ECONOMIC & INVESTMENT SUMMARY

For Quarter Ending June 30, 2019

Economic Activity

Activity in global and domestic manufacturing continued to move lower in the second quarter. The only two G7 nations that remain in growth territory were the United States and France, but manufacturing activity in the United States dipped to its lowest level since October 2016 based on the ISM Manufacturing index. Chinese manufacturing activity (a non-G7 nation) has moved into contraction territory for the past two consecutive months and has been in contraction territory five of the past seven months. The slowdown in manufacturing in the United States and primarily China points to the need for an agreement on trade and tariffs between the two countries and we believe it is essential to get the Chinese manufacturing sector growing again.

First quarter GDP was finalized at 3.1%, a strong number and slightly surprising on the surface but was driven higher by net exports and inventory growth—two contributors that will likely not contribute much in the following quarter. The consumer weakened in the first quarter as personal consumption only grew by 0.9% amidst the trade issues with China and the economic concerns it creates, but we have seen retail sales numbers in the second quarter that have been good and could be catalysts for second quarter GDP to grow at a rate faster than the expected 1% growth rate from J.P. Morgan economists.

Employment continues to be strong in the U.S. as the unemployment rate is at 3.6% and job openings in the United States have exceeded seven million for 13 consecutive months.

Interest Rates

Interest rates across the entire yield curve moved lower throughout the quarter as the ten-year Treasury declined 40 basis points ("bps") to 2.01% in the second quarter and the two-year Treasury moved 51 bps lower to 1.75%. The pressure on the Federal Reserve to lower rates due to the global and domestic economy slowing continued to grow throughout the quarter and we expect the Fed to now cut their target rate sooner than later. The total bond market returned 3.08% in the second quarter and the Bloomberg Barclays Municipal Bond Index returned 2.14%.

Core inflation has now remained below the Federal Reserve's goal of 2% for 10 consecutive quarters and has averaged 1.58% for the past decade. We believe that the Fed would allow inflation to run higher than 2% for a while due to the lack of inflation in the system over the past decade. The real issue here is how much power the Federal Reserve has on determining the amount of inflation in the economy and it appears despite their great monetary efforts since the most recent recession that they have fallen short. Inflation is not a concern of ours and we see it putting little pressure on longer-term bond yields going forward.

Stock Market

Equity markets finished the quarter on a strong note after rebounding from a 6% correction in the month of May. The S&P 500 and the Dow Jones Industrials rose to record levels after the Federal Reserve removed "patient" from the Fed's statement and acknowledged they stand ready to lower interest rates as global economic growth continues to weaken. For the quarter the S&P 500 led all major equity markets up 4.2% and the Dow Industrials was up 3.2%. The NASDAQ finished the quarter up 3.8% and the small cap Russell 2000 was up 1.9%. Developed international markets improved late in the quarter with the MSCI EAFE up 3.4%. Emerging markets were the laggard with a 0.6% return for the quarter with the inability of the U.S. and China to reach a trade agreement creating a new level of uncertainty for emerging economies.

Growth style investing continued its record out performance versus value style investing with the relative out performance for the year to date being 5.0% and the 1 year 3.0%. The 5-year average annual return difference is a significant 5.8% in favor of growth investing versus value investing. The leadership in growth style investing began in 2009 at the market lows and has continued for 11 years with only sporadic periods of value out performance. The old market adage is proving true when economic growth is below trend growth investing does well as investors search for companies that can grow in a slow economy, but when economic growth is strong growth investing commands less of a premium and value investing out performs. We have an overweight allocation to growth investing with the view global economic growth will remain below historical trends and that growth companies have significant tailwinds absent economic growth with the ability to disrupt traditional business models.

The inability for the U.S. and China to reach a trade agreement has had a limited impact on U.S. financial markets. U.S. exports to China are $120 billion an amount equal to less than 1% of GDP. At the core of the trade discussions is the protection of U.S. intellectual property and forced technology transfers to Chinese companies. China may be playing the long game realizing there is a U.S. election in 2020 allowing them the possibility of dealing with a different administration. We continue to monitor the developments and believe the impact to the financial markets is limited if both sides remain in discussion.

ABOUT THE INVESTMENT ADVISORS

1st Source Bank has been providing comprehensive financial planning and wealth management services since 1936 and currently manages over $3.5 billion in assets.

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