



Navigator® Market Update

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Yield Curve Inverts, Stocks Take a Tumble

Stocks took a tumble yesterday and bonds surged, as weak economic news in Europe and China coincided with an important development in U.S. bond markets. Yesterday, the 2-Year Treasury yield rose above the 10-Year Treasury yield for the first time during this Fed cycle. While many parts of the yield curve have been inverted for months, yesterday's development has grabbed the attention of major media organizations, and we have seen a number of "Major Recession Warning Flashes" headlines.

In this post, we will detail where a number of important indicators stand and share our modestly bullish view on equities. We also will assess other concerns that might influence our stance to become more defensive. Let's lay out the situation as it currently stands:

A number of economic and market indicators that we follow remain positive, including:

- Expected GDP growth for the coming quarter remains stable and the Atlanta Fed GDPNOW sits at a modest, but positive 1.9%.
- The Index of Leading Economic Indicators (LEI) remains in a positive trend. While the Index has flattened recently, it is off its high for only one month. We often see the LEI turn down months before a recession officially begins, and we are continuing to monitor it closely.
- Unemployment and initial jobless claims remain quite strong, with no real stress in the labor markets. Prior to most recessions, we have seen the job market turn south before a recession begins. That has not occurred yet, and labor markets are solid.
- Credit markets and credit conditions are stable. While spreads have risen slightly since markets peaked in late July, broad credit condition measures remain solid.

On the other hand, the following indicators are negative:

- Outside of the U.S. many economies are struggling, as witnessed by negative interest rates in Europe and Japan, and poor economic data out of Germany and China.
- Many parts of the U.S. yield curve have been inverted for several months. As a reminder, while an inverted yield curve has not always led to a recession (there have been two false signals), each of the past seven recessions dating back to 1962 have been preceded by an inverted yield curve.
- On a global basis, only 40% of nations' purchasing managers' indexes (PMIs) are above 50, which would indicate expansion. Only 20% of Manufacturing PMIs are positive on a year over year basis. The United States' Manufacturing PMI is declining but remains above 50.

Regarding valuations, absolute valuations remain at the high end of their normal

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range, indicating risk in the stock markets. However, with bond yields tumbling globally, we believe stocks still appear attractive compared to bonds.

Overall, we remain modestly bullish on equities but as noted in our January Market Outlook, we view 2019 as a year with the potential for a wide range of outcomes given the many risks and uncertainties. We are seeing some of the volatility we expected come to bear and as an active manager, we will continue to monitor the markets closely and remain disciplined in our approach.

The inverted yield curve is an important recession warning sign, but not determinative by itself. An inverted curve certainly has us looking closely at other important indicators of recession such as LEI, the jobless rate, and U.S. PMIs, along with stock market technicals (currently modestly positive).

Should the LEI roll over, and/or the jobless claims/unemployment rate begin to rise, we will look closely at modifying our view on the economy and markets. Right now, we must note that short-term stock market sentiment is extremely pessimistic and we believe that a sizable short-term rally is a good possibility.

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