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Economic and Market Environment
Third Quarter 2019

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The Economy

- This month the U.S. economy celebrates ten years of recovery/expansion, the longest such cycle in its history. We expect a further extension of this trend.
- The unemployment rate at 3.6%, a 50-year low, is perhaps the strongest element in the economy.
- Despite the current strength, trade war concerns and slow growth in the global economy may be negatively impacting the rate of U.S. economic growth. Several leading indicators have weakened.
- The Federal Reserve (Fed) has taken note of the slowing trend and has made a major adjustment to its monetary policy. Investors are now expecting federal funds reductions this year.
- Some recession indicators have deteriorated, most notably, the yield curve which has inverted on portions of the curve, signaling the possibility of a recession over the near-to-intermediate term.
- Inflation remains well-contained, in fact, too contained relative to the Fed's 2% target. This is a major factor in determining Fed policy.
- The consumer, representing 70% of Gross Domestic Product (GDP), remains in good shape. This augurs well for underlying demand.

Stocks and Bonds

- The stock market enjoyed a strong advance in the first half of the year. Equity investors seem to be placing faith in the Fed's ability to extend the recovery/expansion cycle.
- Corporate earnings expanded sharply in 2018 and are expected to continue growing this year but at a much slower pace.
- Stock valuations are slightly higher than long-term averages but seem reasonable given the outlook for inflation and interest rates.
- Sluggish global growth and fears of disruptive trade policies remain as the chief concerns among stock investors.
- High-quality bonds also performed well in the first half, benefitting from the expectation of lower federal funds and declining inflation.
- Recent events support a growing conviction among investors that we live in a world of low inflation and interest rates, a condition likely to remain in place for the foreseeable future. The impact of this condition on stock and bond returns is unclear.

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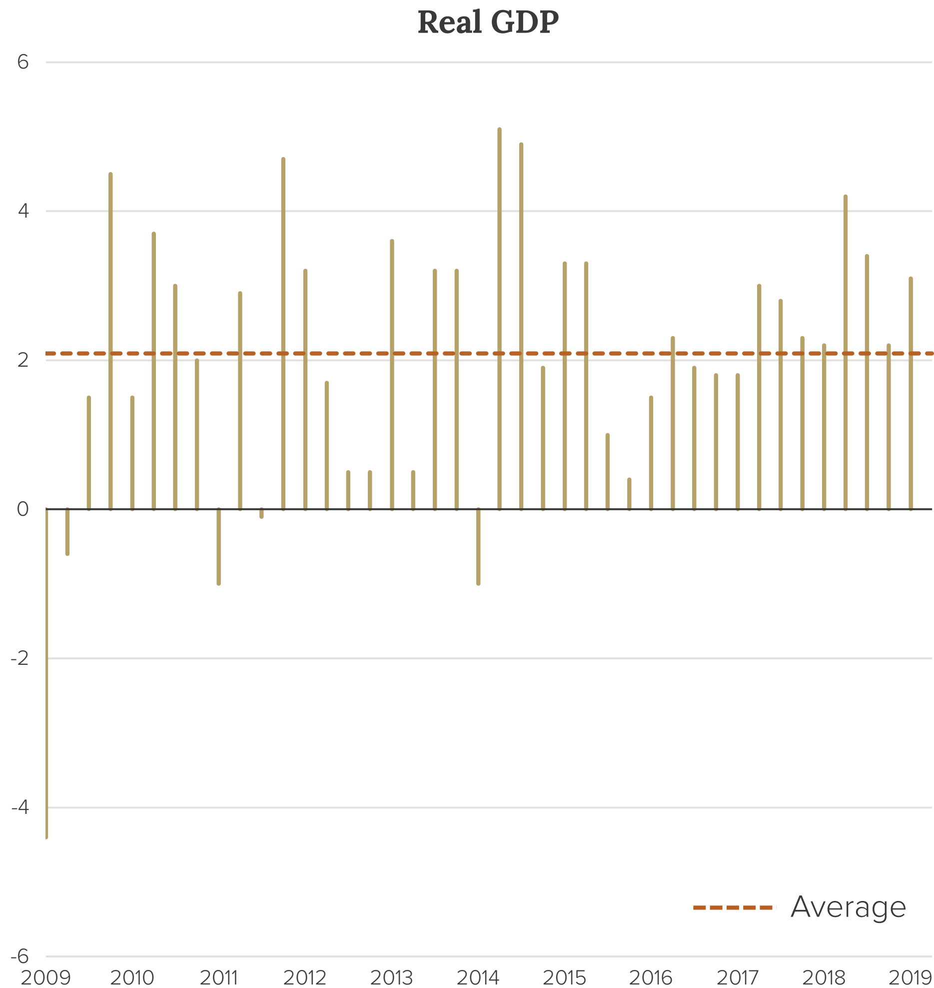
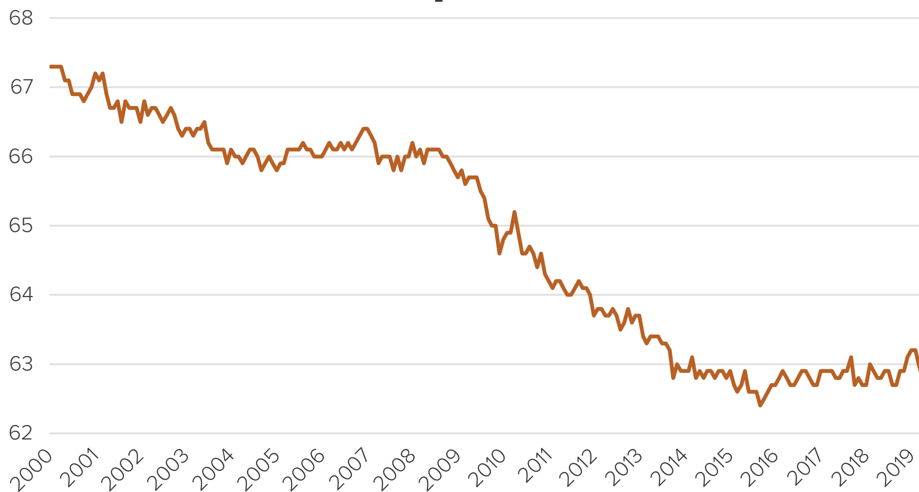


Source: Federal Reserve Bank of St. Louis
Real Gross Domestic Product, Percent Change from Preceding Period, Quarterly, Seasonally Adjusted Annual Rate (Data Through: 1Q 2019)

- This month the U.S. economy celebrates ten years of recession-free recovery/expansion, the longest such cycle in U.S. history. Congratulations to Mr. and Mrs. Economy.
- Despite the record advance, GDP has grown at a below-average rate of 2% per year, reflecting residual damage from The Great Recession and secular trends toward lower growth.
- Inflation and interest rates have remained low throughout the recovery/expansion, mitigating to some extent the lower-than-average growth in GDP.
- Both the Fed and International Monetary Fund project sustainable growth from the U.S. economy in the 2% range. These forecasts are based upon labor force and productivity trends.
- We expect further extension of the cycle.

EMPLOYMENT: THE STRONGEST ASPECT OF THE ECONOMY

Source: Federal Reserve Bank of St. Louis
Civilian Unemployment Rate, Percent, Monthly, Seasonally Adjusted (Data Through: May 2019)



Source: Federal Reserve Bank of St. Louis
Civilian Labor Force Participation Rate, Percent, Monthly, Seasonally Adjusted (Data Through: May 2019)

- At 3.6%, unemployment is at a 50-year low, implying that anyone who wants a job can find one. This is a far cry from 10% unemployment in 2009.
- Since the recovery began in 2009, over 20 million new jobs have been created, averaging some 175,000 per month.
- Around 100,000 new jobs need to be created each month to keep pace with growth in the labor force.
- The lone negative in the employment picture is the participation rate. This measure declined sharply after The Great Recession and has yet to show meaningful improvement, suggesting slack still exists in the employment picture.

THE ECONOMY: A FEW CRACKS AROUND THE EDGES

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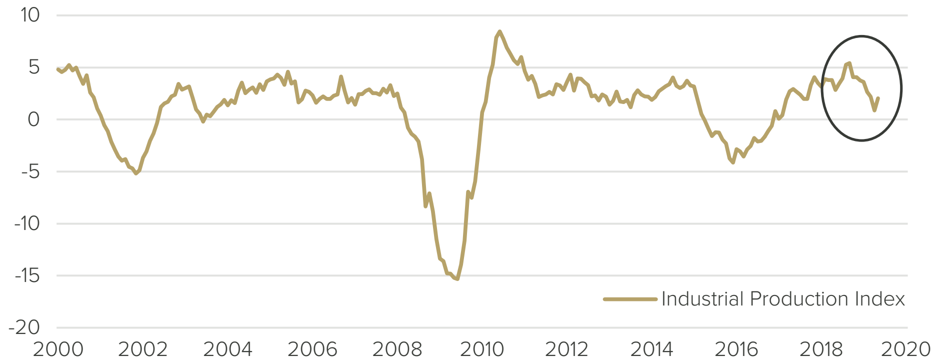

Source: Federal Reserve Bank of St. Louis, FactSet
Industrial Production Index, Percent Change from Year Ago, Monthly, Seasonally Adjusted (Data Trough: May 2019)
ISM Manufacturing Index, Monthly (Data Trough: May 2019)
Housing Starts: Total: New Privately Owned Housing Units Started, Thousands of Units, Monthly, Seasonally Adjusted Annual Rate (Data Trough: May 2019)

- There are a few economic numbers that are disquieting: Industrial Production, ISM Manufacturing, and Housing Starts, among others.
- The industrial and manufacturing indices have been declining for about 18 months.
- Housing starts have been basically flat for several years, an oddity, considering the length of the cycle. Housing has only recovered to roughly 50% of its peak level in 2006.
- Notice that the industrial measures declined sharply from 2015 into 2016 only to stage a sharp rebound.

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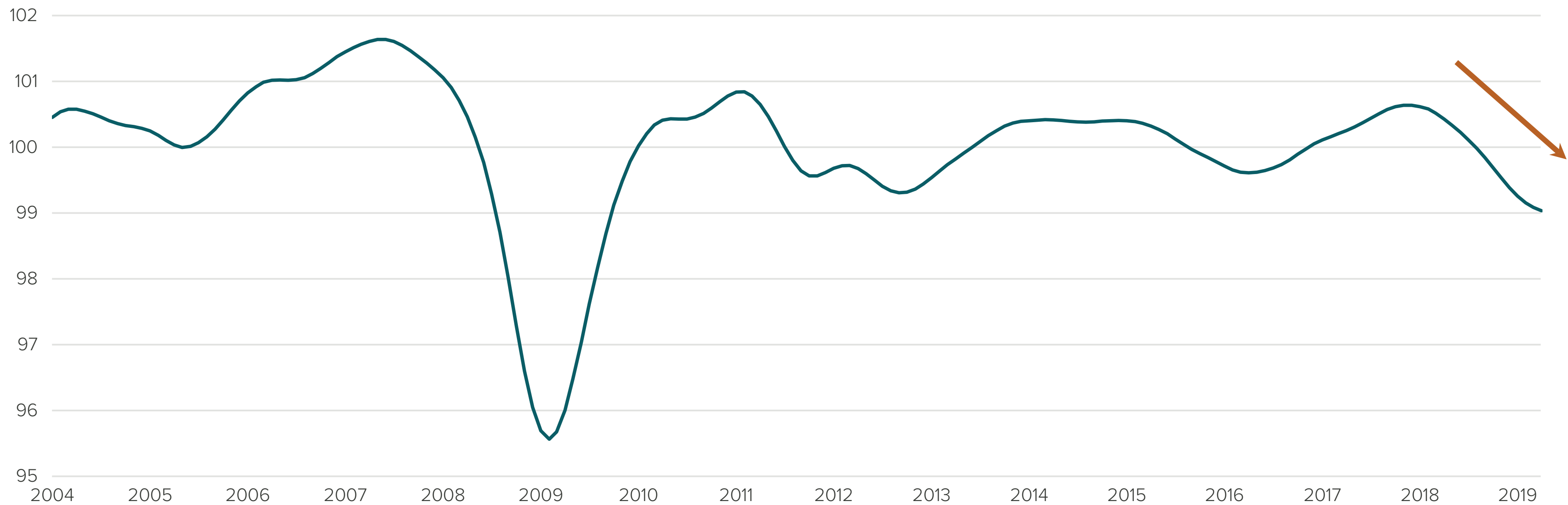
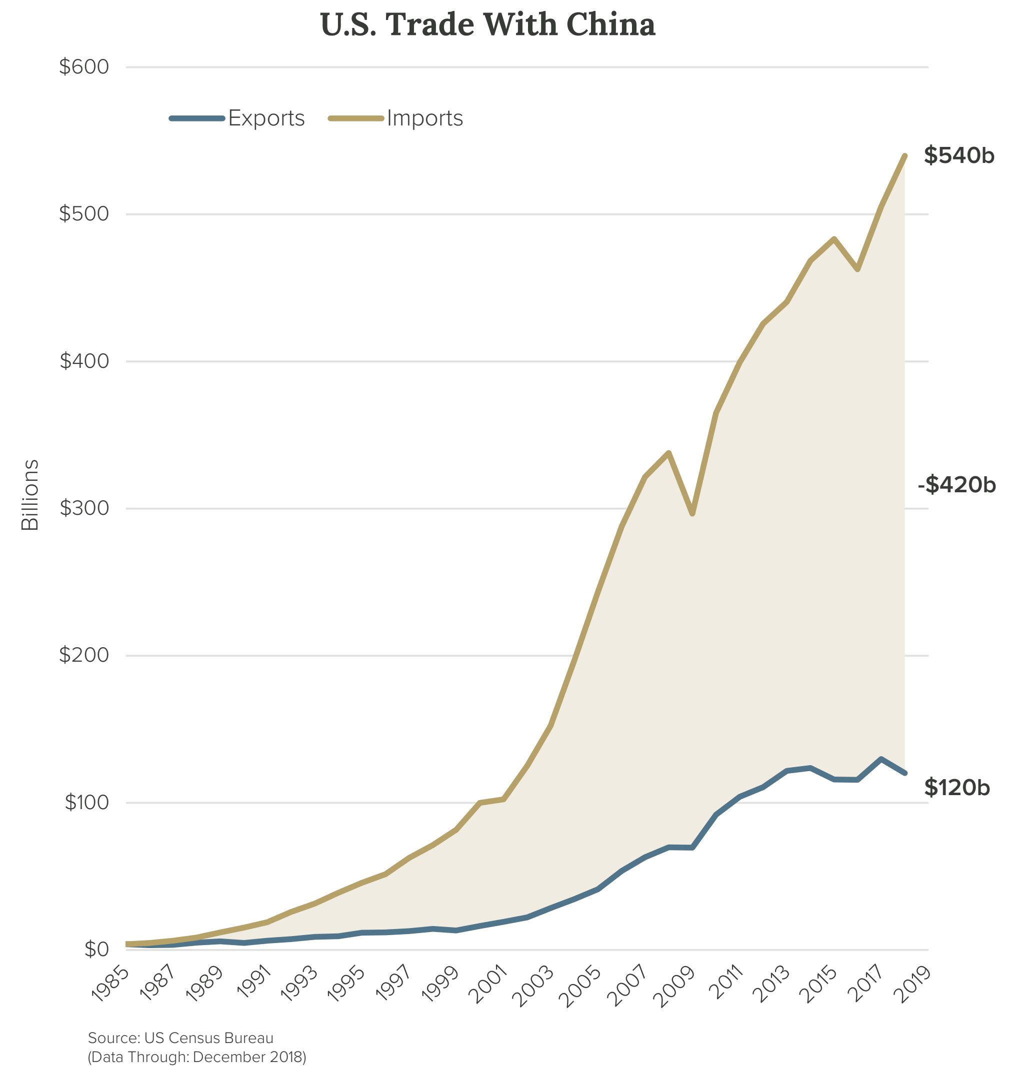


Source: OECD (2019)
Composite leading indicator (Data Through: April 2019). The composite leading indicator (CLI) is designed to provide early signals of turning points in business cycles showing fluctuation of the economic activity around its long term potential level.

- The Organization for Economic Cooperation and Development (OECD) provides a leading economic index of its 36 member countries.
- The index is designed to provide early signs of turning points in business cycles of its membership.
- The index peaked in early 2018 and has declined steadily since then.
- Even though the U.S. economy has withstood global pressures to date, investors are concerned that foreign weakness will eventually affect our economy negatively.

- The U.S. is currently engaged in a trade war with China.
- The chart presents a vivid picture of how important China has become to the U.S. economy.
- The trade war has many dimensions. Seeking greater balance in trade with China is one. Protecting intellectual property is another. Fairness in trade is essential to all parties.
- There are geopolitical aspects of the trade war with China. China will eventually overtake the U.S. as the largest economy, and managing China's increased power in the world will be a longer-term challenge.



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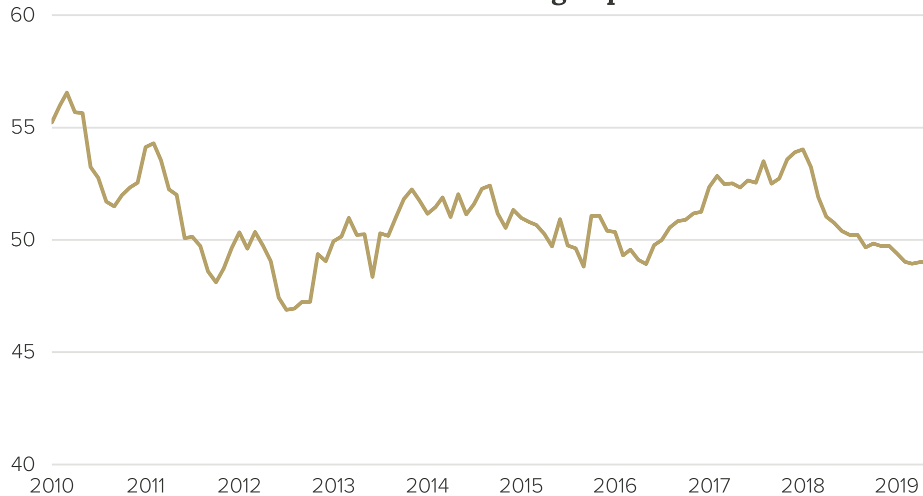
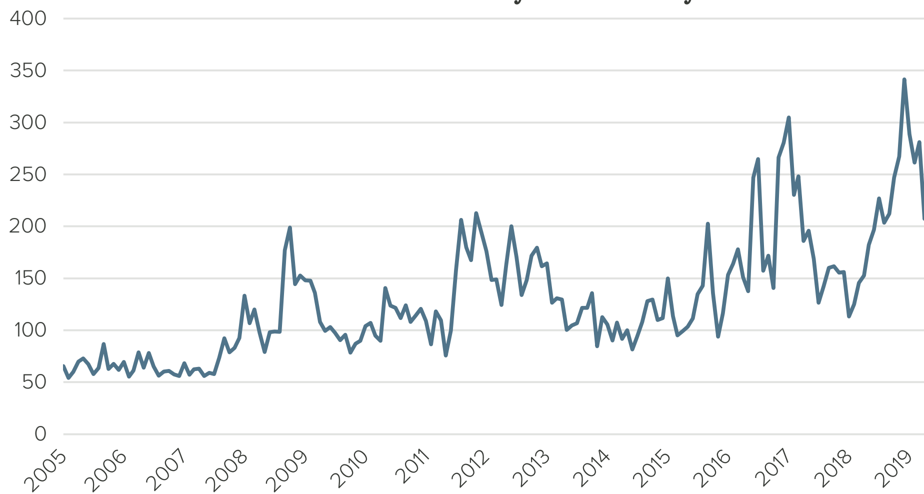


Source: JPMorgan
JPMorgan Global PMI – Manufacturing Export Orders, index, seasonally adjusted (Data Through: May 2019)



Source: Economic Policy Uncertainty; http://policyuncertainty.com
Global Economic Policy Uncertainty Index, based on PPP-adjusted GDP (Data Through: May 2019)

- On a global basis, international trade has declined, impacting global manufacturing.
- Trade wars create uncertainty. Businesses always prefer certainty and without it, future investment can be delayed or postponed, causing lower overall growth.
- The index graph at the bottom confirms heightened uncertainty, presumably because of trade tensions.

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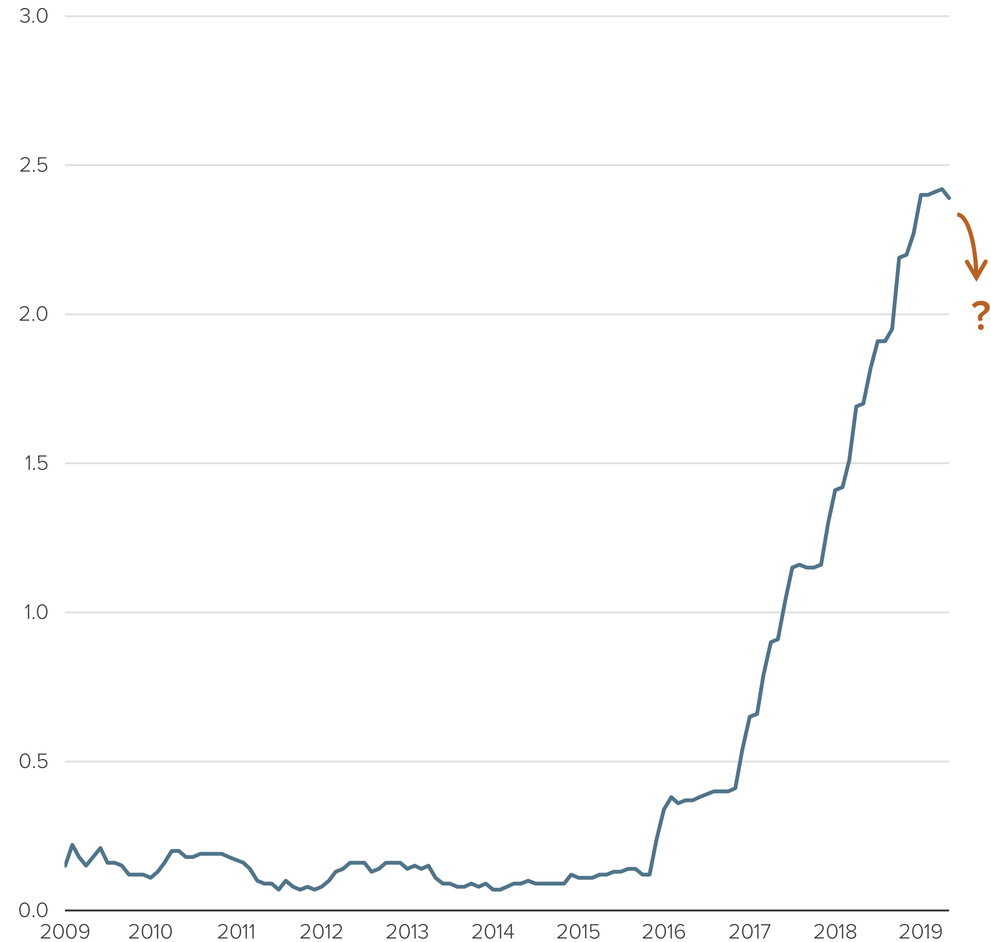
"The benefit of international trade – a more efficient employment of the productive forces of the world."

John Stuart Mill

Things to think about:

- Without trade, consumption is limited to domestic production.
- International trade makes larger world production possible.
- Tariffs limit international trade.
- A tariff is a tax. Furthermore, it is a regressive tax.
- Tariffs cause uncertainty and may delay investment in capital projects.
- Tariffs, as money received, do not provide fiscal stimulus.
- Trade wars can restrict economic growth and, as such, can be deflationary.
- Trade wars can go beyond economics to the geopolitical realm by increasing tensions between trading partners.

- The cumulative effect of weaker domestic activity and global economic slowdown has captured the attention of the Fed. They want to do whatever it takes to avoid a recession.
- After nine federal funds increases since 2016, the Fed is officially on "hold," but recent statements indicate that federal funds cuts are on the way.
- Normally, the Fed cuts rates by some 500 basis points to avoid or correct a recession. Since they currently have only 250 basis points to work with, they are motivated to move early and aggressively.
- Major changes in Fed policy usually occur at inflection points in the economy.



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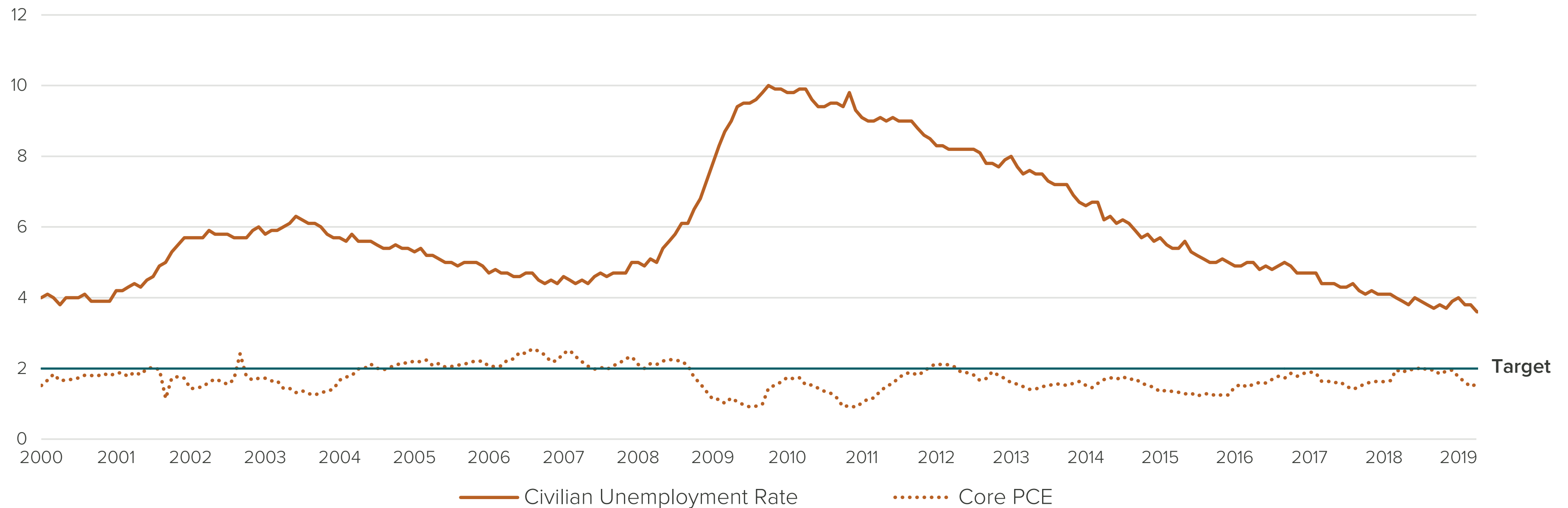

Source: Federal Reserve Bank of St. Louis
Civilian Unemployment Rate, Percent, Monthly, Seasonally Adjusted (Data Through: May 2019)
Personal Consumption Expenditures Excluding Food and Energy (Chain-Type Price Index), Percent Change from Year Ago, Monthly, Seasonally Adjusted (Data Through: April 2019)

- Notice that since The Great Recession, the inflation rate has stayed consistently below the Fed's 2% target.
- This is despite a long and steady decline in unemployment to its current low level of 3.6%.
- Theory suggests that a fully employed economy will create inflation pressures.
- Evidence continues to mount that secular forces toward lower growth are inhibiting inflationary tendencies.

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STOCKS AND BONDS: TWO DIFFERENT VIEWS OF THE WORLD

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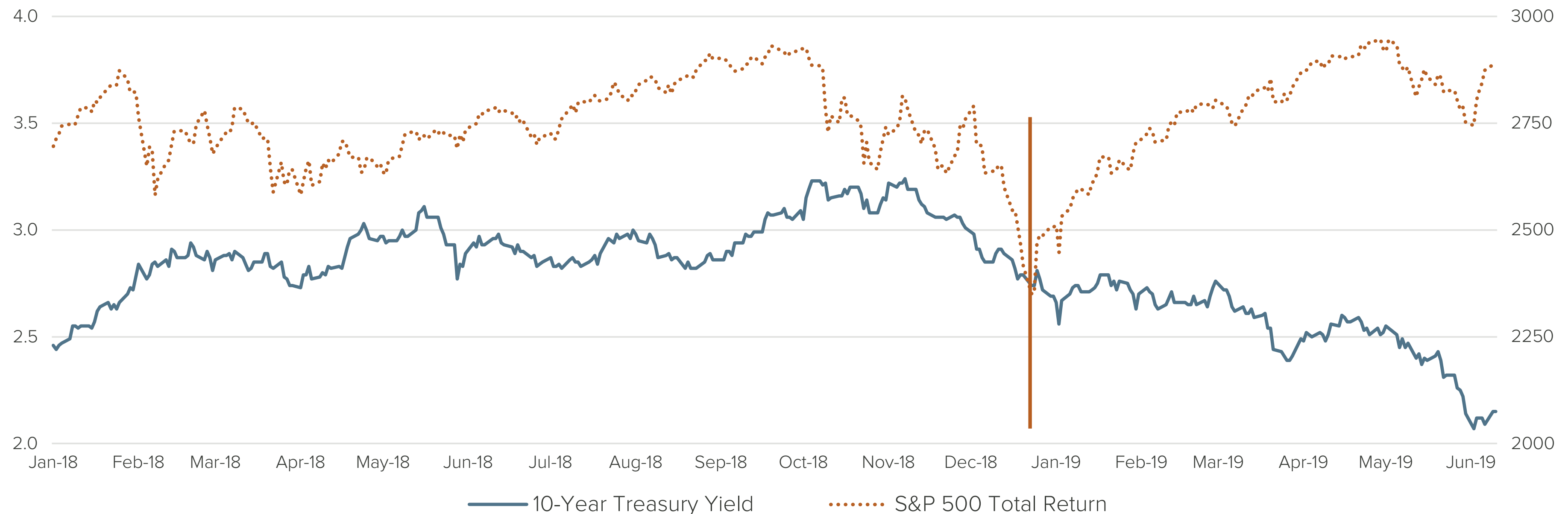

Source: Federal Reserve Bank of St. Louis, Bloomberg
10-Year Treasury Constant Maturity Rate, Percent, Daily, Not Seasonally Adjusted (Data Through: 6/11/2019); SPY total return (Data Through: 6/11/2019)

- The stock and bond markets are projecting different views of the future. This year stocks have been rising while bond yields have been declining.
- Generally speaking, bond investors tend to be more pessimistic, equity investors more positive.
- Stock investors seem to be ignoring signs of economic weakness in the belief that the Fed can solve things by lowering interest rates.
- Bond investors are taking a dimmer view, focusing on the weakness that has led to the Fed's policy change and the prospect of further weakness ahead.
- Time will tell which is correct, but we believe the recovery/expansion is likely to be sustained.

Everything is converging around 2%:

- 2% sustainable growth in real GDP
- 2% target for inflation by the Fed – (2% real GDP + 2% inflation = 4% nominal GDP)
- 2% yield on the 10-year U.S. Treasury note
- 2% yield on the S&P 500

What does it all mean?

- Demand is insufficient to power higher growth.
- Low inflation keeps interest rates low.
- Dividend growth keeps the yield on stocks at 2%.

Conclusion: We live in a 2% world. It may be permanent.

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