The Weekly

Economic & Market Recap

Peapack-Gladstone Bank, Private Wealth Management

December 7, 2018

As of 12/07/2018		Wk	Wk		YTD	12 Mos
		Net	%	Div	%	%
STOCKS	Close	Change	Change	Yield	Change	Change
DJIA	24,388.95	-1149.51	-4.50	2.31	-1.34	0.73
S&P 500	2,633.08	-127.09	-4.60	2.03	-1.50	-0.13
NASDAQ 100	6,613.28	-335.74	-4.83	1.13	3.39	4.70
S&P MidCap 400	1,780.94	-97.71	-5.20	1.79	-6.29	-5.45
Russell 2000	1,448.09	-85.18	-5.56	1.56	-5.69	-4.76

TREASURIES	Yield	**FOREX**	Price	Wk %Change
2-Year	2.71	Euro/Dollar	1.14	0.77
5-Year	2.70	Dollar/Yen	112.66	-0.73
10-Year	2.85	Sterling/Dollar	1.27	-0.09
30-Year	3.14	Dollar/Cad	1.33	0.11

Source: Thomson Reuters & Bloomberg

What Caught Our Eye This Week

Normally, short-term interest rates are lower than longer-term rates. However, there have been periods of time when the opposite was true. This anomaly is called an inverted yield curve. Inverted yield curves most often occur when the Federal Reserve increases short-term interest rates to tame inflation expectations while at the same time investors participating further out on the yield curve drive down longer-term interest rates in expectation of slowing economic growth. Inverted yield curves are one of the best predictors of recessions. According to research provided by Crandall, Pierce & Co., since the late 1950s in the U.S., the eight significantly inverted yield curves (defined as 3 to 6-month treasury bills yielding more than the 10-year U.S. treasury bond) presaged peaks in the S&P 500 stock index. This week, for the first time since the last recession, the 2-year note has a yield greater than the 5-year note. This partial inversion has investors concerned that the yield curve could invert more fully in the near future. To add to the complexity, short-term inversions can sometimes reverse themselves. There have been times when market peaks have come nearly two years after an inversion. Additionally, during some of these periods of time leading to market peaks, stocks have performed considerably well.

Economy

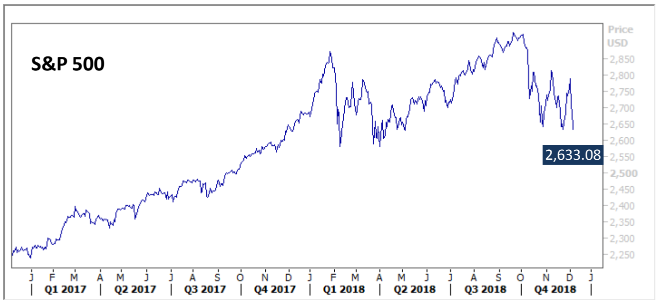
On Monday, the ISM manufacturing index rose to 59.3 in November from 57.7 in October and beat consensus expectations of 57.5. The new orders index also increased to 62.1 from 57.4 in October. The major measures of activity were mostly higher in November, and all were well above 50 which signals expansion. The ISM non-manufacturing index, also released this week, showed an increase to 60.7 in November which beat expectations of 59.0. The services sector continues to exhibit strong growth with the November reading hitting its second highest level in more than a decade. The most anticipated report this week was the nonfarm payroll report which was released on Friday. This report showed payrolls increasing by 155,000 in November which was below the consensus expected 198,000. Furthermore, the September/October readings were revised downward by 13,000. The unemployment rate was unchanged at 3.7%, and the U-6 measure of unemployment rose to 7.6%. Average hourly earnings increased by 0.2% and are up 3.1% year-over-year.

Fixed Income/Credit Market

The future of the Federal Reserve's monetary tightening policy has been a topic of debate throughout the week – with the pace and number of rate hikes in 2019 being the point of contention. Falling inflation has forced the FOMC to reconsider its hike-a-quarter approach heading into next year, suggesting that once again the Fed will move towards a data dependent approach to hiking rates in 2019. On the week, the Treasury bond market did not make the Fed's decision making any easier as 2-year through 30-year U.S. Treasury yields rallied back anywhere from 6.7 basis points (bps) to 14.4 bps. The benchmark 10-year Treasury yield decreased 13.4 bps week-over-week which caused further flattening of the 2-year and 10-year Treasury spread now at just 13.5 bps. The 10Y closes the week at approximately 2.85%, lowest closing level since September 6th when it ended the day at roughly 2.87%.

Equities

This week, while shortened by a market holiday in honor of former President George H.W. Bush's funeral, was marked by additional volatility in the global equity markets. The S&P 500 Index advanced 1.12% on Monday on optimism that the U.S. and China had reached a ceasefire in their trade dispute. These hopes were quickly dashed and stocks spent the rest of the week in decline, ending the week -4.58% as investors realized that real progress on trade had yet to occur and acted on other concerns about slowing global economic growth, wage inflation, and a flattening yield curve. The best performing sector this week was Utilities, +0.93%; the worst performing sector was Financials, -5.33%.



Our View

The financial markets have been extremely volatile during the fourth quarter. The proximate cause for the equity market weakness has been Federal Reserve messaging following the September rate hike. In early October, Federal Reserve Chairman Powell shocked markets by stating the Fed funds rate was well below neutral, and given the strength of the economy, the Fed could raise rates beyond neutral on its path to rate normalization. Powell's hawkish statement caused Treasury yields to spike as investors became concerned over a potentially more aggressive rate path in 2019. John Williams, President of New York Fed, added fuel to the fire by suggesting that a yield curve inversion would not be "worrisome" or a "deciding factor" in setting future policy. Investor sentiment was also negatively impacted by a softening global economic growth environment. Growth concerns have been amplified by the deleterious effect of a trade war. In our view, the October to December correction has largely been a function of two overly zealous policies. First, the Fed went from its data dependent approach to rate setting to a much more aggressive stance. The Fed funds rate had to get above neutral despite little apparent evidence of an acceleration of inflation. The comments by Powell and Williams were an unforced error. In November, Powell tried to ameliorate some of the damage by suggesting that perhaps rates are close to neutral already. But the damage was already done. Second, the trade rhetoric has been too public and too antagonistic to not create concern. Tariffs raise the price of products for imported goods and provide a pricing umbrella for domestic producers. Higher prices dampen demand, thereby lowering economic activity. Costs for producers also rise due to higher input prices and supply chain disrupt-ions, negatively affecting corporate margins and earnings. The Trump administration has raised legitimate trade concerns that need to be addressed. To not create additional problems, it is sometimes better to negotiate issues less publicly. The Fed and trade concerns could moderate as we get into 2019 allowing for better market sentiment and less volatility.

COMING UP NEXT WEEK		Est.
12/12 CPI MM, SA	(Nov)	0.1%
12/13 Initial Jobless Claims	3 Dec, w/e	
12/14 Retail Sales MM	(Nov)	0.2%
12/14 Industrial Production MM	(Nov)	0.3%

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