The Weekly

Economic & Market Recap

Peapack-Gladstone Bank, Private Wealth Management

October 5, 2018

As of 10/05/2018		Wk	Wk		YTD	12 Mos
		Net	%	Div	%	%
STOCKS	Close	Change	Change	Yield	Change	Change
DJIA	26,447.05	-11.26	-0.04	2.10	6.99	16.12
S&P 500	2,885.57	-28.41	-0.97	1.82	7.91	13.05
NASDAQ 100	7,399.01	-228.64	-3.00	0.99	15.67	22.15
S&P MidCap 400	1,967.98	-51.57	-2.55	1.59	3.55	8.13
Russell 2000	1,632.11	-64.46	-3.80	1.41	6.29	7.94

TREASURIES	Yield	**FOREX**	Price	Wk %Change
2-Year	2.89	Euro/Dollar	1.15	-0.78
5-Year	3.07	Dollar/Yen	113.65	-0.05
10-Year	3.23	Sterling/Dollar	1.31	0.63
30-Year	3.40	Dollar/Cad	1.30	0.33

Source: Thomson Reuters & Bloomberg

What Caught Our Eye This Week

Italy is the third largest economy in the eurozone, and its economy has declined by 6% over the past decade. Italy's government debt as a proportion of its gross domestic product is 131%, and it is the eurozone's biggest government borrower ($2.6 trillion). In June, a populist government was formed that vowed to cut taxes, increase welfare and reduce the retirement age. Last week, Italy's government stated that it expected to have a 2.4% budget deficit for the next three years. This was three times the deficit planned by the previous Italian government. Concern over Italy's finances precipitated a 5.7% decline in the Italian stock market, a 2.5% drop in the euro, and a fall in Italian bond prices. Government 10-year bond yields (which move inversely to price) increased from 2.82% two weeks ago to 3.46% on Tuesday, the highest yield in 4 ½ years. On Wednesday, the government retracted its deficit projections and stated that it had new plans for a 2.4% deficit in 2019 which would decline to 2.1% in 2020 and 1.8% in 2021. This calmed the markets for now. In order to meet the European Union's prudent budget rules and to make a material impact on debt reduction, the Italian government is going to have to come up with a viable plan. Italy's budget is required to be submitted for approval to the European Commission by October 15th.

Economy

The most anticipated report this week was the nonfarm payroll report, which was released on Friday. This report showed payrolls increasing by 134,000 in September, which was below the consensus forecast of 185,000. The unemployment rate decreased to 3.7% and the U-6 measure of unemployment increased to 7.5%. Average hourly earnings increased by 0.3% (8 cents) and are now up 2.8% year-over-year. The labor force participation rate was unchanged at 62.7%. Overall the best news was the positive revisions made to the July and August job figures totaling 87,000. In other news this week, the ISM manufacturing index decreased to 59.8 in September, which was below the consensus forecast of 60.0. The new orders index decreased to 61.8 and has now been above "60" for 17 consecutive months. On Wednesday, the ISM nonmanufacturing index showed an increase to 61.6 with the new orders index also increasing to 61.6. Overall, 17 out of 18 service sector industries reported growth.

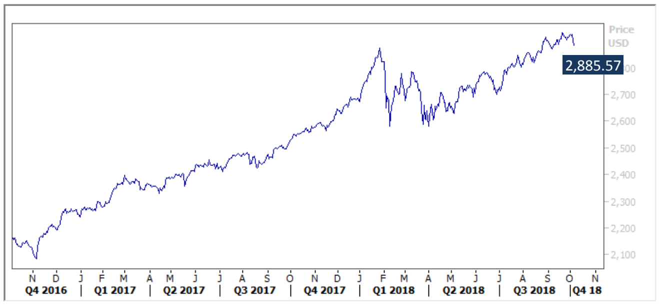
Fixed Income/Credit Market

Fixed income performances were mixed across all the sectors that we follow during the third quarter. The top performing sectors were intermediate-term high yield bonds, senior loans, and emerging market bonds which had total returns of 2.37%, 2.23% and 2.23%, respectively. The worst performing sectors were international treasury bonds and TIPS (Treasury Inflation-Protected Securities) which returned -1.07% and -0.86%, respectively. On the quarter, interest rates across the U.S. Treasury curve increased as much as 36.3 basis points (bps) at the 1-month tenor, while the benchmark 2-yr and 10-yr Treasuries increased 29.1 bps and 20.1 bps, respectively. While the FOMC continued its path towards normalization, increasing the Fed funds rate another 25 bps in September, the theme for the U.S. Treasury curve was higher and increasingly flatter. The spread between the 2-yr and 10-yr Treasuries began the quarter at 33 bps but flattened 9 bps to close 3Q at 24 bps.

Equities

Equities started the week hovering near highs, but hit headwinds mid-week. Jobless claims reported on Thursday illustrated a strong job market that continues to tighten, with the four-week moving average for continuing claims falling to the lowest level since October 1973. The tight job market, improved Italian budget projections, and inflation concerns led the Treasury market to sell off. Comments from Federal Reserve Chair Jerome Powell that Fed Funds rate may need to rise past neutral spooked the bond market. The sudden rise in bond rates triggered a sell-off in the broad equity market. Sectors with the most appreciation year-to-date witnessed the largest declines, including consumer discretionary and technology stocks which both fell over 2%. Despite the broad market decline, some sectors were actually up for the week, including energy stocks and financials. Next week earning season picks up momentum with large banks reporting results.

S&P 500



Our View

The devastating impacts of the financial crisis were widespread and extreme. Between 2008 and 2009 more than 8 million U.S. jobs were eliminated and GDP declined by 4.7%. Moreover, home prices fell over 30% from 2006 to 2009, which caused foreclosures to skyrocket and a large loss of home ownership. Both fiscal and monetary stimulus were instituted in an enormous and innovative fashion to stabilize the economy and mitigate the depth and duration of the recession. For the past decade, the Federal Reserve has remained extremely accommodative by taking rates to historic lows and building its balance sheet to over $4 trillion. Banking regulations increased dramatically in the aftermath of the recession and risky borrowers searching for leveraged loans found it extremely difficult to obtain funding. The need for funding and the lack of sources caused non-bank lenders to step into the market and fill the void once occupied by banks. Since leveraged loans reside high in the capital stack, are secured by physical assets and are floating rate, investors had little concern funding the deals. However, as time progressed and liquidity continued to pour into leveraged loans, the maintenance covenants, which allow lenders to review and manage the financial stability of a loan, were dropped and they became known as covenant-lite loans. The insatiable appetite for leveraged loans has allowed the debt to EBITDA ratio to reach an all-time high at the middle market level. With interest rates on the rise coupled with weaker balance sheets, it is our belief that the default rates on leveraged loans during a time of economic stress will be higher than what has been experienced in the past.

COMING UP NEXT WEEK		**Est.**
10/10 PPI Final Demand YY	(Sep)	2.8%
10/10 PPI exFood/Energy YY	(Sep)	2.5%
10/11 Core CPI YY, NSA	(Sep)	2.3%
10/11 CPI MM, SA	(Sep)	0.2%
10/12 U Mich Sentiment Prelim	(Oct)	100.5

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