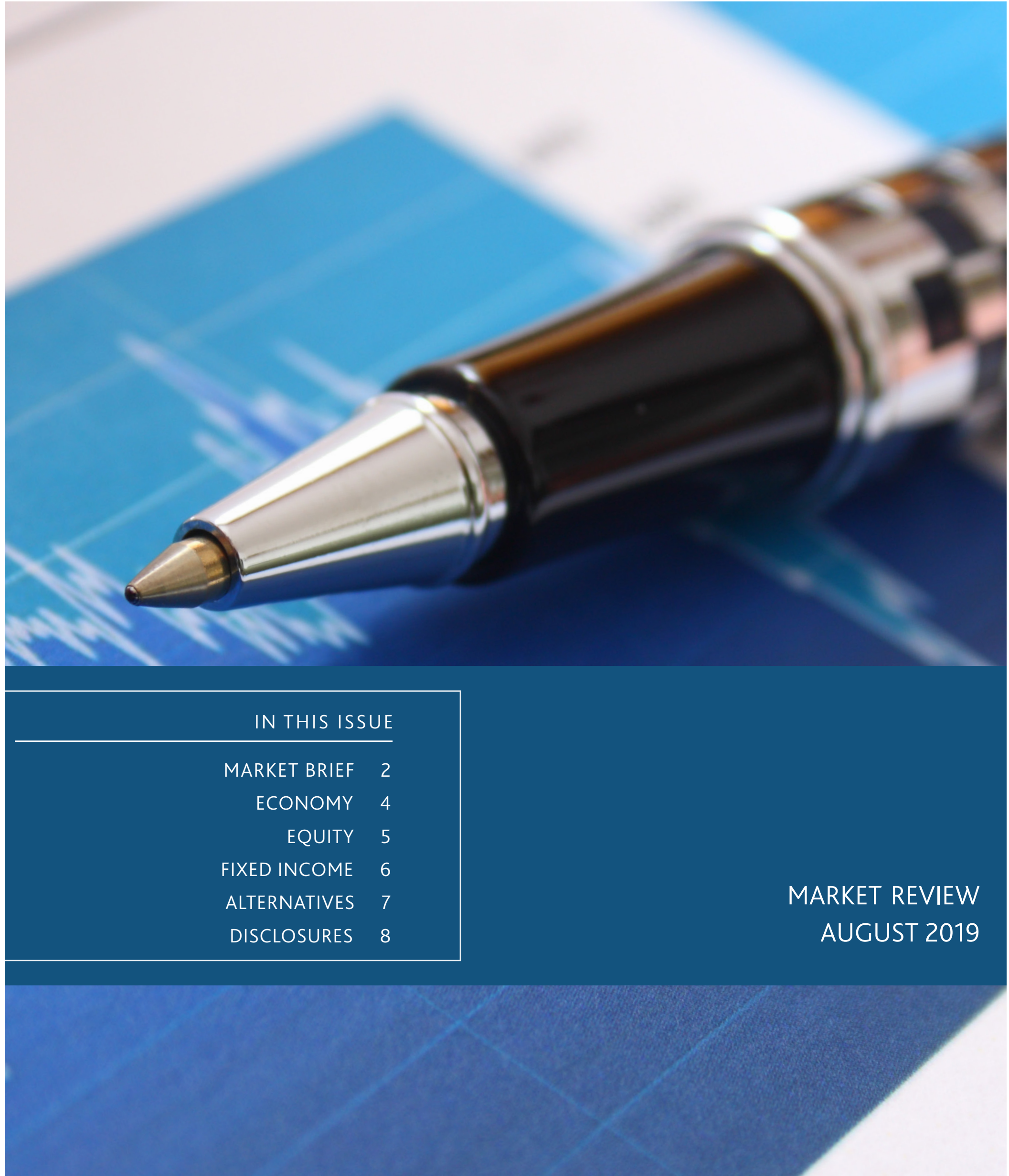

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MARKET REVIEW
AUGUST 2019

Itasca Bank & Trust Co.

Together we'll shape the future

THE OLDEST U.S. ECONOMIC EXPANSION ON RECORD

The current economic expansion entered its 121st month this July to become the longest expansion in U.S. history, according to the National Bureau of Economic Research (NBER). Until now, the longest expansion on record was the 120-month long cycle during the 1990s that ended in March 2001. Given the unprecedented length of this expansion, market commentators and investors have been increasingly questioning how long economic growth can persist.

History illustrates that economic expansions do not die of old age alone and usually end because a recessionary trigger arises that disrupts the status quo. Without such a trigger expansions can last for extended periods of time. For example, Australia is approaching 28 years for its current expansion. Multiple European countries and Canada recorded expansions of 15 years or longer between the early 1990s and 2008. The remainder of this market brief will review how the U.S. expansion has lasted so long, the current economic environment and the absence of typical recession triggers for the time being.

HOW HAS THE EXPANSION LASTED SO LONG?

There are multiple factors that contributed to the historic length of the current expansion. First, the economic environment when the expansion began was optimal for a long expansion. The National Bureau of Economic Research (NBER) official record of economic cycles shows our current expansion began in June 2009 following one of the worst and longest economic downturns since the Great Depression.

The severity of the 2008 recession created an unusually large amount of slack, or unused capacity, in the economy and labor market. The slack created a situation where the economy could grow for many years before reaching overheated territory. Overheating can be a threat to expansions because the Fed may respond with steep interest rate hikes to cool the economy in order to prevent excessive inflation and the formation of financial imbalances.

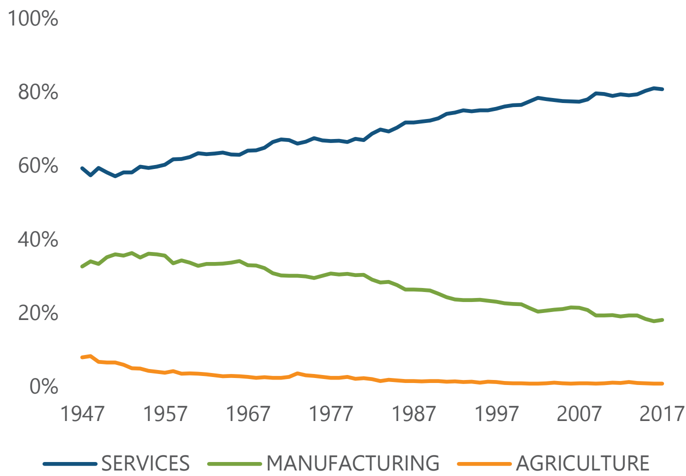
Second, the 2008 recession led central banks around the world to provide economic stimulus packages in the form of historically low interest rates and massive asset purchase programs. This stimulus continued for multiple years and is still in effect a decade later in some foreign countries.

Third, the composition of the economy has shifted toward services and away from manufacturing. Services have grown from 58% of U.S. GDP in 1950 to 81% of U.S. GDP in 2017, while manufacturing shrank to 18% from 35% over that same period. The remaining few percent of the economy is agriculture. The shift toward a more services-driven economy is notable because services tend to be less cyclical than manufacturing. As a result, an economy driven by services may experience more stable and sustainable growth.

Fourth, economic growth has been weaker than previous expansions. Since June 2009, GDP has grown 25.7% which is below the post-World War II average expansion growth of 27.0% and well below growth in other cycles of similar length including the 42.7% growth in the 1990s and the 51.9% growth in the 1960s.

U.S. ECONOMY COMPOSITION

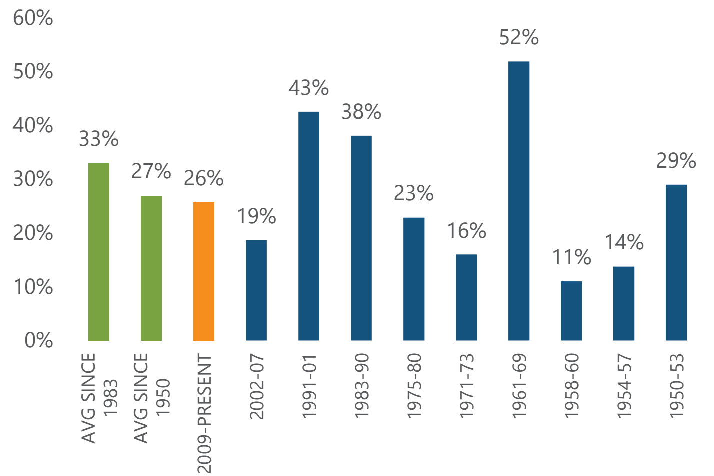
INDUSTRY AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT



Source: Bureau of Economic Analysis
Past performance does not guarantee future results.

EXPANSION GROWTH SINCE 1950

CUMULATIVE REAL GDP GROWTH DURING EXPANSIONS



Source: Bloomberg
Past performance does not guarantee future results.

The modest growth of this expansion has helped prolong the cycle because the economy has taken a longer time to reach its full potential capacity. One driver of this lower growth could be that in the initial years following the recession, consumer confidence and spending took much longer to recover than in previous post-recession periods.

SNAPSHOT OF THE CURRENT ECONOMIC ENVIRONMENT

The U.S. economy appears to be in the later stages of the cycle, but it is still showing signs of health. Slack in the economy and labor market appears to be close to zero as the economy has risen above its estimated potential GDP and the unemployment rate is below the projected level where the labor market and consumer prices would be in equilibrium.

Steady employment growth, rising wages, and low household leverage are providing support for the heart of the economy, consumer spending, which continues to grow at a solid rate. In recent quarters, the contribution to GDP from strong consumer spending has been partially offset by weakness in exports due to softer economic growth abroad.

Typical recessionary triggers do not appear to be a threat to the expansion at this time. A few common recessionary triggers include the bursting of financial asset bubbles, oil price shocks, and Federal Reserve interest rate hikes to prevent excessive inflation and financial imbalances in an overheated economy. First, the International Monetary Fund's April 2019 Global Financial Stability Report cited corporate sector debt as the top financial risk, but Fed Chairman Powell's recent comments suggest he believes this is not a major threat because "the current situation looks typical of business cycles."

Second, the U.S. has become the world's largest oil producer and a net exporter, making the country somewhat energy self-sufficient. Lastly, the Fed's recent pivot to cut interest rates demonstrated their desire to prolong the expansion.

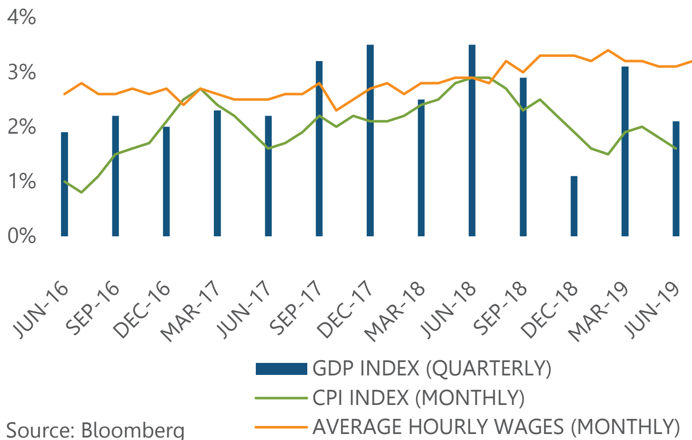
CONCLUSION AND INVESTMENT IMPLICATIONS

The current U.S. economic expansion has entered its 11th year, making it the longest in history. Historical examples indicate old age alone will not prevent the expansion from persisting. In addition, the near-term risk of recession appears low given the reduced probability of typical recessionary triggers and the strength of consumer spending which accounts for two-thirds of the U.S. economy.

Equities often experience strong performance in the late stages of the economic cycle. Since 1950, the S&P 500 has experienced an average return of 14.2% in the 13 to 24 months prior to recessions and 8.0% in the 7 to 12 months before recessions. While the economy appears to be in the later stages of the cycle it is important to keep in mind there is a difference between late cycle and end of cycle, and premature defensive asset allocation shifts can be costly to portfolio performance.

ECONOMY

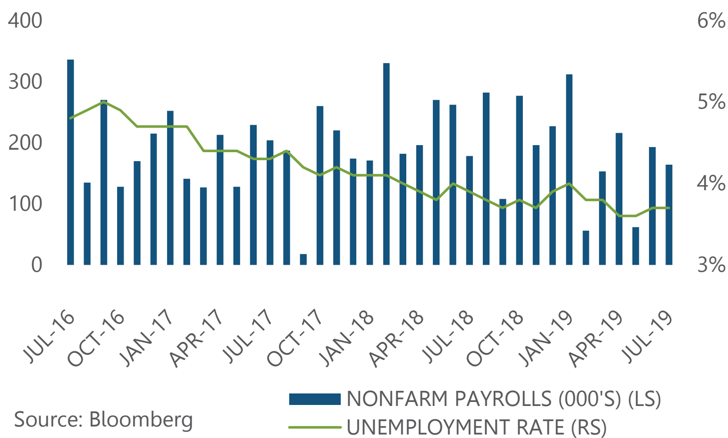
GDP, CONSUMER PRICES AND WAGE INFLATION
JUNE 2016 THROUGH JULY 2019



Source: Bloomberg

- GDP increased 2.1% in the second quarter, down from the first quarter's 3.1% growth and above consensus estimates of 2.0%. Healthy consumer spending partially offset export weakness caused by global trade disputes.
- The Core Personal Consumption Expenditure (PCE) price index, the Fed's preferred inflation measure, rose 1.6%, on a year-over-year basis in June. Continued lack of inflationary pressure will likely play a role in the Federal Reserve's next monetary policy decision.
- The Core Consumer Price Index (CPI), which excludes volatile food and energy costs, rose 0.3% in June. The year-over-year reading for Core CPI increased to 2.1%.

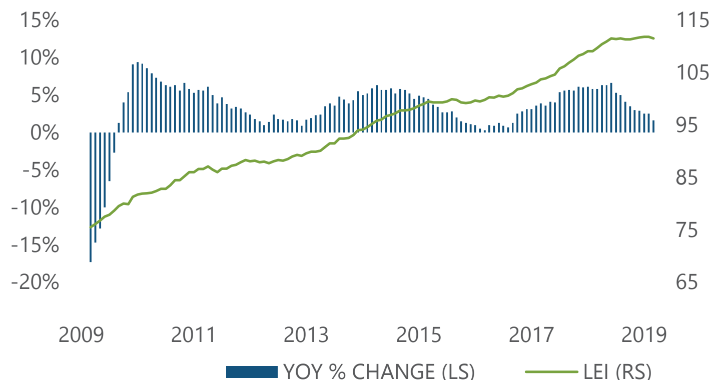
LABOR MARKET
JULY 2016 THROUGH JULY 2019



Source: Bloomberg

- July U.S. employment growth of 164,000 jobs was in line with economists' estimates. Job growth for May and June was revised down by 41,000. Through the first seven months of 2019 employers added an average of 165,000 jobs per month.
- The unemployment rate held steady near a 50-year low of 3.7%. The labor force participation rate increased for the second straight month to 63.0%.
- Average hourly earnings increased 3.2% from a year earlier, up slightly from last month's 3.1% pace but below the February peak of 3.4%.

LEADING ECONOMIC INDICATORS
JUNE 2009 THROUGH JUNE 2019



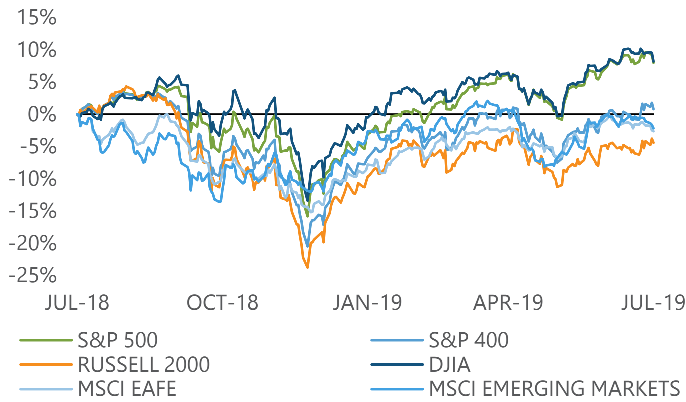
Source: Bloomberg

- U.S. economic growth continues to slow, evidenced by this year's first month-over-month decline in the Conference Board Leading Economic Index (LEI). The U.S. LEI dropped to 111.5 in June, a 0.3% decrease which followed no change in May and 0.1% increase in April.
- Weakness in manufacturing new orders, building permits, and unemployment insurance claims were the drivers of the June decline. Additionally, the negative interest rate spread between the 10-year Treasury and the Fed Funds rate negatively impacted the index for the first time since 2007.
- Despite the recent LEI weakness, the data suggests continued expansion through the second half of 2019, but at a much slower pace than in 2017 and 2018.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, JULY 2018 THROUGH JULY 2019

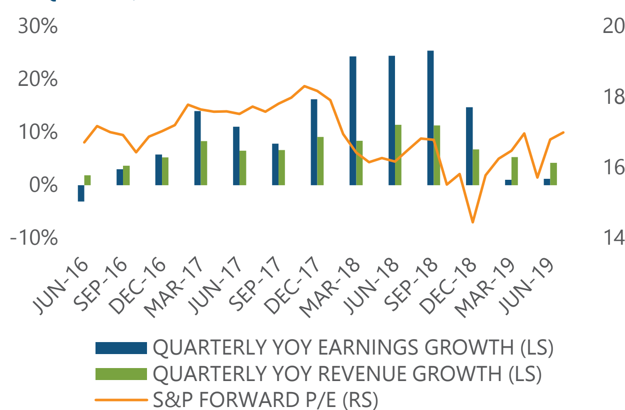


Source: Bloomberg

- The S&P 500 rose by 1.4% in July after June's strong 7.1% gain. The index was on pace for a higher return, but dipped 1.1% lower on the last day of the month after Fed Chairman Powell's comments dampened market expectations for further interest rate cuts this year, and trade talks between the U.S. and China ended without progress.
- European banks' 4.9% monthly decline led the MSCI EAFE index lower. The banks fell partially due to the European Central Bank hinting at fresh stimulus and a continuation of negative interest rates.
- South Korea's trade dispute with Japan and India's proposal to increase taxes on foreign investors weighed on the MSCI EM index.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, JUNE 2016 THROUGH JULY 2019

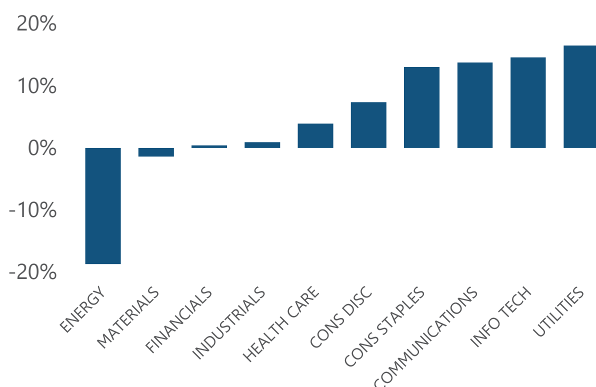


Source: Bloomberg

- For a second consecutive quarter S&P 500 earnings growth is on pace for positive growth while analysts' consensus estimate originally projected negative growth. About 66% of S&P 500 companies have reported second quarter earnings, which are on track for 1.2% growth compared to the original analysts' consensus estimate for a 2.2% decline.
- Revenue growth of 3.5% is better than analysts' estimates for 2.8% growth.
- Analysts are forecasting a trough in earnings growth next quarter followed by an improvement in the fourth quarter and into 2020.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

JULY 2018 THROUGH JULY 2019



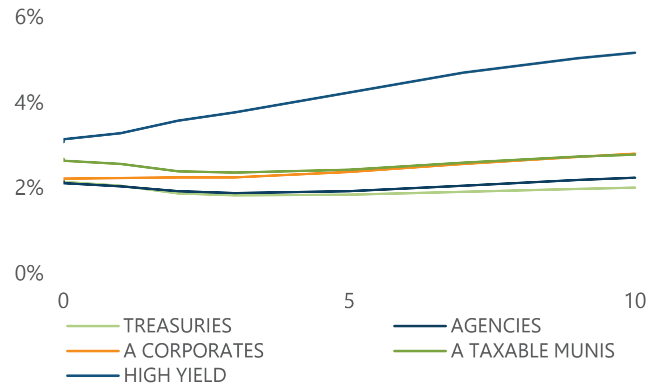
Source: Bloomberg

- The communications sector led the S&P 500 higher with its 3.4% monthly return. The sector's largest component, Alphabet, gained 12.5% due to a reacceleration in revenue growth which alleviated investors' concerns about slower growth in the first quarter.
- Technology was right behind communications, up 3.3% in July. Favorably received second quarter earnings from some semiconductor companies and Apple were the main drivers for the sector.
- Energy was the worst performing sector with a loss of 1.8%. Second quarter earnings for the sector are on pace for a 13.6% decline, worse than analysts' estimates for a 1.9% decline. Energy is the only sector not beating analysts' projections.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF JULY 2019

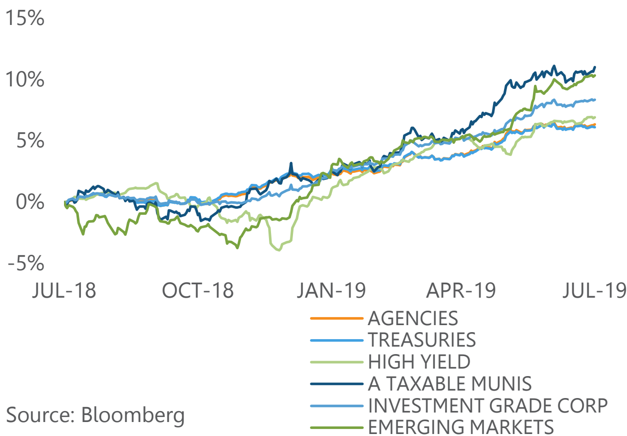


Source: Bloomberg

- July marked the third consecutive month where the three-month Treasury bill closed the month yielding more than the 10-year Treasury note. Historically, a persistent U.S. yield curve inversion has preceded periods of economic deceleration in the U.S.
- As of July 31, a three-month single A-rated corporate bond yielded 2.21%, just 4 basis points less than a three-year single A-rated corporate bond despite investors' normally demanding higher yields in longer maturities.
- Credit begins to have some significant spread pickup over Treasuries starting at two year maturities and increasing toward the longer end of the yield curve.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

JULY 2018 THROUGH JULY 2019

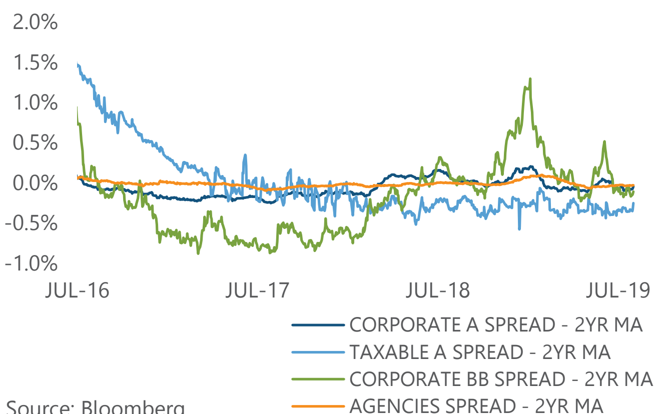


Source: Bloomberg

- All of the fixed income sectors shown in the accompanying chart have received a healthy price return of over 6% in the past twelve months as yields have declined.
- Out of the fixed income sectors tracked in the accompanying chart, single A-rated taxable municipals have posted the best performance, up 11.0%, while Treasuries have posted the weakest performance, up 6.1% over the past twelve months.
- All of the fixed income sectors shown in the chart to the left have been experiencing a positive price return for at least 6 months.

SPREAD VS. TREASURY LESS 2-YR MOVING AVG

JULY 2016 THROUGH JULY 2019



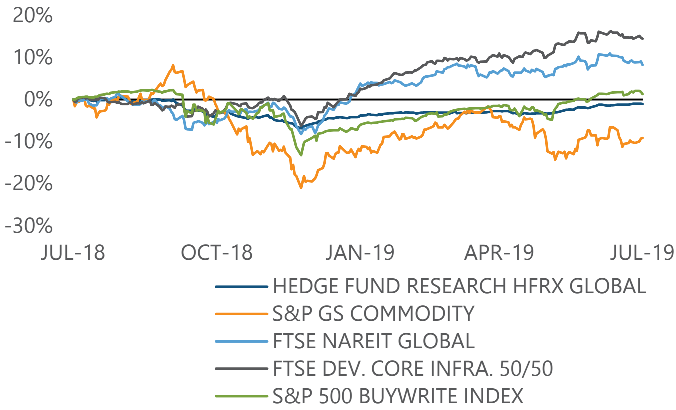
Source: Bloomberg

- The overall credit spread environment improved in July as none of the fixed income sectors had spreads tighten during the month. Despite building concerns of a softening economic environment, broad trends in U.S. corporate credit markets continue to indicate a benign environment.
- As U.S. Treasury prices continued to rally in July, corporate and agency bond spreads remained in-line relative to their levels over the last two years.
- Amid heightened demand and lower issuance in many more creditworthy states and municipalities, single A-rated taxable municipals remain expensive relative to their two-year moving average.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS

JULY 2018 THROUGH JULY 2019

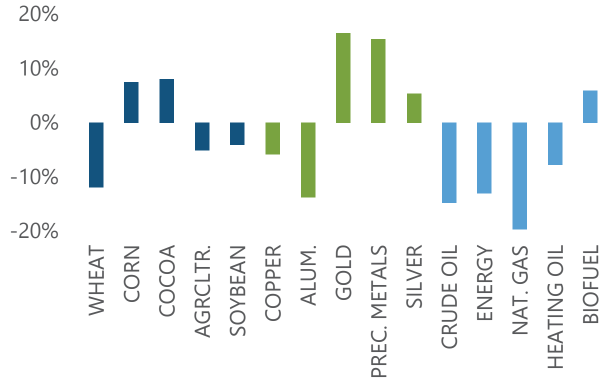


Source: Bloomberg

- Significant dispersion of returns between yield-sensitive alternative asset classes and their more cyclically and hedging-oriented counterparts remains in place since approximately November. This period has coincided with a steep decline in 10-year U.S. Treasury bond yields from 3.14% on October 31 to 2.01% on July 31.
- After climbing 19.3% in the first four months of 2019, the broad commodities asset class declined 5.3% from May through July.
- With the exception of precious metals and resurgent corn prices, commodities have been weighed down in recent months by oil price weakness amid escalating global growth concerns beginning in late 2018.

COMMODITIES, 12-MONTH SPOT RETURNS

JULY 2018 THROUGH JULY 2019



Source: Bloomberg

- Gold prices climbed roughly 8.3% in June and July, propelled by building fears of a global growth slowdown. The Federal Reserve's benchmark rate cut in mid-July eased the precious metal's ascent, but prices resumed an upward trend in July.
- U.S. corn futures prices reached a five-year high in mid-June amid a series of floods in the Midwest which wreaked havoc on planting activity and depleted expected 2019 and 2020 harvest volumes. U.S. farmers' late-season planting seems to have been boosted with tariff war-related federal spending infusions.
- The broad commodity market will likely be pressured until the U.S. dollar reverses its long-term upward trend. According to Bloomberg, the trade-weighted dollar has appreciated 24% since September 2007.

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