NADLER FINANCIAL
GROUP

Investment and Financial Consultants

Nadler Financial Group, Inc.
155 North Pfingsten Road • Suite 160
Deerfield, Illinois 60015-4903
Phone: 847.940.4040 • Fax: 847.940.7246
www.nadlerfinancial.com

THIRD QUARTER 2019 ECONOMIC AND FINANCIAL MARKETS REVIEW

Volatility increased considerably during the third quarter this year as concerns regarding the slowing global economy and escalating trade tensions with China continued to create anxiety among investors and traders. Decelerating global economic growth has caused policymakers around the world to respond with interest rate cuts and other stimulus measures such as buying their own governments' bonds and devaluing their currencies. For example, in the U.S., the Federal Reserve Board lowered interest rates twice in the third quarter by a total of 0.50%. Investors are now worried that the global economic slowdown could reach the U.S., resulting in a U.S. recession. A recession in the U.S. would lead to lower corporate earnings and lower stock prices. Despite these concerns, the S&P 500 Index ended the third quarter up 18.7% year-to-date, while the Dow Jones Industrial Average gained 15.4%. The Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index gained 6.4% year-to-date as of September 30, 2019. * However, due to last year's market decline, most market indices are close to or below where they were in January 2018.

Although the Fed has been lowering interest rates and yields on U.S. Treasury bonds are near historic lows, global investors continue to invest heavily in U.S. Treasury bonds. The reason is that while U.S. bond yields are low, they are still higher than bond yields in most other developed countries and offer comparative safety. This large buying of U.S. Treasury bonds drives the price of these bonds up and lowers their yields further because there is an inverse relationship between bond prices and bond yields. Also, the U.S. dollar has strengthened lately, leading to currency gains for foreign investors seeking safety in U.S. government bonds.

This unusual demand for long-term U.S. Treasury bonds has resulted in an inversion of part of the yield curve. The yield curve illustrates the relationship between short-term and long-term interest rates. Typically, investors obtain a higher yield investing in long-term bonds rather than short-term bonds. However, when the yield curve is inverted, it means that short-term bonds are paying a higher yield than long-term bonds. Historically, an inverted yield curve has preceded many U.S. recessions. Along with fears that an economic slowdown overseas and global trade wars can eventually lead to a recession in the U.S., the inverted yield curve is making investors nervous that a U.S. recession is imminent.

An inverted yield curve is not necessarily a perfect indicator of whether the U.S. is headed for a recession in the near-term. In the past, inverted yield curves have been the result of the Federal Reserve Board raising short-term interest rates too much when fighting inflation so that short-term interest rates became higher than long-term interest rates, thereby harming the economy. This year, the reason short-term interest rates are higher than long-term interest rates is not because the Fed is raising short-term rates, but because long-term interest rates are declining due to excessive buying of long-term Treasuries by institutions such as pension funds, hedge funds, and foreign governments. In this case, low interest rates may even help the U.S. economy to withstand external headwinds.

While it is certainly possible that the U.S. economy could decline into a recession in the coming months, it is unlikely since approximately two-thirds of the U.S. economy is driven by consumer spending, which is currently strong. The real concern is that the trade war is creating uncertainty

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among businesses, thereby slowing manufacturing and exports while raising product costs. Luckily, only one-third of U.S. economic growth is driven by business spending. The U.S. consumer has been spending at a rapid pace due to a strong job market and rising wages. As opposed to manufacturing, the service sector has also held up nicely despite political and economic concerns. With that said, if at some point in the future interest rates begin to rise again across the yield curve, we will become more concerned about a recession and deeper stock market decline. This will likely occur if inflation returns or if investors decide to move their money out of U.S. Treasuries. Rising interest rates would create higher borrowing costs for the U.S. Government, businesses, and consumers, leading to an economic downturn. Also, the furthering of political tensions both in the U.S. and abroad bears watching over the coming months as impeachment proceedings and election uncertainty could create weariness for investors.

Once the current stock market volatility subsides, we are particularly interested in investing in mid-size company stocks because they do not typically have as much foreign exposure as large companies and they are generally less volatile than small-size company stocks. We also believe that gold is going to continue to appreciate due to political and trade uncertainties that are likely to persist. We are not interested in investing in long-term bonds right now because yields on these bonds will rise at some point during the length of their duration, leading to losses for long-term bond investors.

As always, please contact us if you have any questions regarding your investments or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on October 1, 2019.*

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