What Caught Our Eye This Week

Europe's economy has been weakening since the end of 2017, but its woes have been exacerbated by the trade tensions and subsequent slowdown in economic activity in both China and the United States. The Eurozone’s gross domestic product (GDP) growth was a paltry 0.8% in the second quarter of this year. Manufacturers in Europe are struggling, and Europe’s reliance on global trade is far greater than that of the U.S. According to the Wall Street Journal, the Eurozone’s export of goods and services constitutes about 46% of its GDP compared to only 12% in the U.S. Furthermore, in Germany, Europe’s largest economy, the export trade is linked to one out of four jobs. By comparison, only one out of ten jobs in the U.S. relies on exports. Because of its position in the flow of international trade, Europe finds itself disproportionately impacted by the global economic slowdown and stuck in the middle of the trade war between the U.S. and China. Last week, the European Central Bank (ECB) indicated that most likely in September, it will lower its key interest rate (already at -0.4%) and re institute a bond-buying program in an attempt to promote growth. The ECB’s announcement has followed central bank interest rate decreases in India, Australia, South Korea, Indonesia, and South Africa— to name a few. The U.S. Federal Reserve, in its attempt to promote growth and keep U.S. interest rates in balance with rates around the world, lowered the federal funds rate by 25 basis points on Wednesday.

Economy

The most anticipated report this week was the nonfarm payroll report, which was released on Friday. This report showed payrolls increasing by 164,000 in July, essentially matching the consensus forecast of 165,000. The unemployment rate was unchanged at 3.7% and the U-6 measure of unemployment dropped from 7.2% to 7.0%. Labor force participation inched up to 63.0%, as the household survey showed a 370,000 increase in the overall labor force. Average hourly earnings gained 0.3% month over month, and the advance over the past 12 months is now at 3.2%. Examining the different employment sectors, manufacturing added 16,000 jobs, healthcare gained 30,000 and professional and technical services added 31,000. In other news this week, the ISM manufacturing index declined to 51.2 in July, which was below expectations and the lowest level since August 2016. On Tuesday, we were pleased to see personal income increase by 0.4% in June and personal consumption advance by 0.3%. Over the past 12 months, personal income has increased 4.9% and personal consumption was up 3.9%.

Fixed Income/Credit Market

Week-over-week, the 10-year U.S. Treasury (UST) yield decreased approximately 22 basis points (bps) to close at 1.85%. The downward move was precipitated by the FOMC cutting the Fed funds rate 25 bps and President Trump imposing a 10% tariff on $300B of additional Chinese imports beginning September 1st. Despite the 10-year UST yield hitting its lowest level since November of 2016, investors continue flocking to the safety of U.S. government assets. Furthermore, yields along the U.S. Treasury curve remain an attractive alternative versus our global peers.

Equities

Last week’s momentum reversed as investors reacted to the Fed’s decision to cut rates by 0.25%, second quarter earnings reports, and President Trump’s timely announcement of an additional 10% tariff on $300B of Chinese exports starting September 1st. Investor sentiment declined following news on Tuesday that the U.S. and China made little progress on a trade resolution. Following this announcement, the FOMC took center stage announcing the first rate cut in more than a decade. By the end of the week, 77% of the S&P 500’s constituents reported second quarter earnings results. So far, 76% have beat EPS expectations and 59% have surpassed sales expectations, both in line with their five-year averages. These results show revenue growth of 4.1% and EPS declining 1% on a year-over-year basis. With growing uncertainty, oil prices fluctuated over 8% throughout the week and volatility increased in both equity and credit markets. The best performing sector on a weekly basis was real estate up 2.0%; the worst performing sector was consumer discretionary down 4.9%.

S&P 500

Our View

The monetary tightening cycle in the U.S., which began in December of 2015, officially came to an end this week as the FOMC cut the Fed funds rate by 25 basis points and terminated its balance sheet runoff two months earlier than expected. The rate cut was initiated due to the “implications of global developments for the economic outlook as well as muted inflation pressures.” The market, which was looking for the rate cut to be the beginning of a longer easing cycle, was disappointed when Chairman Powell hinted that further rate cuts this year were not guaranteed, but that the FOMC will still be data dependent and will act as necessary to keep the expansion going. Lowering interest rates certainly has the potential to prolong the economic expansion in numerous ways. First, lower interest rates encourage consumers to borrow and increase their consumption as their cost of debt is reduced. Second, businesses that are faced with new demand will be incentivized to hire and invest in new capital expenditures. Third, corporate debt costs are reduced which leads to higher corporate profits. Lastly, lower interest rates reduce discount factors which effectuates higher asset prices. However, the benefits of lower rates may have less efficacy moving forward given the fact that the upper bound of the Fed funds rate resides at a relatively low level of 2.25% (less than half the level it was during prior downturns). Structural issues such as aging demographics, high debt levels and technological innovation have been headwinds against elevating inflation. Moreover, the U.S. 10-Year breakeven rate (a measure of inflation expectation) currently resides at only 1.65% and is roughly 31 bps below the mean dating back to 1998, which indicates doubt that the Fed will be able to achieve its symmetric 2% inflation target anytime soon.

COMING UP NEXT WEEK

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<td>08/05</td>
<td>ISM Non-Manufacturing SA</td>
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