**What Caught Our Eye This Week**

Indexed investments are securities that do not attempt to perform better than a particular market but simply strive to match a market’s performance—often by buying each holding in a specific index such as the Standard & Poor’s 500 Index. Generally, indexed products exist in the form of mutual funds and exchange traded funds (ETFs). According to Morningstar, ETF fees have declined by 30% over the past decade. Over the past six years, this price war among index providers has intensified. The Wall Street Journal indicates that there are now 112 funds that mimic the S&P 500 Index with fees ranging from zero to 2.33%. The average fee on index funds is approximately 10 basis points (10/100ths of 1%). In August, one firm reduced the fee on two of its index funds to zero—creating quite a lot of publicity. The firm is able to do this by tracking its own proprietary indices and thus eliminating the roughly 3-basis-point licensing fee that it would customarily pay for tracking well-known indices provided by firms such as Standard & Poor’s, MSCI, or Russell Investments. Additionally, the index company can make money on lending out securities held in its funds. Finally, the firm has let the “zero-fee buzz” publicize the new products instead of paying upwards of one basis point for marketing. The ETF market continues to broaden its offerings.

**Economy**

The most anticipated report this week was Monday’s retail sales report. Retail sales increased 0.1% in September and are now up 4.7% year-over-year. Retail sales have now grown for eight consecutive months, and the gains in September were broad-based with ten of thirteen major categories showing rising sales. The all-important control category, which excludes food service, autos, gas and building materials advanced by 0.5%. The headline figure was weaker than expected, as food service sales declined by 1.8%. In other news this week industrial production figures were reported on Tuesday and showed a 0.3% gain in September which was better than expected. Manufacturing output increased by 0.2% and is now up 3.5% year-over-year. On Wednesday housing starts came in weaker than expected dropping by 5.3% to 1.201 million units at an annual rate. Both multi-family and single family starts declined in September. Finally on Friday existing home sales data was reported and showed a decline of 3.14% to 5.15 million units at an annual rate in September. This reading disappointed most forecasters and included downward revisions for August.

**Fixed Income/Credit Market**

Looking at U.S. ETF fixed income fund flows over the previous week indicates investors stepped up their efforts to de-risk their investment portfolios. In aggregate, ETF investors added $938MM to their investment grade (IG) allocations on the week, a 0.6% increase. High yield (HY) bond funds saw net outflows of approximately $153MM for the week. Fixed income fund flows clearly reflect investors’ reduced risk appetite as some of the riskier sub-asset classes (e.g. preferred equities and bank loans) saw net outflows of roughly $319MM and $208MM, respectively. Not surprisingly, government bond funds had net inflows of $983MM, a 1.1% increase. The attractiveness of U.S. Treasury yields has grown relative to recent history and in comparison to the low global interest rate environment. Investors also seem keen on managing their duration risk as ultra-short bond funds saw net inflows of $592MM which equated to a 1% increase.

**Equities**

Equity markets experienced another volatile trading week with the S&P 500 Index finishing mostly unchanged from last Friday’s close. Corporate earnings reports, the release of the Federal Reserve’s September meeting minutes and controversy surrounding the disappearance of a Saudi Arabian journalist were just a few of the reasons for the continued volatility. On Tuesday, the S&P 500 posted its largest single day gain since March 26th. Generally oversold conditions and a series of strong earnings results from major US companies helped drive equities higher. Investors’ positive sentiment reversed on Thursday due to a significant selloff in Chinese shares overnight, a deteriorating relationship between the US and Saudi Arabia and concerns over Italy’s proposed fiscal plan breaching the European Union’s budget rules. All major indexes declined over 1.25% on the day. Despite this, the S&P 500 was able to close the week in positive territory. Consumer discretionary stocks were the worst performers while the consumer staples sector posted an impressive 4.27% gain. Investors will look to corporate earnings and the health of the U.S. economy to determine stock prices amidst rising geopolitical tensions as well as a tightening Federal Reserve.

**Our View**

The Chinese economy has numerous headwinds to keep pace with its historical growth rate. Third quarter GDP showed the economy expanded at 6.5% on an annualized basis, the lowest figure since 2009. A vast majority of the slowdown in GDP is domestically driven and is not attributable to the trade war with the U.S at this juncture. Manufacturing, which grew at 6.0% in the second quarter, increased only 5.3% in the third quarter. A major issue facing China is its massive accumulation of debt since the financial crisis. Chinese debt, which was approximately 160% of GDP in 2008 has now ballooned to 266% of GDP. China has approximately $10 trillion of debt in its shadow banking system that is unregulated and highly risky. S&P mentioned this week that local governments have amassed $5.8 trillion in Local Government Financing Vehicles (LGFVs), which are off balance sheet debts to fund infrastructure spending. LGFVs once had the implied guarantee of the Chinese government, which has now been removed. As a result the default cycle has begun and investors have become wary of these investments. Equity weakness is another issue facing China this year. The Shanghai Composite Index is down 28% from its January high. Moreover, 11% of market capitalization is pledged as collateral for loans. If the market declines much further margin calls could force additional selling, which would further weigh on equity returns. On a different note, Chinese 5-yr sovereign credit default swap levels suggest a market view that the Chinese government has the resources to manage the economic turbulence. We will be closely monitoring how this situation evolves.