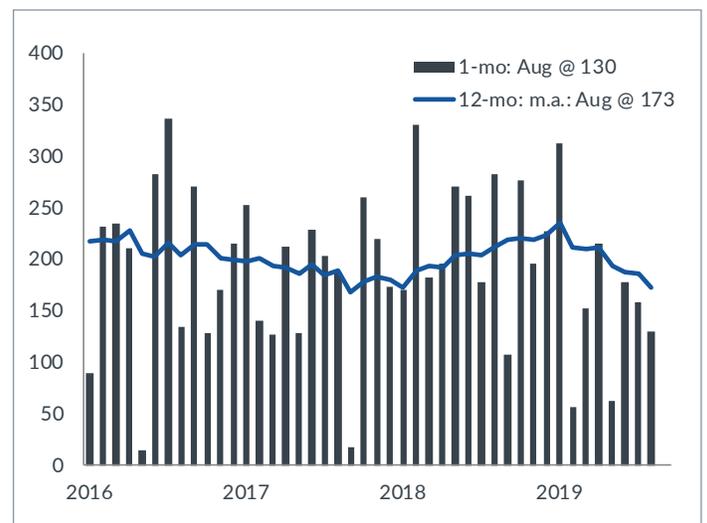
FIGURE 4
Median Federal Funds Rate (%)



Source: Federal Reserve Bank as of 9/18/2019.

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FIGURE 5
Monthly Change in Nonfarm Payrolls ('000)



Source: Bureau of Labor Statistics as of 8/2019.

INFLATION

The hot streak in inflation is continuing. The yearly change in the Core Consumer Price Index (which leaves out the volatile food and energy components of inflation) is at 2.4%, above the Fed’s target level of 2.0%. Back in May, it was at just 2.0%. In the past three months, Core CPI has been up at a 3.4% annualized rate (see Figure 6).

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Inflation momentum has been growing across a broad set of subcomponents. The recent increases have been attributed to a few volatile components. For instance, used car prices have been up 1.0% for each of the past three months. Part of that may be due to a new methodology that is being used to calculate prices. In addition, apparel prices are higher, probably due to tariffs, as we import most of our clothing. And airfares have surged of late, which is being attributed to the shortage of aircraft following the grounding of the Boeing 737 MAX.

EUROZONE

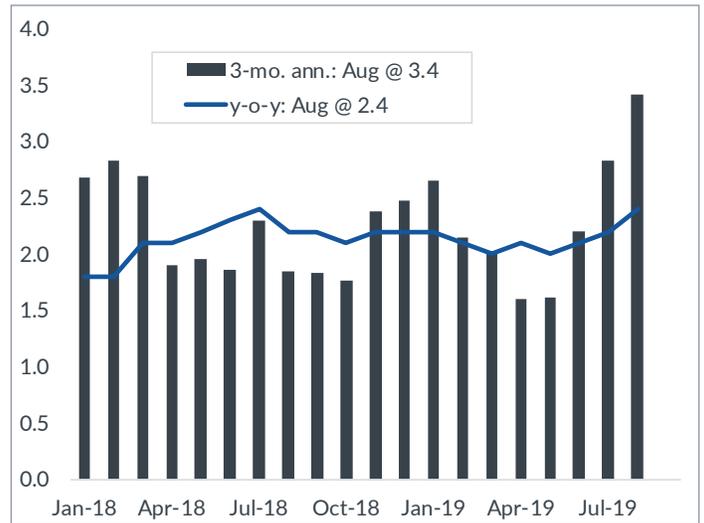
The European Central Bank is trying to avoid a downturn. Recently, the ECB met and took unexpectedly aggressive dovish steps, cutting its overnight rate further into the negative territory – from -0.4% to -0.5%. It will restart its quantitative easing program in November with monthly purchases of €20 billion, just nine months after it ended its previous bond-buying program.

What surprised the markets the most was the aggressiveness of the ECB’s actions when it made its commitment to keep interest rates low for an open-ended period. It will not raise interest rates until inflation, which currently stands at 1.0% and has been drifting down for the past year, is near its target of around 2.0%.

This dovish shift should help economic growth, which has been trending downward since the end of 2017 (see Figure 7).

FIGURE 6

Core CPI
(y-o-y, 3-mo. ann., %)

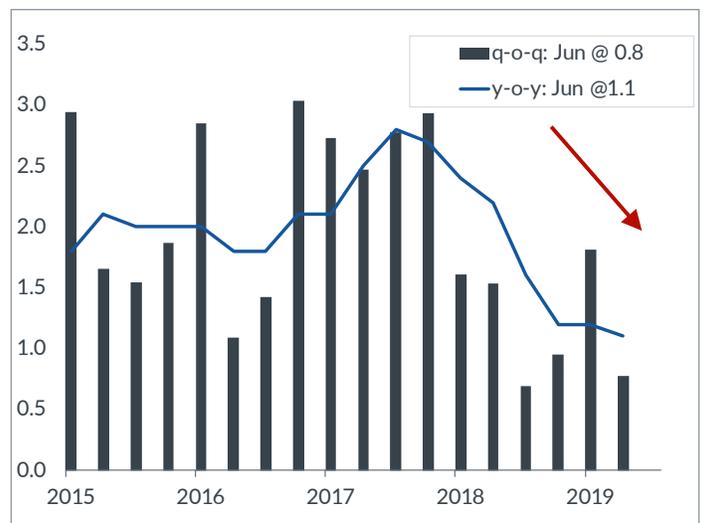


Source: Bureau of Labor Statistics as of 7/2019.

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FIGURE 7

Eurozone Growth Is at Low Levels
GDP (%)



Source: Eurostat as of 8/2019.

Important Disclosures

The information presented does not involve the rendering of personalized investment, financial, legal, or tax advice.

Certain statements contained herein may constitute projections, forecasts, and other forward-looking statements, which do not reflect actual results and are based primarily upon a hypothetical set of assumptions applied to certain historical financial information. Certain information has been provided by third-party sources, and, although believed to be reliable, it has not been independently verified, and its accuracy or completeness cannot be guaranteed.

Any opinions, projections, forecasts, and forward-looking statements presented herein are valid as of the date of this document and are subject to change.

All investing is subject to risk, including the possible loss of the money you invest. As with any investment strategy, there is no guarantee that investment objectives will be met, and investors may lose money. Diversification does not ensure a profit or protect against a loss in a declining market. Past performance is no guarantee of future performance.

Index Definitions

The Standard & Poor's 500 Index (S&P 500) is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

The ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity. Based on a survey of purchasing managers at more than 300 manufacturing firms by the Institute for Supply Management (ISM), the index monitors changes in production levels from month to month.

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Core CPI excludes energy and food prices, which can be very volatile and may bias the measure of inflation.

Indices are unmanaged, and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.

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