Colorado Capital
MANAGEMENT

FALL NEWSLETTER / 2019

# Economic Review

| Key Economic Indicators | Current 9/30/2019 | 3 Months Ago 6/30/3019 | 1 Year Ago 9/30/2018 |
|---|---|---|---|
| **US Economy** | | | |
| Quarterly Real GDP Growth | 1.80 | 2.00 | 2.90 |
| Unemployment Rate | 3.50 | 3.70 | 3.70 |
| Core Inflation (CPI) | 2.39 | 2.13 | 2.18 |
| **Interest Rates** | | | |
| Fed Funds Rate | 1.75 | 2.25 | 2.00 |
| 10-Year Treasury Rate | 1.70 | 2.07 | 3.00 |
| **Currency & Commodities** | | | |
| Crude Oil (WTI) | 54.09 | 58.47 | 70.23 |
| Gold Price | 1,510 | 1,358 | 1,199 |
| Trade Weighted Dollar Index | 130.75 | 128.25 | 126.04 |
| **Confidence** | | | |
| Consumer Confidence Index | 125.10 | 124.30 | 135.30 |
| ISM Purchasing Managers Index | 47.80 | 51.70 | 59.50 |
| **Stock Market** | | | |
| Dow Jones Industrial Average | 26,917 | 26,600 | 26,458 |
| S&P 500 Forward P/E Ratio | 16.8x | 16.74x | 16.8x |

*Legend: green = positive, yellow = caution, red = negative.*

**GDP Growth:** The growth outlook for both the US and global economies slowed during the third quarter of 2019. The Atlanta Federal Reserve projects U.S. real GDP growth to come in at an annualized rate of 1.8% for the quarter (vs. 2.0% the previous quarter and 2.9% a year ago). The World Bank also recently lowered its projection for global economic growth in 2019 to 2.6%, its slowest rate in three years. The slowdown is partly attributable to political and trade tensions, but is also likely reflective of where we are in the economic cycle after an unusually long period of economic growth.

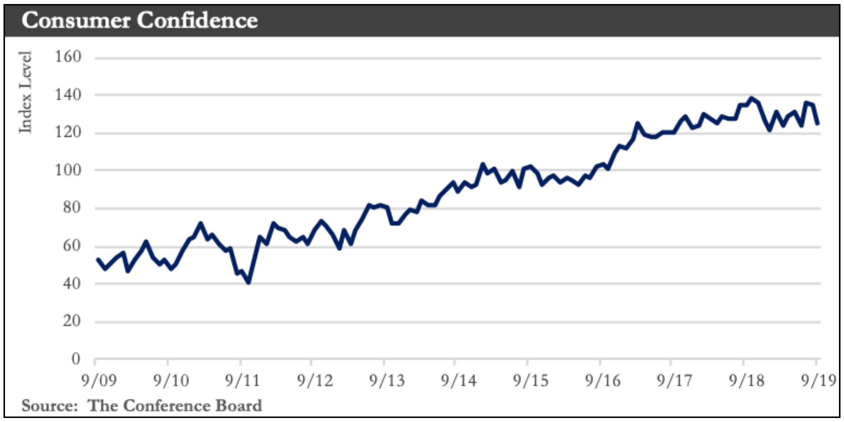
**Manufacturing:** In the U.S. the slowdown has been most pronounced in the manufacturing sector, which has actually contracted for the last couple of months as indicated by the Institute of Supply Management's Purchasing Manager Index. This index fell to 47.8 in September from 59.5 a year ago. Readings below 50 indicate spending reductions.

Softness in the U.S. manufacturing sector is concerning and is thus shaded red as it could be a harbinger of a broader economic slowdown. However, manufacturing weakness appears less related to domestic issues, and more to global factors, specifically, elevated trade uncertainty and slowing global growth. Indeed, the deepest declines in manufacturing shipments have been concentrated in sectors that are relatively more export intensive.

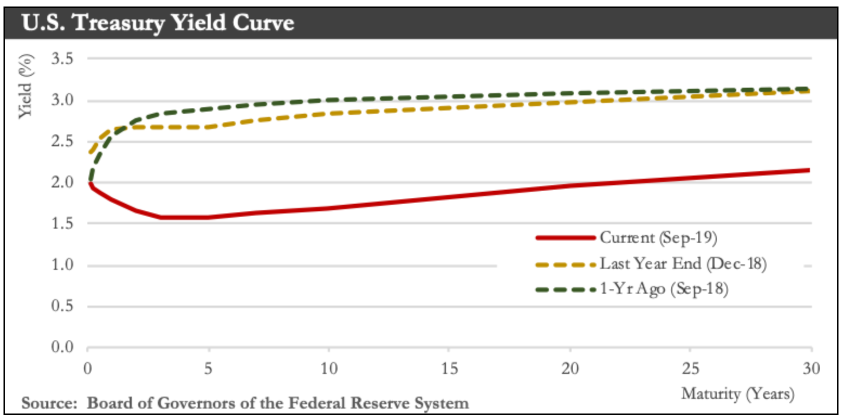
**Consumer Spending & Confidence:** The largest, and of late, strongest sector of the economy has been consumer spending, but this too is showing signs of weakness. Personal consumption increased only 0.1% in August, after averaging 0.5% growth during the first seven months of the year. This conincided with a sharp drop in consumer confidence, which remains high when compared to historical levels, but fell from 134.2 in August to 125.1 at quarter end.

**Inflation and Interest Rates:** The Federal Reserve is also concerned about the slowing economy, and recently reversed course from raising rates by ¼% in both September and December of 2018, to lowering rates by a like amount in August and September. The Fed left the door open for additional cuts amid the costs of rising trade-policy uncertainty. The Fed Funds rate is in now 1.75%, while the 2-year US Treasury Note is earning 1.62% and the 10-year US Treasury note is at 1.70%.

*Colorado Capital Management contributors and editors: Steven Ellis and Monica Mielke.*




While long-term rates are typically higher than short term rates, at times like this when the opposite is true, the yield curve is said to be inverted. During the quarter, the yield on the 2-year Treasury exceeded that of the 10-year Treasury for the first time since 2007.




In the past, yield curve inversions have often preceded economic downturns. However, the current situation has been somewhat different. Previously, most of the yield curve inversions were driven by the Federal Reserve aggressively raising short-term rates to slow the economy down and prevent inflation. With core inflation only modestly above target (ticking to up 2.4% in September), the Fed has been able to lower interest rates (to what are historically very moderate levels) in order to support the economy.

As opposed to rising short-term rates, what is currently driving the yield curve inversion has been the decline in the long-term rate. The depressed long-term yield largely reflects the challenging economic conditions in much of the rest of the world. Currently, U.S. government bond yields are higher than those in most other developed countries. Globally, there is now over $15 trillion of debt with negative interest rates.

This has provided a strong incentive for foreign investors to buy U.S government securities, especially when the risk of a dollar depreciation is perceived as low (the dollar actually appreciated close to 2% during the quarter vs. a basket of foreign currencies).

**Tariffs:** While the direct impact on U.S. economic growth from the China trade standoff has remained minimal, most of the risks to U.S. economic growth have continued to emanate from overseas. Slower growth and rising uncertainty in China have weighed most heavily on nations more exposed to international trade, such as Germany, Japan, Korea and much of the developing world. The resulting slowdown in global growth has weighed on U.S. exports.

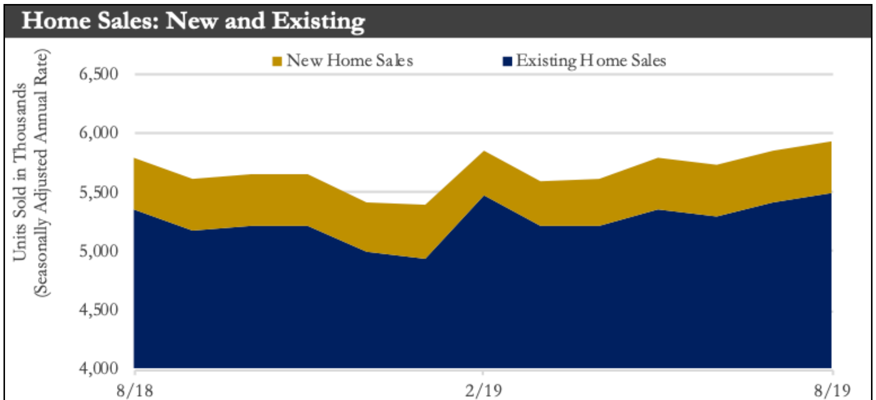
The indirect effects of the trade standoff have been more difficult to quantify and have mainly manifested themselves through increased uncertainty, weighing most heavily on business fixed investment. Financial market volatility has also increased, as a large proportion of corporate earnings have come from overseas.

**Oil Market:** The loss of nearly 6% of global oil output in the September 14th drone strikes in Saudi Arabia risked jolting energy markets and raising prices for U.S. consumers. A significant boost in prices would be a shot in the arm for U.S. shale producers, who have been under tremendous pressure from investors to restrain spending and focus on profits. In the near term, the biggest effects would be felt in Asia, as China, Japan, India, Korea, and Taiwan purchase approximately four million barrels a day of crude oil from Saudi Arabia.

But as luck would have it, the attack came at a time when global oil stockpiles were higher than usual, several producing countries had ample spare capacity, and the slowing global economy had lowered overall energy demand. As a result, crude oil prices actually declined during the quarter.

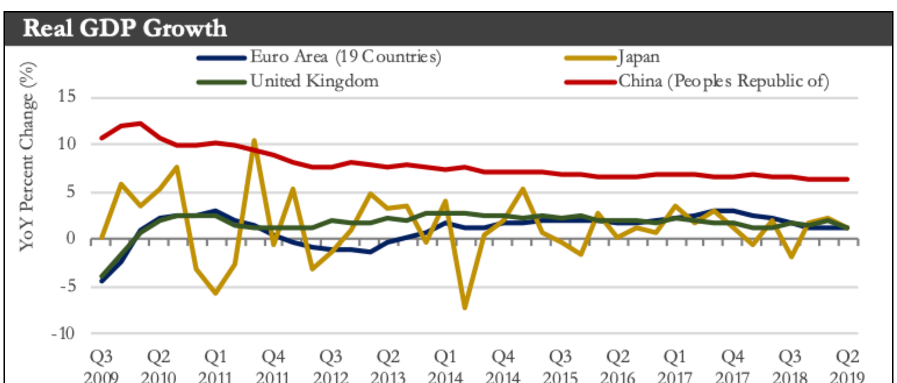
**Income & Employment:** On the upside, incomes rose by a solid 0.4% in August from a month earlier, led by a 0.6% jump in employee compensation. The latest jobs report was also strong, with unemployment dropping to a remarkably low 3.5%. While this is good news for households, it may actually represent a constraint to economic growth as employers may find it difficult to secure talent.

**Housing:** The housing market also had a strong quarter. The decline in long-term rates has boosted sales and firmed prices, while lower short-term rates have helped homebuilders. New home sales increased 7.1% in August and pending home sales rose a better-than-expected 1.6%. On the supply side, housing starts rebounded strongly in August following several months of moving sideways. Total housing starts jumped 12.3%, the highest since June 2007, while existing home sales rose again in August, marking the first back-to-back increase since 2017.



Source: U.S Bureau of the Census, National Association of Realtors

**Emerging Markets:** Some key emerging economies have contributed to a less favorable global outlook. China's economy has remained on a slowing path with Chinese export growth turning negative in U.S. dollar terms. While China's GDP growth is forecasted to be 6.1% in 2019, growth could easily slow to 5.8% in 2020. The chart below highlights the prolonged slowing of the Chinese economy. Another disappointment among the emerging economies has been India, which has seen year over year GDP growth slow



Source: Eurostat, Economic and Social Research Institute Japan, UK Office for National Statistics, National Bureau of Statistics of China

precipitously from 6.4% in Q4 of last year, to 5.8% in Q1 and 5.0% in Q2 of this year. Political and policy uncertainty, along with a difficult monsoon season, have been factors driving India's slowdown, although stronger growth is expected in 2020.

**Outlook:** The gradual slowing of GDP growth is not that surprising – and is not necessarily a signal of a weakening economy headed for a recession, but instead a natural pattern. As resource constraints, e.g., the availability of workers, become more binding and the effects of the fiscal stimulus (tax cuts) wane, actual economic growth should settle in the vicinity of the growth rate associated with the economy's long-term potential.

A forecast for 2019 real GDP growth of around 2.2% is reasonable given the developments of the first three quarters of 2019. However, the longer-term economic outlook remains uncertain due to cooling global growth, a faltering manufacturing sector, trade tensions, and the fading effects from the 2017 tax cut. Brexit, political unrest in Hong Kong, and the recent oil field attack in Saudi Arabia all add to the geopolitical uncertainties, but to date, these global risks seem to have had a limited effect on the US economy.

Our outlook continues to be shaped by expectations that a truce will eventually be found in the trade dispute, which will reduce some of the uncertainty hanging over the economy. Domestic demand should continue to hold up well, given the higher levels of employment, solid income growth and strong position of overall household and corporate balance sheets. The inverted yield curve is a warning, however, that even the less globally exposed U.S. economy is not immune to the effects of slower global growth.

# Market Commentary

The third quarter was marked by ongoing concerns about slowing global economic growth and policy uncertainties, particularly those related to trade relationships. The period saw investor appetite for risk fall and market conditions remain volatile. Growth concerns and dovish central banks action drove global interest rates downward. U.S. stocks and bonds generally outperformed their foreign counterparts, in part due to the dollar appreciating nearly 2% during the quarter vs. a basket of foreign currencies.

**Domestic Equities:** U.S. equity markets were mixed during the quarter. The benchmark S&P 500 rose 1.7% and closed the period within 2% of an all-time high. However, the Russell 2000 index of small company stocks was down 2.4%.

Trade relations with China and other geopolitical concerns weighed on business sentiment and triggered volatility, with August 5th producing the largest one-day market drop of the year. Although encouraged by Fed rate cuts in August and September, markets reacted with disappointment to Fed comments implying these rate cuts were only adjustments rather than the start of an easing cycle. Corporate earnings results, while generally weaker than a year ago, are tending to meet or exceed expectations. Overall, it was generally a "risk-off" quarter led by less economically sensitive market sectors. Utilities were up more than 9%, real estate gained almost 8%, and consumer staples rose more than 6%.

**International Equities:** It was a more challenging quarter for international investments as the MSCI EAFE index of developed countries fell 1.1%, and the MSCI Europe Index dropped nearly 2% during the period.

In Europe, the economy expanded just 0.2% in Q2. In September, the European Central Bank took steps to boost the economy, including restarting quantitative easing and committing to buying assets until its inflation target is reached. Emerging markets were particularly weak during the quarter, falling 4.3%. China, the index's largest constituent, dropped 4.7% as the Chinese economy continued to slow.

**Fixed Income:** During the quarter, the U.S. Aggregate Bond Index was up 2.3%, while foreign bonds dropped 0.6%. Government bond yields declined during the quarter as investors sought safety. The U.S. 10-year Treasury yield fell more than 30 bps and finished the quarter with a yield of 1.7%. Overseas, the 10-year German bund yield fell 24 bps (0.24%) and finished the quarter at a negative 0.57% yield, while The 10-year UK gilt yield dropped 34 bps. U.S. corporate bonds outperformed government bonds, and investment-grade corporates outpaced their high-yield counterparts.

**Outlook:** Overall, markets are expected to remain volatile as the calendar turns from 2019 to 2020. In the near term, economies and markets should continue to be driven by trade disputes, geopolitical friction, domestic politics, and central bank action. Protectionist policies have taken a toll on corporate sentiment, and business spending has slowed. Given this environment, returns are likely to be driven more by earnings growth than by further investor enthusiasm. Late cycle dynamics imply that risks to the downside probably outweigh the potential upside. It may be appropriate for investors to reduce risk and emphasize quality.

*Sources: Capital Market Consultants, Dept. of Labor, Dept. of Commerce, Bloomberg, Morningstar, Federal Reserve of St. Louis, Federal Reserve Board, Institute for Supply Management, the Conference Board.*

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