Investors Trust
Investment and Trust Services

3rd Quarter 2019 Market Commentary

Index	9/30/2019	6/30/2019	12/31/2018	Total Return 2019 YTD	Total Return Q3 2019
Dow Jones	26,916.83	26,599.96	23,327.46	15.4%	1.2%
S&P 500	2,976.74	2,941.76	2,506.85	20.6%	1.7%
Nasdaq	7,999.34	8,006.24	6,635.28	21.5%	0.2%
S&P 400 Midcap	1,935.48	1,945.51	1,663.04	17.9%	-0.1%
Russell 2000	1,523.37	1,566.57	1,348.56	14.2%	-2.4%
MSCI World ex US	1,893.70	1,923.86	1,710.88	10.7%	-1.6%
MSCI Emerging Mkts	1,001.00	1,054.86	965.78	3.6%	-5.1%
Yield on 10-Year Bond	1.68%	2.01%	2.69%		

Source: FactSet

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Investment Overview

The third quarter of 2019 was largely characterized by volatility and uncertainty in the US equity markets. Investors faced increased US-China trade war threats, talks of impeaching President Trump, concerns out of Europe related to Brexit, negative interest rates across much of the globe, an inverted yield curve, a slowdown in global manufacturing activity, and a drone attack on Saudi Arabia that shut down about 50% of its oil production. **Yet, in the face of these challenges, the US equity markets generally eked out gains for the quarter.** Returns for the quarter ranged from modest losses to up about 2%, which has brought gains for the year for the US equity markets to a range of 14-22% depending on the index. In fact, the S&P 500 had the best first nine months of the year since 1997. In our last update, we shared our view that returns for the balance of 2019 would be more difficult to come by following strong double-digit returns in the first half of the year. So far, that has proven to be correct. While there will likely be ongoing swings in the market based on various attention-grabbing headlines, we continue to believe that returns for the balance of the year will likely be muted, as there is a balance between positives and negatives impacting the markets.

On the positive side, the fact that equity markets have held up so well in the face of so much negative news is encouraging. As we consider what could drive markets higher, we note that: (a) interest rates should stay low and the Federal Reserve has suggested it could lower rates further if circumstances merit it; (b) the US and China have high-level trade talks set for October; Wall Street does not expect a substantive deal from these negotiations, but it is possible that both sides agree to de-escalate the rhetoric, if not agree to waive upcoming tariffs that are set to go into effect by year-end; and (c) the US economy has exceeded expectations and remains on pace to grow 2.0% to 2.5% in 2019. These factors would typically be positive for US equities.

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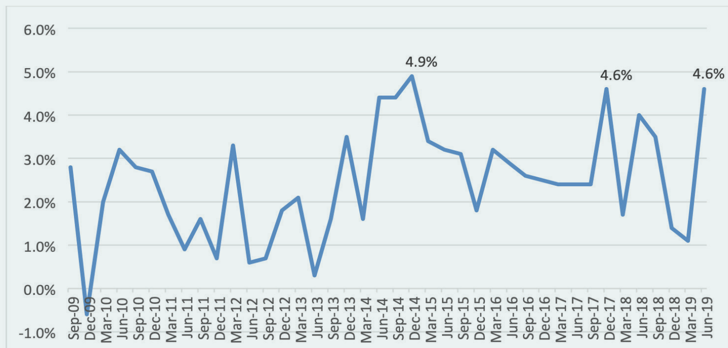
Offsetting these positives, we note that: (a) estimates for US corporate earnings growth have continued to decline, with the consensus on Wall Street now calling for 2019 earnings growth of 2.1%, down from 3.6% at the end of the second quarter; (b) the US political season is starting to heat up with headlines from candidates supporting policies that are generally negative for business and corporate profits; and (c) the possible impeachment of President Trump, while perhaps only an exercise in politics given the low probability of his removal from office, could empower China to defer any possible trade agreement with the US.

In the fixed income markets, **interest rates dropped notably again in the third quarter as global economic fears increased.** The yield on the US 10-Year Treasury fell to a three-year low of 1.43% before rallying to close the quarter at 1.68%. Further, the yield curve inverted for the first time since the 2008-2009 financial crisis. A yield curve inversion occurs when the yield on the US 2-Year Treasury exceeds the yield on the US 10-Year Treasury, and it gets attention as a potential predictor of a future economic recession. The quarter ended with no yield curve inversion, as the Federal Reserve cut interest rates and has suggested that it will continue to do so if economic conditions deteriorate. Our forecast for interest rates has been wrong thus far, calling for higher rates given the relatively healthy economic backdrop. With downward pressure on rates persisting in the face of the ongoing trade tensions, **we reduce our year-end target for the US 10-Year Treasury to a yield of 1.75% to 2.00%.**

Economy

The US economy has remained much more resilient than many expected in light of the day-to-day headlines that often suggest a gloomier outlook. After very strong 3.1% growth in the first quarter, the US economy posted better-than-expected 2.0% growth in the second quarter, putting the US economy well on pace to grow in the 2.0% to 2.5% range for 2019. Strength has largely been tied to the US Consumer, who not only is propelling the US economy but arguably holding up the global economy as well. Indeed, as Chart 1 shows, US Personal Consumption increased a robust 4.6% in the second quarter, which ranks as the second best quarter of consumption growth in the past ten years.

Chart 1:
US Personal Consumption Expenditures, September 2009 to June 2019



Source: US Bureau of Economic Analysis

The fundamental backdrop for the US Consumer remains quite healthy: the Unemployment Rate sits at a 50-year low (3.5%), wage growth is increasing near its fastest rate in over a decade (~3.0%), and interest rates are hovering not far from historically low levels. As a result, Consumer Confidence remains at high levels, though the recent negative headlines around trade has caused Consumer Confidence to drop modestly. Historically, the US Consumer has shown a strong propensity to spend money when they have it. While the US Consumer is smarter today given the wealth of information that is easily at their fingertips, the propensity for the US Consumer to spend remains in place. With the Consumer representing roughly 70% of US economic activity, we believe the outlook for the US economy should remain healthy as long as the US Consumer is strong.

With that said, it is clear that the rate of growth for the US economy has begun to slow, with the uncertainty around trade likely having the biggest negative impact. Indeed, last quarter we mentioned US manufacturing could move into "contractionary" territory following a steady decline in activity for the past few quarters. That did occur in August and worsened in September, with manufacturing activity now at its lowest levels since mid-2009. The trade tensions are having a disproportionate impact on the manufacturing sector, so we would expect ongoing weakness until there is substantive progress on that front. While manufacturing only accounts for about 12% of US economic activity, it has historically served as a good barometer of profit growth for the broader US economy, so the sooner those issues can be resolved, the better. We are currently monitoring any potential impact on the US Consumer that these developments may have.

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Equities

US equity markets remained volatile in the third quarter in light of the growing list of challenges being thrown at it. Yet, impressively, the US markets generally posted slight gains in the quarter, bringing year-to-date returns for US equities up to a range of 14-22% depending on the index. Indeed, the S&P 500 posted its best returns for the first three quarters of the year since 1997, admittedly coming off a very weak fourth quarter of 2018. On the surface, double-digit returns through the third quarter across the various indices suggest broad strength; however, underneath the surface, **equity markets took on a much more defensive tone in the third quarter.** As Chart 2 shows, the third quarter saw the perceived "safer" equity asset classes perform the best and the perceived "riskiest" equity asset classes perform the worst. While one quarter does not make a trend, we would expect this dynamic to continue until the trade tensions ease.

Chart 2:
Third Quarter 2019 Returns by Equity Asset Class

Asset Class	Q3
US Large Cap Value	2.2%
US Large Cap	1.7%
US Large Cap Growth	0.3%
US Mid Cap	-0.1%
International Developed	-1.6%
US Small Cap	-2.4%
Emerging Markets	-5.1%

Source: FactSet

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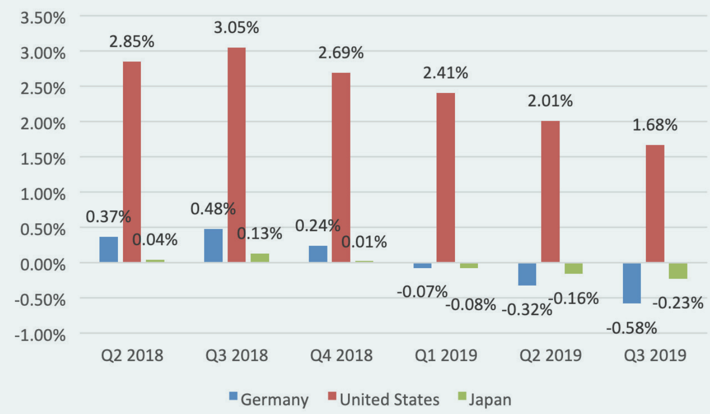
Estimates for US corporate earnings growth for 2019 have continued to decline, with Wall Street consensus now expecting growth of about 2.1%, down from roughly 3.6% last quarter and 8.7% at yearend 2018. This is largely due to a sharp decline in the Energy and Materials sectors (forecasts down 22% and 15%, respectively), though most sectors are only expected to post mid-to-low single digit earnings growth in 2019. Earnings reports for the third quarter will begin in mid-October, and Street expectations call for a decline of about 2.7% compared to last year, also driven by weakness in the Energy and Materials sectors. In light of ongoing pressures on corporate earnings, we continue to believe that returns for the balance of the year will likely be muted.

Fixed Income

The fixed income markets remained quite volatile in the third quarter, as interest rates dropped sharply. The yield on the US 10-Year Treasury fell to a near historic low of 1.43% in the quarter before closing the quarter at 1.68%. We believe there have been several factors at work driving US rates lower including (a) global economic concerns largely tied to the US-China trade dispute and (b) the fact that yields across much of the developed world are actually negative, meaning that investors in these fixed income instruments actually have to pay for the privilege of owning them. As Chart 3 shows, the yields on both German and Japanese bonds have been negative since the first quarter of 2019. We believe that global fixed income investors, when faced with the choice of owning a bond with a negative yield or a bond with a positive yield, they will typically choose bonds with a positive yield. As a result, global fixed income investors may be flocking to US bonds simply because the alternatives are much less attractive, putting further pressure on US interest rates.

Chart 3:
Comparison of Rates for US, German, and Japanese Bonds



Source: FactSet

The Fed lowered the Fed Funds rate by an expected 0.25% at its meetings in July and September, and the Street is currently placing a roughly 80% likelihood that the Fed cuts rates by another 0.25% at its meeting in October. The economic justification to do so increasingly exists now that measures of US manufacturing activity have moved into contractionary territory.

The media placed much attention in the quarter on the yield curve inversion, which occurred briefly in August and September. A yield curve inversion occurs when the yield on the US 2-Year Treasury is greater than the yield on the US 10-Year Treasury. It gets attention because every recession over the past 50 years has been preceded by a yield curve inversion. The last time it occurred was before the 2008-2009 financial crisis, first occurring in the fourth quarter of 2005, then again in 2006 and 2007. After each inversion, the yield curve subsequently steepened, and a recession did not occur until 2008/2009. So while a yield curve inversion could be a predictor of an economic recession, it does not mean that a recession is right around the corner. Other economic data do not suggest a recession is near. But it does suggest that rates should stay low as fears about a pending recession increase. Accordingly, we have reduced our outlook for the US 10-Year Treasury to finish the year with a yield in the 1.75% to 2.00% range.