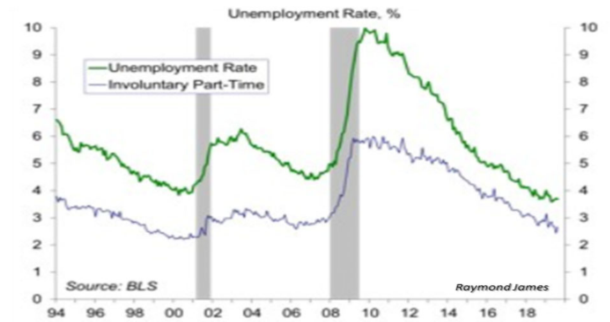
Recession or Recovery?

September 2019

As expected, the economy continues to chug along despite the recent narrative of an impending recession. The Fed is now caught between a rock and a hard place as markets are still signaling 1-2 more rate cuts this year, and yet we feel conditions don't quite warrant it. In political news, the Democrats are beginning to winnow out the field with the top three clearly separating themselves from the pack. As expected, the U.S.-China tariff drama continues to oscillate between deal/no-deal, and markets continue to vacillate between recession/global slowdown concerns, and the just-beyond-reach China trade deal rallies. We suspect volatility will remain higher than most would prefer, and there will be few durable trends to trade between now and 2020, as we discuss below.



We have been saying for nearly a year the economy would enter a "growth recession" or "earnings recession" (where GDP grows between 1 and 2%) in the first half of 2019. Now the question is "Recession or Recovery"? It's a complicated scenario with multiple potential outcomes, several key factors, and a basketful of potential catalysts.

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Slow and Steady

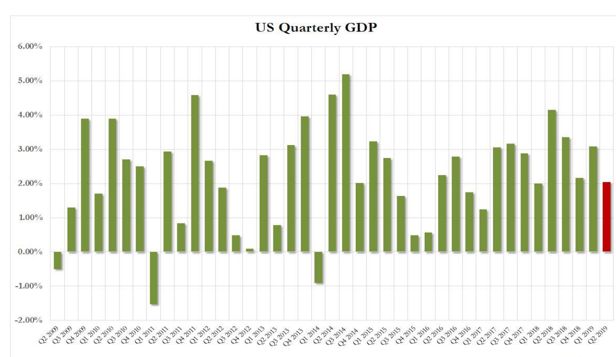
The U.S. economy continues to post solid growth despite headlines blaring the impending arrival of a new recession (again). GDP growth slowed throughout the summer since the Q2 2.0% growth report, in line with our forecast, and down from 3.1% annualized GDP growth in Q1. Manufacturing bore the brunt of the slowdown as we'll discuss below, with the Business Investment and Trade components slipping, while Consumer Spending buoyed the results.

The question remains, how much does the global slowdown, driven in part by U.S. tariffs, ricochet back to the domestic market? Are we insulated enough to avoid the contagion spreading through the E.U. and Asia? While manufacturers (and to some degree farmers) have suffered from the U.S.-China trade and tariff standoff, service businesses have been largely unaffected. Additionally, a record percentage of small business owners reported trouble finding qualified workers in August.

In any event, we continue to expect a slide below 2% annualized growth GDP in the second half of the year as the full impact of prior rate hikes and a slowing global economy manifest themselves .

So far, employment remains solid as unemployment for minorities reached historic lows, corporate profits rebounded from the Q1 drop, hiring intentions are stable, and layoffs remain low. Business and consumer confidence is still relatively strong and hourly wages are increasing at rates not seen in over a decade. All indications are that the China tariffs are not being passed on in any significant manner to U.S. consumer, as core CPI (inflation) remains subdued at 2.4%.

In our opinion, low inflation and unemployment, modest economic growth, accommodative rate policies, and confident consumers and small businesses do not indicate a near-term recession.

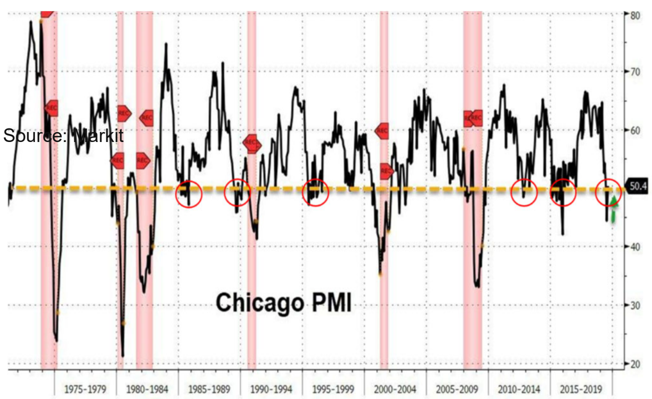


Source: U.S. Bureau of Economic Analysis

Manufacturing is a Drag

The Markit Purchasing Managers Index (PMI) features a headline number, which indicates the overall health of an economy, and sub-indices, which provide insights into other key economic drivers such as GDP, inflation, exports, capacity utilization, employment and inventories. The Markit PMI recently posted a barely positive 50.3 for August, the slowest growth since September 2009 as we exited the "Great Recession". Values below 50 would indicate that purchasing managers view their businesses as contracting.

Markit stated: *Output and order book indices are both among the lowest seen for a decade, indicating that manufacturing is likely to have again acted as a significant drag on the economy in the third quarter, dampening GDP growth. At current levels, the survey indicates that manufacturing production is falling at an annualized rate of approximately 3%. "*



Similarly, the Chicago PMI (which measures the performance of the manufacturing and non-manufacturing sector in the Chicago region, and is computed from five weighted raw indexes: Production, New Orders, Order Backlog, Employment, and Supplier Deliveries, and then seasonally adjusted to support month-to-month comparisons) posted a barely positive result of 50.4 for August with some analysts arguing that it portends a slide into recession is just around the corner.

However, this is something that has in fact happened outside of a recession in the past. Indeed, it's a fairly frequent occurrence as the graph above indicates (red circles). There have been five significant slowdowns, or contractions, in the Chicago PMI since the early 1970s as compared to six recessions over the same period. So while it does raise some concerns, we believe it is not yet time to ring the *Recession Alarm*, and we continue to suggest a "Growth Recession" is well in progress.

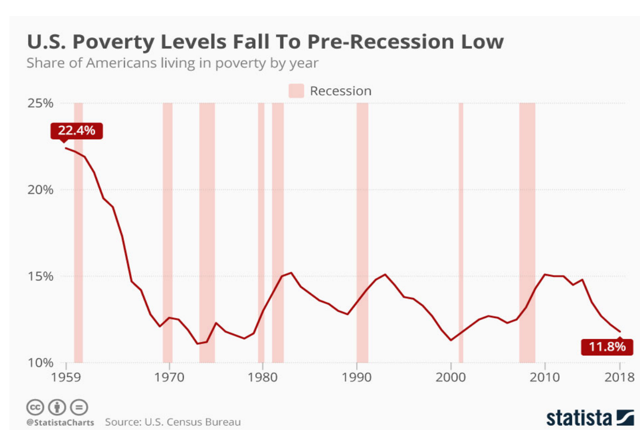
Employment is the Key

Employment is the magic key for Trump's 2020 re-election bid, and one that will have significant impact across the middle and lower class electorate barring a 2020 recession. Wages are growing solidly with average hourly earnings rising 0.4% (+3.2% y/y) up 0.5% (+3.5% y/y) for production workers in the latest report. Reports have also highlighted that the fastest growth rates have been in the bottom deciles.

A major driver in these trends has been the strength of small business hiring although hiring intentions have recently weakened slightly. That said, small business optimism rose 1.4 points to 104.7 in July. A strong jobs market leads to a more confident consumer and the University of Michigan *Consumer Confidence Index* rebounded solidly from a weakened 88 in August to 92 in the first week of September. This pattern is also in line with what we saw in the 2015 growth and earnings slowdown.

Further, median U.S. household income reached $63,200 in 2018, the highest figure on record, according to newly released data from the Census Bureau. As a result, Nial McCarthy at *Statista* writes: "The official poverty rate also reached its lowest level since at least 2001, dropping to 11.8% of Americans, or 38.1 million people who are in poverty. The number of people in poverty in 2018 decreased by 1.4 million people from 2017 levels."

One major factor for Trump's continuing improvement in polling among minorities is the strength of the jobs market, which has driven Black, Hispanic, Asian and women's unemployment rates to historical lows. Politically, macro-economic numbers like GDP don't resonate as strongly with voters as higher after-tax money in their paychecks, low levels of inflation, and the perception of greater job security.



https://www.statista.com/chart/share-below-poverty-line/

Is The FED Trapped?

The FED has acknowledged that we are having a “mid-cycle adjustment” as we have been forecasting for nearly a year. They also currently see no recession on the horizon and don’t consider the trade tensions with China as sufficient cause to warrant more aggressive policy action. Indeed, St. Louis Fed President Jim Bullard recently said, "While additional policy action may be desirable, the long and variable lags in the effects of monetary policy suggest that the effects of previous actions are only now beginning to impact macroeconomic outcomes.”

And yet, markets are tentatively pricing in 1-2 more rate cuts before year end; however, we are extremely skeptical that such action is called for, and yet it will likely occur. We had believed there was a possibility the Fed would stand pat at their next opportunity to cut and indeed a rising chance that they might have been done for the year. The recent attack on Saudi Arabia’s main oil facilities has removed 5-7% of global capacity for a relatively short period of time and likely augmented the case for the Fed to preemptively ease rates more than they might have preferred.

Source: Bloomberg

Inflation remains subdued for this part of the economic cycle, with Core CPI coming in at 2.4%, modestly higher than the Fed’s official target. At the same time, the Fed-watched core PCE rose 1.7%, up from 1.1% in Q1. The below-expectations result was largely due to the deflationary impulse being brought stateside courtesy of China’s currency devaluation efforts.

We think the Fed is trapped; unable to freely maneuver without appearing to react to Trump’s ever present tweets about being behind the curve and not wanting to take responsibility for staying too tight for too long, and causing a recession. Consistent with historical patterns, the Fed’s rate cuts over the summer and into the fall should begin to positively impact the U.S. economy starting early next year.

Political Winds Are Beginning to Blow

The winnowing out process has begun on the Dem side, with the top 5 jostling for dominance and the remainder gasping for air. Biden and Kamala Harris have seen the biggest slides since June with Warren overtaking Sanders in some polls. The D’s *Russia, Racism and Recession* narratives against Trump appear to be failing as Trump’s recent poll numbers have rebounded from the El Paso slump.

Trump still gets trounced in polls using “*All Adults*” or even “*Registered Voters*” and a recent Fox News poll of RVs showed Trump losing by 5-12 points across the board to the leading Dems. That said, Zogby recently released a poll of “*Likely Voters*” (that is usually considered a more accurate forecast) with Trump winning against all comers in the Dem primaries by 1-3 points.

The challenge for Dems is that Trump has a 94% approval rating among Republicans, and routinely pulls 12-20k into his rallies while the best showing so far for D’s was about 10-12k for a recent Warren rally in Seattle. No other Dem candidate, even Biden, has come anywhere close to matching Warren’s crowds.

The “Enthusiasm Gap” is very real at this point, as the more liberal wing of the Dem party just can’t get excited by Biden, the more centrist Dems are lukewarm to key policies offered by Warren and Sanders, and younger voters have problems with all of the above. Further, many minority voters, who turned out for Obama, declined to show up for Hillary and remain unexcited about the current frontrunners. The remainder of the pack has had trouble gaining traction.

Judges, Judges And More Judges

Since inauguration day, Trump has appointed 150 Federal District and Appellate Court judges, as well as 2 Supreme Court Justices. Along with Immigration, judges are a top voting issue for Republican voters, and Trump is delivering for them. Comparatively, over the course of nearly three hours of debate among 10 Democratic presidential frontrunners, there was just one mention of the US Supreme Court. One.

By the end of a second term, Trump will have appointed a higher percentage of judicial nominees than any other President, except George Washington. We could see a 6-3, or even 7-2 conservative majority on the Supreme Court over that time period. While many call for court reform, there is no way that Republicans would support term limits for all those newly installed Justices in their 40’s and 50’s.

Has The Storm Passed?

Markets continue to be trapped between two competing narratives: that a recession/global slowdown is imminent, and that there is a "jack-in-the-box" possibility that a China trade deal will emerge at any moment. As a result, we have spent all year, and in fact the last 22 months, in a rally/correction mode where it's like climbing successive mountains in the Smokies, struggling to attain the next peak, only to give back all the ground, and start the process all over again.

This is typical for a market in a growth/earnings recession as investors can't determine if things are getting better, worse or just muddling along. It usually manifests itself with higher volatility levels, intense sector and asset class rotation, a short-term trading mentality due to the "trendless" nature of many moves, and occasional bursts of euphoria and/or terror.

The breakout above the August consolidation set the market up to rally above 3000. However, with the markets already pushing back into a short-term overbought condition, we think we'll see another short-term peak and pullback shortly. A possible catalyst is that several Fed speakers are suggesting the Fed is likely to move forward with cutting rates and increasing monetary accommodation if the economy continues to slow. However, if incoming macro data remains solid, there could be a letdown in those expectations, triggering the next pullback.

We updated our market cycle chart, which confirms our Spring forecast that the summer set-back would look a lot more like the growth slowdown corrections we saw in 2012 and 2015, than a precursor of a pending recession (ala 2008). The green ovals suggest we have come out of the correction and after some additional consolidation, should move higher as we did in the prior slowdowns.

We believe we will avoid a recession for the remainder of 2019 and likely for the first half of 2020. We suspect a China trade solution to be announced late in Q4 and implemented early in the first half of next year. If the Fed does indeed cut rates several more times, the economy should pick up with a 6-9 month lag, just in time for a 2nd-half sprint to election day.

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Now What?

Domestic markets have rallied back to new highs, and we have likely completed a multi-month correction as the US economy shifted to lower growth in the first half of 2019. We acknowledge we are in the late stages of the economic cycle, and higher volatility levels and shorter trading cycles may continue to occur.

We maintain our positions in high quality, medium duration bonds, but would continue to lower weights for longer duration high yield bonds and interest rate sensitive securities. The Fed has become more accommodative as the global economy continues to slow, and a tariff solution remains just out of reach. At this point, we don't foresee a recession, but the outcome may depend on how long the current trade standoff with China lasts, which may be longer than markets expect.

If you would like more information please contact us at 954 809-6363.