**What Caught Our Eye This Week**

In the next two months, Google’s Waymo autonomous car division will launch its commercial driverless taxi business in Phoenix. The service will be rolled out to more cities over the next few years. Similarly, General Motor’s Cruise division plans to launch its driverless taxi business in 2019. Similar to the way Uber and Lyft operate today, passengers will be able to hail a cab using their smartphone, except that the car that shows up at your curb will be driven by a very sophisticated computer. Nearly every major auto company in the world has partnered with each other or with technology companies in order to share the development costs and the risks associated with their autonomous vehicle (AV) efforts. General Motors estimates that an AV business could generate 30% profit margins instead of the relatively paltry 7% profit margins that the company earns today. As noted in the Wall Street Journal, “The digital transformation of the auto industry will deliver $3.1 trillion annually in societal benefits by reducing the number of crashes, the impact of carbon emissions and the cost of car ownership, including maintenance, fuel and insurance. A 2017 study from Intel predicted that the global AV market will generate $7 trillion annually by 2050 – both directly (industrial use) and indirectly (savings from shorter commutes and a reduced need for emergency services).”

**Economy**

The most anticipated report this week was the retail sales report, which was released on Thursday. Retail sales increased 0.8% in October and are now up 4.6% year-over-year. The all-important control category, which excludes food service, autos, gas and building materials advanced by 0.3%. This significant measure is now up 4.8% over the past 12 months. Once again, nonstore retailers led the way with an impressive gain of 9.9% at an annual rate over the last three months. Earlier in the week, the Consumer Price Index data was released and displayed an increase of 0.3% in October, matching consensus expectations. The CPI is now up 2.5% year-over-year. The “core” CPI increased by 0.2% and is now up 2.1% versus a year ago. Overall energy prices were the biggest gainer, advancing by 2.4% in October. Finally on Friday industrial production figures showed a 0.1% increase in October which was less than expected. Manufacturing, which excludes mining/utilities, increased by 0.3% while capacity utilization fell to 78.4%.

**Fixed Income/Credit Market**

The U.S. Treasury market experienced strong demand this week, which caused yields to compress approximately 3 to 15 basis points (bps) between the 1 to 30-year tenors. Fed Chair Jerome Powell commented on Wednesday that the current U.S. economic environment is strong, but slowing global growth, diminishing domestic fiscal stimulus and the lagging impact of higher interest rates could hinder U.S. growth to a degree in 2019. The market interpreted Powell’s slightly cautious forward guidance by indicating that the Fed will most likely pause hiking rates in the middle of 2019. This week’s flight to quality trade caused investment grade credit spreads to increase to their highest level of 2018. Moreover, the 5-year BBB-rated spread to Treasury increased 12 bps to 1.23%. By comparison, the median 5-year BBB-rated spread to Treasury going back to 2009 is 1.36%, so even though credit spreads are increasing they are still 13 bps below their longer-term median.

**Equities**

Risk off was this week’s dominant theme as a result of trade concerns, energy prices, and Brexit. Technology companies’ guidance as well as results were weaker than expected weighing on the market. Value outperformed growth style by 1.1%. The spread in performance between the two styles year-to-date compressed to approximately 900 basis points (bps), down from its peak, greater than 1,300 bps in late September. During Fed tightening cycles it is common to see multiples compress due to a higher discount rate, impacting growth style equities with elevated valuations. WTI Crude oil continued its descent falling $2 or -3.3% for the week. Due to over supply and softer demand concerns, oil’s price declined 20% since its peak price per barrel in October. The issues surrounding a Brexit deal weighed on international markets and led to a volatile currency market. For the week all eleven sectors recorded losses. Energy and Consumer Discretionary sectors were the worst performers declining 3.25% and 1.37%, respectively; best performers Real Estate and Materials declined 0.52% and 0.57%, respectively.

**Our View**

We have frequently commented that one of the most significant risk factors that we focus on is the slope of the yield curve. When the U.S. Treasury yield curve inverts, yields of short-dated maturities are greater than long-term rates, it is a clear signal that the economy will begin to slowdown. The Fed’s effort to contain inflation by pushing up the real fed funds rate produces a higher probability of a recession, and institutional investors respond by lowering long-term bond yields. The yield curve has inverted before each of the last nine recessions. The slope of the yield curve has a powerful predictive value, yet the timing between inversion and recession is relatively variable. The current yield curve has flattened with the 10-year U.S. Treasury yield only approximately 75 bps above the 90-day Treasury Bill yield. However, the predictive efficacy of the yield curve may be less robust this cycle. First, the Fed is not fighting inflation. The Fed tends to be aggressive when they are concerned about inflation, but currently, inflation expectations are well-anchored. The Fed is trying to normalize their balance sheet and interest rates ahead of the next recession. The Fed does not want to create the next recession due to normalization since they would have to reverse course on rates. Second, yields at the long end of the curve remain artificially low because global central banks, except for the Fed, continue to pursue policies that constrain intermediate to long yields. A legitimate argument can be made that the information provided by the slope of the yield curve today is compromised by, or at least obfuscated, by central bank actions. As the Fed lifts rates, we expect that they will become data dependent and more circumspect regarding additional rate increases.

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