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Capital Markets Review and Outlook

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Economy and Outlook

In August, the trade war between the United States and China moved center stage for the global financial markets. The month began with President Trump's unexpected announcement that the United States would move forward with tariffs on almost all remaining imports from China. This statement elicited escalating tit-for-tat responses from both countries over the course of the month creating more confusion and uncertainty as well as market volatility. The protracted and roller-coaster nature of the trade war between the world's two largest economies has been a primary catalyst for the downturn in the world's industrial-side, as the manufacturing sector is most impacted by impediments to global trade. The slowdown in manufacturing has not yet spilled over into the broader U.S. economy. Exports account for only around 12% of U.S. GDP compared to 20% for China and well over 40% for Germany and the Euro area. While the U.S. economy grew by 2.6% in the first half of this year, investors are increasingly concerned that the weakness in manufacturing might broaden out and tip the economy into a recession. However, the U.S. economy remains underpinned by a strong employment picture with the lowest unemployment rate in 50 years. Consumer confidence is at high levels, and the resilience in consumer spending, which accounts for over two-thirds of the U.S. economy is shown in the chart on the left. Additionally, the Conference Board's Leading Economic Index for the U.S. just made a record high in July. Due to concerns that tariff-induced business uncertainty might lead to a retrenchment in the investment and hiring plans of companies which, in turn, could negatively impact consumer spending, the Federal Reserve has signaled its willingness for further monetary policy accommodation. At the same time, the Fed's Chairman Powell as well as the heads of other global central banks speaking at the recent annual symposium at Jackson Hole warned about the limitations of monetary policy as a tool to offset economic weakness brought about by a worsening trade war. While uncertainty and market volatility are likely to continue in the near-term, the most likely longer-term outlook remains for a resolution of the trade war between the United States and China, especially since the U.S. presidential election takes place next year, and Mr. Trump is determined to win re-election. Besides the trade war, there are other geopolitical risks for the financial markets. These risks include the widespread protests in Hong Kong, Brexit, Kashmir and Iran. However, risk assets are likely to be supported by the global stimulus currently underway through interest rate cuts by central banks across both developed and developing markets, as well as the various fiscal stimulus measures being undertaken.

Source: U.S. Bureau of Economic Analysis

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Equity Markets

For only the second month this year, equity markets were lower as volatility rose on the back of escalating trade war rhetoric between the United States and China. The equity markets, however, ended the month well off their intra-month lows as some of the trade-related harsh language softened by month-end, and the Federal Reserve also indicated the possibility of further interest rate cuts. While the broad domestic equity market represented by the Russell 3000 index declined -2% in August, the index was only -3.6% below the all-time highs reached in late July. For the first 8 months in 2019, the Russell 3000 index was up a strong +18%.

In terms of investment performance differentiation, the capitalization and style trends this year continued in August. For the month, Large Cap outperformed Small Cap by over +300 bp bringing its year-to-date outperformance to +660 bp. Likewise, Growth outperformed Value across all capitalizations. The average outperformance was +171 bp for the month of August and over +1,000 bp year-to-date. The negative market tone in August was reflected in sector performance as Defensives outperformed Cyclicals. Defensive sectors such as Consumer Staples and Utilities had positive returns for the month (+1.8% and +5.2% respectively), while the cyclical Industrials and Materials sectors had negative returns of over -2%. The Energy sector was hit especially hard due to a combination of declining prices and rising inventories. The sector had a return of -8.1% for the month. Year-to-date, Energy was the weakest sector with a return of +2.1%.

The continued trade skirmish between the United States and China, the strength in the U.S. dollar and the sharp rise in market volatility weighed on international equity markets, especially emerging markets. In August, the MSCI Developed Markets equity index declined -2.6%, while the Emerging Markets index was down -4.9%. The Federal Reserve's recent move towards more monetary policy accommodation together with interest rate cuts by a number of central banks, including several in the emerging markets, are likely to be supportive of asset prices in the international markets.

Fixed Income Markets

Market participants in the fixed income markets are anticipating deeper economic weakness and more policy accommodation by the Federal Reserve than what is reflected in economic data releases. As a result, U.S. interest rates plunged in August with the 10-year Treasury note's yield declining by 52 bp to 1.5%, the lowest yield in more than three years. The yield on the 30-year Treasury bond fell by 57 bp to 1.96% which is the lowest yield in history for this maturity. Shorter maturity Treasury yields declined by less with 2-year and 5-year Treasury yields decreasing by 39 bp and 45 bp respectively. This caused the Treasury yield curve to flatten with the 2-year/10-year spread narrowing by 13 bp to end the month at 0. At the beginning of the year, the spread was +21 bp. At the end of August, the entire Treasury coupon curve from 2-years out to 30-years had a 1%-handle, the first time ever that this has occurred.

While spreads in the corporate bond market widened in August reflecting the downturn in the equity markets, the spread widening was significantly less than the bleak economic picture painted by the Treasury market. The spread on the Bloomberg Barclays Investment Grade Credit index widened by 11 bp to end the month at +114 bp and resulted in -92 bp of underperformance over duration-matched Treasuries. Investor risk aversion was also reflected in the steepening of the corporate credit curve as longer maturity corporate bonds underperformed short and intermediate issues. Likewise, the corporate quality curve also steepened with AA-rated and Single-A rated bonds outperforming BBB-rated issues. Sector

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performance was similar to the equity markets with Energy the worst performing sector in the corporate bond market, and Cyclicals underperforming Defensives as well. Although spreads also widened in the High Yield bond market, higher coupons and the drop in Treasury yields helped the overall market produce a positive return of +0.4% for the month. Year-to-date, the high yield market was up a strong +11%. While yields declined in international government bond markets as central banks cut interest rates, the stronger U.S. dollar was a headwind for investment performance. In August, the non-dollar government bond market had a return of +2.2% bringing its return for the year to +7.1%.

			Returns as of 8/31/19 (In %)				
		Month	QTD	YTD	1 Year	3 Years	5 Years
Russell 3000®	US AllCap Equity	-2.0	-0.6	18.0	1.3	12.2	9.6
Russell 1000®	US Large Cap Equity	-1.8	-0.3	18.5	2.5	12.6	9.8
Russell 1000® Growth	US Large Cap Growth	-0.8	1.5	23.3	4.3	17.0	13.1
Russell 1000® Value	US Large Cap Value	-2.9	-2.1	13.8	0.6	8.1	6.6
Russell Midcap®	US Mid Cap Equity	-2.8	-1.5	19.6	0.5	10.1	7.9
Russell Midcap® Growth	US Mid Cap Growth	-1.8	0.5	26.7	6.0	14.9	10.7
Russell Midcap® Value	US Mid Cap Value	-3.5	-2.7	14.8	-3.1	6.5	5.9
Russell 2000®	US Small Cap Equity	-4.9	-4.4	11.8	-12.9	7.9	6.4
Russell 2000® Growth	US Small Cap Growth	-4.3	-3.4	16.3	-11.0	10.6	8.1
Russell 2000® Value	US Small Cap Value	-5.6	-5.4	7.3	-14.9	5.1	4.6
MSCI ACWI ex-US	Global Equity ex-US	-3.1	-4.3	8.8	-3.3	5.9	1.4
MSCI EAFE	Global Developed Mkts Equity	-2.6	-3.8	9.7	-3.3	5.9	1.9
MSCI EM	Emerging Mkts Equity	-4.9	-6.0	3.9	-4.4	5.8	0.4
Bloomberg/Barclays US Agg	US Core Fixed Income	2.6	2.8	9.1	10.2	3.1	3.3
Bloomberg/Barclays US Interm. Agg	US Intermediate Fixed Income	1.5	1.6	6.4	7.8	2.5	2.7
Bloomberg/Barclays US Credit	US Corporate Bonds	3.1	3.7	13.4	13.0	4.5	4.4
Bloomberg/Barclays US MBS	US Mortgage Backed Securities	0.9	1.3	5.5	7.1	2.4	2.8
Bloomberg/Barclays US Corp HY	US High Yield	0.4	1.0	11.0	6.6	6.2	4.9
FTSE Non-US WGBI	Global Fixed Income ex-US	2.2	1.5	7.1	7.3	1.5	0.7