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Commerce Concepts

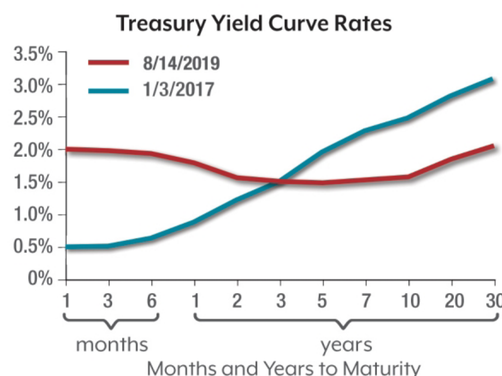
Market Updates, Asset Allocation, and Investment Education for Plan Participants and Individuals

What Does the Yield Curve Suggest About Growth?

On August 14, 2019, the Dow Jones Industrial Average plunged 800 points, losing 3% of its value. The Nasdaq Composite also lost 3%, while the S&P 500 lost 2.9%. The slide started with bad economic news from Germany and China, which triggered a flight to the relative safety of U.S. Treasury securities. High demand briefly pushed the yield on the ten-year Treasury note below the two-year note for the first time since 2007. This is referred to as a yield curve inversion, which has been a reliable predictor of past recessions.

From short to long

Yield relates to the return on capital invested in a bond. When prices rise due to increased demand, yields fall, and vice versa. The yield curve is a graph with the daily yields of U.S. Treasury securities plotted by maturity. The slope of the curve represents the difference between yields on short-dated bonds and long-dated bonds. Normally it curves upward, as investors demand higher yields to compensate for the risk of lending money over a longer period.



Source: U.S. Treasury, 2019

The curve flattens when investors are willing to accept lower rates to keep their money invested in Treasuries for longer terms. A flat yield curve suggests that inflation and interest rates are expected to stay low for an extended period of time, signaling economic weakness.

Inversion as an indicator

An inversion of the two-year and ten-year notes has occurred before each recession over the past 50 years, with only one "false positive" in that time. It does not indicate timing or severity, but has reliably predicted a recession within the next one to two years. A recent Federal Reserve study suggested that an inversion of the three-month and ten-year Treasuries — which occurred in March and May 2019 — is an even more reliable indicator, predicting a recession in about 12 months.

Is it different this time?

Some analysts believe that the yield curve may no longer be a reliable indicator, due to the Federal Reserve's unprecedented balance sheet of Treasury securities. Although the Fed has trimmed that balance sheet, it continues to buy bonds in large quantities to replace maturing securities. This reduces the supply of Treasuries and increases pressure on yields when demand rises, as it has in recent months.

At the same time, the Fed has consistently raised its benchmark federal funds rate over the last three years, while other central banks have kept their policy rates near or below zero. This has raised yields on short-term Treasuries, which are more directly affected by the funds rate, while increasing global demand for longer-term Treasuries. Even at lower rates, U.S. Treasuries offer relatively safe yields that cannot be obtained elsewhere.

continued on page 4...

WIN A $25 GIFT CARD

to your choice of Regal Cinemas or Starbucks!

(See page 2 for more details)

Congratulations to our most recent winner:

Paula L. of Borders Perrin & Norrander Inc.

Visit ***thecommco.com/commerce-concepts*** *for the answer to last issue's question.*

Market Update

Through September 30, 2019

		Trailing Returns			
		3 mos	12 mos	5 yrs	10 yrs
Blue Chip US Stocks	Dow Jones Industrial Average	1.83%	4.21%	12.28%	13.56%
Large Company US Stocks	S&P 500	1.70%	4.25%	10.84%	13.24%
Small Company US Stocks	Russell 2000	-2.40%	-8.89%	8.19%	11.19%
Non-US Stocks	MSCI EAFE (Gross Div)	-1.00%	-0.82%	3.77%	5.39%
US Bonds	Barclay's Capital US Aggregate	2.27%	10.30%	3.38%	3.75%
Cash Alternatives	ICE BofAML 3 Month US Treasury Bill	0.56%	2.39%	0.98%	0.54%

Indexes are unmanaged and cannot be invested in directly. Past results are not predictive of future results. Individual results will vary. The trailing returns shown include dividends. See page four for index definitions.

Source: Raymond James Financial Services

Economic Snapshot

Gross Domestic Product (GDP)

Economic activity has been mixed, but generally moderate, with an increased drag from tariffs. Risks to the growth outlook are weighted to the downside, but a lot hinges on the direction of trade tensions.

Employment

The job market remains tight. Companies continue to note difficulties in hiring skilled labor. The underlying trend in job growth has slowed this year, while wage growth has picked up.

Inflation

The sub-2% trend is a significant concern for the Fed. Despite tariffs, pipeline pressures have moderated. Firms have had mixed success in passing higher costs along.

Manufacturing

Slower global growth has dampened exports, while trade policy has disrupted supply chains and raised production costs. Factory output contracted in the first half of the year.

Housing and Construction

Continued strength in the labor market and low mortgage rates should support housing activity in the near term. Higher building costs and affordability remain key issues.

Monetary Policy

The Fed has lowered short-term interest rates twice, but officials differ in their expectations of whether further cuts will be needed. The Fed may start mini quantitative easing to maintain an adequate level of bank reserves.

Investment Strategy Quarterly: Published by Raymond James and Associates, October 2019 . For a complete PDF copy of the October 2019 issue of Investment Strategy Quarterly, click here or email newsletter@thecommco.com.

To be entered into a drawing to win a

$25 GIFT CARD,

email free@thecommco.com with the answer to this question:

Prior to August of 2019, when was the last time the yield on the two-year note exceeded the ten-year note?

Markets Rebound as Trade Tensions Cool

- Raymond James Chief Economist Scott Brown believes that job gains and wage growth should support consumer spending growth into 2020, more than offsetting a slow patch in business investment, while the Federal Reserve has again lowered short-term interest rates to ensure against downside risks.
- Adding to the mix are impeachment inquiries, unsettled Brexit, growth concerns in Germany and China, and pending U.S. elections. Trade negotiations between the U.S. and China remain uncertain, though officials are set to meet in both October and November, increasing optimism. Washington Policy Analyst Ed Mills expects fluctuating sentiments to fuel market volatility through the 2020 election.
- Raymond James Chief Investment Officer Larry Adam credits cooling trade tensions between the U.S. and China, the Fed rate cut, and solid domestic U.S. economic data for a rebound in risk-asset performance, which led the S&P 500 to rise to within 1% of all-time highs. The U.S. dollar also rose to its highest level since May 2017, and the 10-year Treasury yield bounced approximately 0.25% after it hit its year-to-date lows and lowest level (1.46%) since July 2016 on September 3.

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Asset allocation models can be viewed online anytime at ***thecommco.com***

Strategic Asset Allocation Models

As of October 2019

Equities
Fixed Income
Cash Alternatives

	Conservative	Moderate	Balanced	Growth	Aggressive
Equity	**27%**	**47%**	**64%**	**80%**	**93%**
Equity allocation comprises:					
U.S. Large Cap Blend	15%	17%	21%	26%	29%
U.S. Large Cap Growth	0%	4%	6%	8%	9%
U.S. Large Cap Value	0%	4%	6%	8%	9%
U.S. Mid Cap Equity	2%	5%	7%	8%	10%
U.S. Small Cap Equity	1%	3%	4%	6%	6%
Non-U.S. Developed Market Equity	9%	14%	16%	20%	25%
Non-U.S. Emerging Market Equity	0%	0%	4%	4%	5%
Fixed Income	**71%**	**51%**	**34%**	**18%**	**5%**
Fixed income allocation comprises:					
Investment Grade Intermediate Maturity	56%	42%	28%	15%	5%
Investment Grade Short Maturity	7%	5%	6%	3%	0%
Non-Investment Grade (High Yield)	3%	2%	0%	0%	0%
Multi-Sector Bond	5%	2%	0%	0%	0%
Cash & Cash Alternatives	**2%**	**2%**	**2%**	**2%**	**2%**
Totals	**100%**	**100%**	**100%**	**100%**	**100%**

These asset allocation targets are based on our changing views of the risk and return in the various asset classes, looking out over three or more years. The models assume fully allocated portfolios and do not take into account outside assets, additional cash reserves held independent of these models, or any actual investor's unique circumstances. Investors should consult their financial advisor to decide how these models might assist in the development of their individual portfolios. Material is provided for informational purposes only and does not constitute a recommendation.

The investment profile is hypothetical, and the asset allocations are presented only as examples and are not intended as investment advice. Asset allocation and diversification do not assure a profit or protect against loss. Investing involves risk and investors may incur a profit or a loss, including the loss of all principal. International investing involves special risks, including currency fluctuations, differing financial accounting standards, and possible political and economic volatility. Investing in small- and mid-cap stocks generally involves greater risks, and therefore may not be appropriate for every investor. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices generally rise. High-yield bonds are not suitable for all investors. When appropriate, these bonds should only comprise a modest portion of your portfolio. Commodities and currencies are generally considered speculative because of the significant potential for investment loss. They are volatile investments and should only form a small part of a diversified portfolio. Real estate investments can be subject to different and greater risks than more diversified investments. Declines in the value of real estate, economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments.

Index definitions: The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. The Dow Jones Industrial Average (DJIA), commonly known as "The Dow" is an index representing 30 stock of companies maintained and reviewed by the editors of the Wall Street Journal. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index. The MSCI EAFE (Europe, Australasia, and Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the United States & Canada. The EAFE consists of the country indices of 22 developed nations. The Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The ICE BofAML 3-Month US Treasury Bill index consists of a single issue that is purchased at the beginning of the month and held for a full month. At month's end, that issue is sold and rolled into a newly selected issue, which is the outstanding Treasury Bill that matures closest to, but not beyond, three months from the rebalancing date. The selected issue must have settled on or before the month-end rebalancing date.

The information contained in this report does not purport to be a complete description of the markets or developments referred to in this material. The information has been obtained from sources considered to be reliable, but we do not guarantee that the foregoing material is accurate or complete. Any information is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation. You should discuss any tax or legal matters with the appropriate professional. Expressions of opinion are as of this date and are subject to change without notice. Commerce Concepts is a quarterly publication produced by the team at The Commerce Company. The opinions, commentary and topics are those of the professionals of The Commerce Company and not of Raymond James Financial Services, Inc. or Raymond James & Associates. Registration does not imply endorsement. If you have any questions call Jed Schlanger, Branch Manager, at (503) 203-8585.

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The Fed lowered the federal funds rate by 0.25% in late July, the first drop in more than a decade. While this slightly reduced short-term Treasury yields, it contributed to the demand for long-term bonds as investors anticipated declining interest rates.

Economic headwinds

Even if these technical factors are distorting the yield curve, the high demand for longer-term Treasuries represents a pessimistic economic outlook. One day after the initial two-year/ten-year inversion, the yield on the 30-year Treasury bond fell below 2% for the first time. This suggests that investors expect decades of low inflation and tepid growth.

The "flight to safety" is being driven by many factors, including the U.S.-China trade war and a global economic slowdown. Five of the world's largest economies (Germany, Britain, Italy, Brazil, and Mexico) are at risk of a recession, and others are struggling.

Although the United States remains strong by comparison, there are concerns about weak business investment and a manufacturing slowdown, both weighed down by the uncertainty of the trade war and costs of the tariffs.

Market bounceback

Regardless of further movement of the yield curve, there are likely to be market ups and downs for many other reasons in the coming months. Historically, the stock market has rallied in the period between an inversion and the beginning of a recession, so investors who overreacted lost out on potential gains. Of course, past performance does not guarantee future results.

While economic indicators can be helpful, it's important to make investment decisions based on your own risk tolerance, financial goals, and time horizon. Please email newsletter@thecommco.com with questions or to request an account review.