BOK FINANCIAL

# Quarterly Investment Perspectives

**Q3 2019 Review & Outlook**

Volatility increased in the third quarter of 2019 as we expected. Evidence that uncertainty tied to the ongoing trade dispute with China is slowing economic activity in the U.S. led the Federal Open Market Committee (FOMC), the interest rate setting committee of the Federal Reserve (Fed), to lower rates for a second time this year. Importantly, while the chances of a U.S. recession have increased, we still expect growth to remain positive for the remainder of this year and into next year.

The U.S. consumer is responsible for seventy percent of the U.S. Gross Domestic Product (GDP). Manufacturing, which has taken a direct hit from tariff policies, is a smaller part of our economy. We cannot ignore the slowdown in manufacturing, but manufacturing weakness on its own should not be enough to tip the U.S. economy into recession. The outlook for the U.S. consumer continues to be supported by low unemployment and income gains. Job growth has slowed recently but this should be expected as the unemployment rate, 3.7% at the end of the third quarter, remains near 50-year lows. And while wage growth is positive, it is not at levels which will cause the Fed heartburn from an inflationary standpoint.

Globally, the growth picture is more negative than here in the U.S. As a result, international monetary authorities have been more aggressive in reducing rates, which has led to a surge in the amount of negative yielding global bonds, as shown in the chart below. These lower global rates have had an impact on rates in the U.S.

**Bloomberg Barclays Global Aggregate Negative Yielding Debt ($ Trillions)**

Much has been written about the inversion of the Treasury yield curve, as historically an inversion of the yield curve has been a harbinger of a domestic recession. In our view, the inversion is a message from the bond market that domestic interest rates are too high within a global context, but it is not a definitive message that a recession is imminent. The Fed has begun to ease and we would expect at

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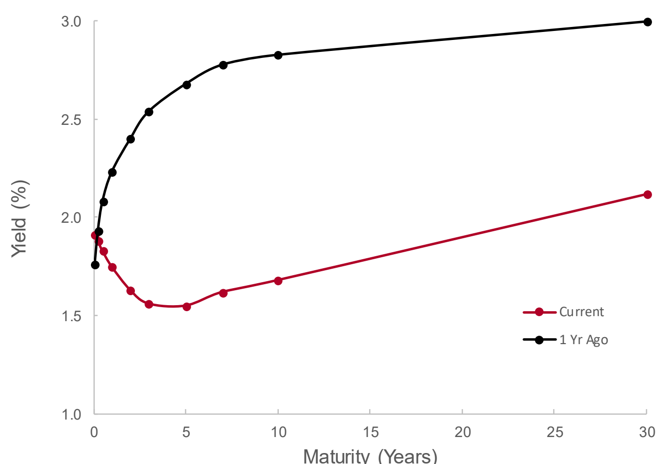
least one more rate reduction between now and year-end. At the end of the third quarter, the yield curve was still inverted on the short end as 3-month T-bills were yielding more than 10-year T-notes; but 2-year T-notes were now yielding less than 10-year T-notes. We view this as a reflection in the bond market of the belief the Fed is moving in the right direction.

**Yield Curve, Inverted – As of 9/30/2019**




Credit spreads (the difference in yields between corporate bonds and Treasury notes) is another important area we watch within the bond market for clues about future economic growth. If investors are concerned about slowing economic growth, which would negatively impact the repayment ability of corporate issuers, one could expect credit spreads to widen as investors demand a higher rate of return. Over the course of this year, credit spreads have narrowed, indicating greater confidence in the ability of corporations to repay debt. This factor has been additive to our outlook for continued positive economic growth. If we begin to see spreads widen, we will reassess our outlook.

After finishing the first half of this year with the best returns in some 22 years, equity markets were marginally positive while witnessing a material increase in volatility in the third quarter. Lower interest rates are supportive of equity valuations, but both the economic and earnings outlook has become less certain. As is normal, an increase in uncertainty is unsettling to capital markets. Our Asset Allocation Committee had recommended reductions in equity exposure two times this year. As a result, we are now roughly neutral within client portfolios between our fixed income and equity allocation.

Published data on mutual fund flows, which shows what investors overall are doing with their money, indicates that money continues to come out of the equity market and into the bond market. In one sense, we view this as supportive of equity values as investors have reduced their exposure to equities prior to any significant economic slowdown. We know that a correction in the stock market can happen at any time, but our outlook for continued positive economic growth has kept us from being underweight stocks at present.

As the FOMC has lowered the Fed funds rate and the global economy continues to slow, interest rates have fallen. One beneficiary of this decline has been the U.S. housing market. Lower mortgage rates have led to a surge in demand for refinancing as well as new mortgages to purchase new and existing homes. Housing does not have a huge impact on economic activity, as measured by the GDP, but it is a positive to have housing be a tailwind to growth as opposed to a headwind. Additionally, an improving housing market indicates continued positive consumer confidence.

We will be watching measures like consumer confidence and employment closely. The trade environment has negatively impacted CEO confidence and reduced the outlook for capital

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expenditures (CAPEX). If we begin to see similar reductions within consumer confidence measures, which could lead to changes in consumer behaviors, we will re-evaluate our outlook. We are also sensitive to the increasingly acrimonious political atmosphere within the U.S. The recent actions concerning an impeachment investigation create political uncertainty. Unfortunately, periods of increased political uncertainty can make it more difficult to make reasoned investment management decisions. Our investment approach is to remain neutral on the process and the outcome while thinking about the longer-term investment implications as it pertains to managing risk and/or pursuing returns within your portfolio.

We thank you for your continued trust and confidence. We remain committed to staying focused and disciplined in our investment management approach to achieve your long term goals and objectives.

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