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ECONOMIC & MARKET UPDATE

It is an understatement to say that the financial markets treated investors well during the first quarter. After a sharp decline in stocks during the fourth quarter of last year, the first quarter saw a rebound of dramatic proportions. Bonds also gained in value as investors responded favorably to a change in Federal Reserve (Fed) policy that accrued to the benefit of both asset categories.

"Just wait until the new normal comes back."
David P. Gilmore, CFA

This epigram may well prompt two questions. One, what does "new normal" mean, and two, who is David Gilmore? We will happily answer both and, in the process, illustrate why we have chosen this sentence to introduce a positive scenario for the economy and financial markets, one that we believe has a reasonable chance of being realized.

In the past we have opened our letters by quoting such luminaries as Jerome Powell, Larry Summers, Reinhold Niebuhr, and others. David Gilmore's profile doesn't match these public figures, but he is very important to both Crawford Investment Counsel and our clients. As an employee of our firm, David serves as a senior research analyst and is a member of our eight-person equity research team. We are very proud of this group and believe it is one of the more important resources of the firm that enables us to properly manage our clients' portfolios. David has been with us for the last 10 years. He follows the Consumer Staples sector as well as the newly constructed Communications sector. He also serves as the strategy director for our Dividend Yield strategy, one of our six equity strategies. His remark cannot be found in writing, for he spoke it in an equity research meeting, but it serves as a good introduction for our discussion of the outlook.

The phrase "new normal" was coined in 2009 by Mohammed El-Erian, former head of investments for the Harvard endowment, and was used to describe the condition of our economy in the aftermath of the financial crisis and the Great Recession. Recall that coming out of the Great Recession, growth was very sluggish, inflation was very low, and short-term interest rates were hovering near zero. The "new normal" was used to contrast then-current economic conditions to what was formerly considered normal, namely, average Gross Domestic Product (GDP) growth around 3% with higher levels of inflation and interest rates. As time progressed and the economy continued to recover, the phrase was used less frequently, reflecting investor acceptance of economic growth of around 2% on average with interest rates and inflation at the same general level. The "new normal" morphed into a generalized summary of what became known as the "2% economy."

Then, in 2018, the 2% average annual economic growth rate finally yielded to a higher growth rate at just under 3%. Under the Trump administration, fiscal stimulus was applied to the economy through tax cuts in late 2017, providing a boost to growth in 2018. The President would also claim deregulation as a reason for higher growth. His Council of Economic Advisors is projecting growth of 3% or better for years to come, and while we would be very pleased to be proven wrong, we agree with the Fed and International Monetary Fund (IMF) that sustainable, long-term growth for the U.S. economy is in the 2% range. Their forecasts are based on 1) realistic assumptions of population and immigration trends and 2) productivity growth, the two pillars of economic growth.

It is at this point that our beginning quote becomes relevant. Peak quarterly GDP growth of 4.2% was achieved in the second quarter of 2018. It then stepped down to 3.5% in the third quarter and 2.2% in the fourth quarter. This presents a noticeable trend toward slower growth. Forecasts for this year and next tend to fall in the 2% range. Therefore, we are suggesting that when investors fully accept a return to 2% real GDP growth, it will represent a return of the "new normal." And while the term does not imply anything about durability of the recovery/expansion, for us, durability is one of the more important factors. If the economy can achieve sustained growth of 2% with low inflation and interest rates, this is a sufficiently positive environment for companies to prosper in.

Should the U.S. economy avoid a recession over the next three months, it will be the longest recovery/expansion in U.S. history. This fact prompts many to assume that it has to end soon. We do not necessarily agree. While there are worrying signs of severe slowing in economic growth, there are also many aspects that suggest continuation of the expansion. A very flat yield curve is concerning as is sluggish growth in the rest of the world. But our economy is moving forward and, importantly, is experiencing low and stable inflation. When there is economic stress, inflation is usually the culprit since it presents a reason for the Fed to tighten monetary policy, which, in turn, halts the expansion. We remain of the view that inflation is likely to be well-contained for the foreseeable future.

Apparently, the Fed shares our views on inflation. Otherwise, they would not have abruptly abandoned their previous policy path. In going from two expected federal funds increases in 2019 to none, the Fed has basically taken their hands off the economy. They are now officially in “pause” mode. We believe this move is proper and enhances the possibility of further extension of the near-record recovery/expansion.

When David Gilmore exhibits his enthusiasm for the return of the new normal, he is doing so as the voice of our Dividend Yield strategy and, by inference, other approaches to investment that focus on dividends. If investors fully embrace the permanence of the new normal, it means they fully embrace low interest rates. Dividend strategies, especially those that also emphasize dividend growth, become increasingly attractive since they provide a yield advantage that is also growing. In summary, we believe it is a reasonable expectation that our economy can keep expanding for a few more years and that its growth will be accompanied by low inflation and interest rates. Furthermore, we believe such an environment can be very conducive to equity strategies that focus on dividends. And we are very encouraged by the fact that not only did your higher quality investments, once again, provide defensive returns in the stock market correction during the fourth quarter of last year, but the participation in the upside thus far in 2019 indicates that other investors seem to be in agreement that consistent, dividend-paying companies are an attractive way to invest, given the environment.

The new normal will also have implications for bond investors. Over the last 38 years, bond yields have been in steady decline. Using the 10-year U.S. Treasury note as a benchmark for the bond market, the low point was reached in 2016 at a yield of approximately 1.36%. The yield now stands a bit more than one percentage point above that, and many have heralded the low point as the end of the great bond bull market. We, however, are hesitant to proclaim its end. Surely there will be another recession at some point, and the previous low could be eclipsed. The main point is that, as the concept of the new normal again becomes generally accepted, belief in continued low interest rates removes the threat of serious damage to bond returns from rising interest rates. Under the new normal, bond yields and interest rates should be contained in a reasonable range.

While we would prefer an economy that could generate higher levels of growth and thus greater standards of living in the future, we also welcome the return of the new normal if, in fact, it can allow for a longer expansion of our economy, especially with the favorable attributes of low interest rates and inflation. We also believe it can be an environment in which returns from stocks and bonds can be positive and ongoing. As always, we will attempt to provide such returns by investing the portfolio assets in high-quality securities.