The Weekly

Economic & Market Recap

Peapack-Gladstone Bank, Private Wealth Management

October 12, 2018

As of 10/12/2018		Wk	Wk		YTD	12 Mos
		Net	%	Div	%	%
STOCKS	Close	Change	Change	Yield	Change	Change
DJIA	25,339.99	-1107.06	-4.19	2.19	2.51	10.94
S&P 500	2,767.13	-118.44	-4.10	1.90	3.68	8.67
NASDAQ 100	7,157.21	-241.80	-3.27	1.03	11.89	17.91
S&P MidCap 400	1,871.25	-96.74	-4.92	1.68	-1.54	2.83
Russell 2000	1,546.68	-85.43	-5.23	1.48	0.73	2.76

TREASURIES	Yield	**FOREX**	Price	Wk %Change
2-Year	2.86	Euro/Dollar	1.16	0.30
5-Year	3.02	Dollar/Yen	112.18	-1.37
10-Year	3.17	Sterling/Dollar	1.32	0.21
30-Year	3.34	Dollar/Cad	1.30	0.70

Source: Thomson Reuters & Bloomberg

What Caught Our Eye This Week

"Inflation this year is shaping up weaker than expected despite Fed assurances that inflation will rise above 2% in the next couple of years" said FTN chief economist Chris Lowe. Bond yields are a barometer of where investors think economic growth and inflation are headed. Recently, longer-term interest rates have moved higher with the 30-year mortgage hitting nearly 5%, the highest level in 7 years. If inflation figures are not as strong as expected then why are interest rates rising? Recently, the unemployment rate came down to 3.7%, the lowest since 1969. It is expected that with a tight labor market, there is going to be greater pressure on wages to rise and that could lead to inflation. The Federal Reserve has been raising short term interest rates since December 2015 and it wants interest rates to return to "normal". The common belief is that rates should go up because the economy is strong. Federal Reserve Chairman Powell recently commented that the Fed had a long way to go before short-term rates could be considered normal. An important factor will be inflation figures. If inflation looks to be falling short of the Fed's 2% target, the Federal reserve could hold off on increasing short-term rates.

Economy

This week the economic data centered around inflation statistics with the release of the producer price index and the consumer price index. On Wednesday, the PPI figures matched expectations with an increase of 0.2% in September. Over the past twelve months this metric has increased by 2.6%. The "core" PPI which excludes food and energy prices also advanced by 0.2% and is now up 2.5% year-over-year. Energy prices declined by 0.8% and food prices dropped by 0.6%, but prices for airline passenger services surged by 5.5%. The consumer price index was reported on Thursday and displayed an increase of 0.059% in September, which was below the consensus forecast. The "core" CPI increased by 0.116% and is now up 2.2% year-over-year. Core inflation actually cooled off during late summer with used car prices dropping by 3.0% and owners equivalent rent contributing only 0.18%, which was the softest increase since late 2014. Finally, on Thursday, weekly jobless claims showed a small increase of 7,000 to 214,000 during the week ending October 6th. The four week moving average is now at 210,000 and weekly jobless claims have now been below 300,000 for 189 consecutive weeks.

Fixed Income/Credit Market

After interest rates rose sharply last week, U.S. Treasury Notes pared some of their losses this week when interest rates decreased as much as 7.3 basis points (bps) at the 10Y tenor. The 10-year U.S. Treasury Note Volatility Index (TYVIX) closed last week 21% higher at 4.21. After a few peaks and valleys during the current week, the TYVIX closed at 3.93, an 11% decrease from this week's high of 4.42. Additionally, after a 25% increase last week, the MOVE Index (Merrill Lynch Option Volatility Estimate) increased just 2% on the week. The 2-year and 10-year Treasury spread narrowed this week 4.2 bps to close at 30.5 bps after steepening 10.6 bps last week. As the Fed continues their quantitative tightening, it will be interesting to see if the yield curve flattens further, the opposite of which occurred during each bout of quantitative easing.

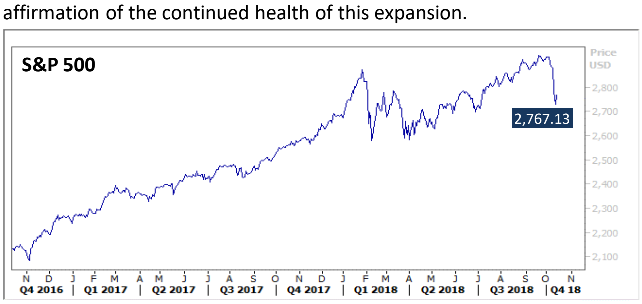
Our View – Equity Market Drawdown

Equities continued their broad-based selloff this week with the S&P 500 declining 4.1%. There was little selling pressure on Monday and Tuesday, but investor sentiment began to shift after earnings reports from two industrial companies indicated that corporate profit margins are being impacted by higher raw material and transportation costs and softer demand in China. Concerns over margin pressures, the rapid rise in interest rates and continued trade rhetoric triggered substantial declines in global equities. Furthermore, the International Monetary Fund (IMF) lowered its global growth forecast for 2018 and 2019 to 3.7% from 3.9% saying that trade tensions and rising import tariffs are taking a toll on commerce, while emerging markets struggle with tighter financial conditions and capital outflows.

The CBOE Volatility Index (VIX) more than doubled over the past two weeks and the S&P 500 declined roughly 6.9% from September's all-time high of 2930.75. All 11 sectors posted major declines with the technology sector being the most severe. The more defensive, high dividend yielding sectors such as utilities and consumer staples fared better than others.

This week's equity market drawn down is uncomfortable, but not unusual. From the beginning of the recovery in 2009, market draw-downs from annual highs have averaged 9.2% and ranged from 19% to 3%. The S&P 500 Index has experienced drawdowns that typically range from 5% to 10%. The average U.S. equity market decline over the last 40 years was 9.5% and lasted 31 days. Regarding market corrections of 10% or more, since 1928 corrections have generally occurred as frequently as every twelve months with an average drop of 13%.

Even though a spike in volatility coupled with a sharp equity selloff can cause anxiety levels to rise, it is always prudent to view the market activity within the context of the current economic environment. The Federal Reserve has commented on the current economic strength which can be seen in the following data: the labor market is strong with over 210,000 jobs added per month on average over the past year, leading economic indicators are up 6.4% on a year-over-year basis, the economy weighted ISM index hit 61.4 which is the highest figure ever recorded and high yield credit default swaps are currently trading at 354 basis points (bps), which is within 4 bps of the median dating back to 2012. It is also important to note that the Bloomberg financial conditions index is currently 0.38, which indicates financial conditions are still accommodative even with the Fed tightening monetary policy. Our view is that what happened this week (and it may not be over) is a correction within an ongoing (albeit aging) economic expansion. We are keenly focused on corporate profit margins and 2019 earnings guidance for affirmation of the continued health of this expansion.



COMING UP NEXT WEEK		**Est.**
10/15 Retail Sales MM	(Sep)	0.6%
10/16 Industrial Production MM	(Sep)	0.2%
10/17 Housing Starts Number	(Sep)	1.228M
10/19 Existing Home Sales	(Sep)	5.30M

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