SEPTEMBER 30, 2019

CRAWFORD INVESTMENT COUNSEL Est. 1980

ECONOMIC & MARKET UPDATE

The financial markets continued to provide a constructive environment for both stock and bond investors as both asset classes moved higher during the third quarter. Stocks overcame heightened recession fears by reacting favorably to Federal Reserve (Fed) interest rate reductions and ended the quarter not too far from all-time highs. Bond yields declined sharply in response to slowing growth in the domestic and global economies, thus providing higher total investment return for bond holders.

> "We believe this cycle of recovery/expansion can be a lengthy one, although when measured over the entire cycle, economic growth will be slower than normal."

Crawford Investment Counsel, Inc.
Economic and Market Environment
October 2012

We are not in the habit of quoting ourselves, but we make an exception on this occasion because the endurance of the long economic recovery/expansion that our economy has experienced is being called into question. As this quote from 2012 illustrates, as far back as seven years ago we were suggesting that the lack of excesses within the U.S. economy would likely produce a run of many years without a recession. In fact, we are now into the eleventh year of this cycle, a record for the U.S. economy, and we believe it has not yet run its course. As noted earlier, recession fears have been rising. We do not dismiss these fears outright, but we do try to keep them in perspective. In this letter we will review economic issues that could cause a recession in the near future and, conversely, those that could help keep the economy moving forward. For now, we believe the balance of factors favors a further extension of the cycle, perhaps even for a matter of years.

WHAT COULD CAUSE A RECESSION IN 2020? To be clear, there are warning signs that suggest caution when contemplating the economic outlook. The yield curve has attracted much attention of late since several parts of it have inverted, that is, shorter-term interest rates are higher than longer-term ones. Historically, inverted yield curves have been a good predictor of recessions, although their record of timing the beginning of an economic downturn is poor. Furthermore, the most traditional yield curve measurement has been the two-year U.S. Treasury note compared to the ten-year note. This measure did briefly invert but has now turned positive again, so the signal, while worrisome, is indecisive at this point. We have always respected the power of the yield curve and are not forgetting that warnings from the yield curve should be ignored at one's own peril.

We also note that two important areas of the economy are in a weakening trend, specifically, investment and manufacturing. The investment component of GDP (Gross Domestic Product), of which the largest portion is capital spending, has been trending downward and, in the second quarter, declined slightly. This is of concern because one of the central tenets of the Trump corporate tax cut was the expectation that it would spur a boom in capital spending and lead to higher growth in the economy. Also, manufacturing in the U.S. actually contracted in August, something that last occurred in 2016.

Manufacturing and capital spending are closely related. Capital spending is used to build manufacturing facilities and to buy computers and other machinery and equipment, both of which create the ability to produce goods and jobs. While manufacturing and capital spending are much smaller than consumption as a percentage of the economy, they are important as indicators. The predictive power lies in their volatility. For instance, capital spending is about six times more volatile than consumption in the U.S. economy and may decline as much as 10% in a recession. Because of this volatility, its influence is magnified, mainly because booms and busts in capital spending tend to drive recoveries and recessions. Thus, the slowing trend in capital investment is worth noting and, should deterioration continue, would be of major concern.

We are all aware of the trade issues that are playing out on the world stage, principally between the U.S. and China. Importantly, trade issues are having a negative effect on manufacturing and capital spending and, as such, the eventual outcome of trade disputes is among the higher risk factors for the economy. Capital investments require a degree of certainty as to their eventual profitability, and until there is more certainty regarding the eventual outcome of the trade issues, the less inclined businesses will be to invest. This is the risk: lingering uncertainty from a continuation of trade disputes causes such hesitation among businesses that further declines occur in the key areas of capital spending and manufacturing and eventually spread to other areas such as consumption and employment.

WHAT CAN KEEP THE ECONOMY GOING? We believe there are at least four reasons to expect a continuation of the record-long U.S. recovery/expansion. They are as follows: a healthy consumer that spends at a satisfactory rate, a fairly predictable manufacturing cycle that may be nearing a bottom, a stock market that is showing few signs of worry about a recession, and a Federal Reserve that is easing policy in order to sustain the expansion.

Consumption represents 70% of Gross Domestic Product (GDP) and is currently running at a healthy pace. Real personal consumption expenditures growth appears to have been close to 3% in the third quarter. Keep in mind that this 70% portion of the economy compares to approximately 18% in investment and only around 10% in manufacturing. It would require a drastic drop-off in investment and manufacturing to offset the strength in consumption. This is not likely, in our opinion. Our conclusion is that the consumer is in good shape because the savings rate is elevated, the financial obligations ratio is low, and confidence is reasonably high.

While the softening trend in manufacturing is of concern, it is encouraging to remember that manufacturing moves in fairly predictable cycles. In the past, these cycles have typically run in increments of about three years, some eighteen months up and eighteen months down. It has been trending down since early 2018 and may be approaching a bottom. If so, we can look forward to an expansion of manufacturing activity over the remainder of this year and next. Why do these cycles occur? It is because manufactured goods are durable, that is, they have a long shelf life. They are not consumed immediately, thus tend to create gluts which cause the down cycle, which in turn leads to shortages that spur the recovery. If historical tendency holds, manufacturing should be improving soon.

The stock market is one of the officially designated leading economic indicators. It has been mocked through the years for false signals on the economy but, in fact, its record has been pretty good. Most of its false signals have occurred when market declines have failed to predict a recession. Right now, the signal is a strong one. Trading near its all-time high, the stock market is expressing little concern over the possibility of a near-term recession.

Finally, it is important to keep in mind that the economic expansion has the support of the Fed. As evidenced by two recent federal funds reductions, policy has shifted to ease, and the intent has been clearly stated: do whatever is necessary to keep the expansion in place. This attitude certainly buttresses the case for further economic expansion.

CONCLUSION There are reasons to be concerned, as certain areas of the economy are trending in the wrong direction. We recognize that the economy is rarely in perfect balance, and that is the case today. But, as we assess the various factors discussed in this letter, we believe the positives outweigh the negatives, favoring further extension of the cycle. Typically, economic cycles do not die of old age. They don't just run out of steam. Cycles usually end because excesses develop in credit, spending, or speculation to a point where the Fed takes punitive action. Today, we are far from such conditions and, until more economic or financial excesses develop, we expect the path of least resistance to be in the direction of further progress. While we are limiting our view to the next couple of years, it may well turn out that the cycle has even longer to run. It is important to state that we are remaining in agreement with our long-held position that the cycle can be lengthy, but also that the sustainable growth rate of the economy is around 2%. Lower but steadier and extended growth is not a bad outlook.