Third Quarter 2019 Outlook and Commentary

Last October we noted the possibility of a U.S. recession within the next couple of years. At the time, the economy was going gangbusters with the second quarter of 2018 marking the first quarter in fifty years of 4%+ GDP growth with sub-4% unemployment. The Fed was signaling three interest rate hikes in 2019 and one or two more in 2020. The historical record of eleven recessions following the last fifteen Fed interest rate hike cycles suggested a bit of caution.

The possibility of a downturn didn't seem to be on investor radar screens back then, but it is now. Some of that is due to the on again, off again U.S.-China trade war—as of this writing it seems to be off again. More generally there is a feeling that after a record long expansion, perhaps it's just time. Worries of a downturn are reinforced by an inverted yield curve in which the interest rate on the 10-year U.S. Treasury bond is lower than the interest rate on three-month Treasury bills. The implication is that interest rates will be lower in the future than they are now, which implies that the Fed will be lowering rates, which suggests a softer economy going forward.

Despite all of that, we're a bit more optimistic than we were nine months ago. Notwithstanding an inverted yield curve, a recession is far from inevitable[1]; the U.S. economy may instead be in for a protracted period of low but positive growth. We are encouraged in part by the Fed's dramatic about-face on interest rates. Instead of three rate hikes in 2019, the question now seems to be whether the Fed will cut rates once or twice. Beyond that, there are the benefits of a stable housing market and the limited role of manufacturing in the U.S. economy.

The relevance of housing and manufacturing are illustrated nicely by the chart on the next page. Over the past 50 years the U.S. economy has been in recession for 27 quarters. The average GDP growth in those quarters has been -1.18%. This negative growth is strikingly concentrated in three specific areas: business investment in equipment and software, housing construction, and changes in manufacturing inventories. These three components of GDP contributed -0.69%, -0.61% and -0.81% respectively, partly offset by a positive contribution of +0.94% from everything else[2].

The good news is that the U.S. economy as currently constituted may be much less exposed to negative effects from housing construction and inventory adjustments than in decades past. Housing construction represents a relatively modest portion of GDP but it can swing dramatically, sometimes accounting for 1.5 to 2.0 percentage points of decline in GDP. But those declines have followed homebuilding booms and we haven't seen one of those in well over a decade. In fact, for the last several years residential construction in the U.S. has been so weak that there is an

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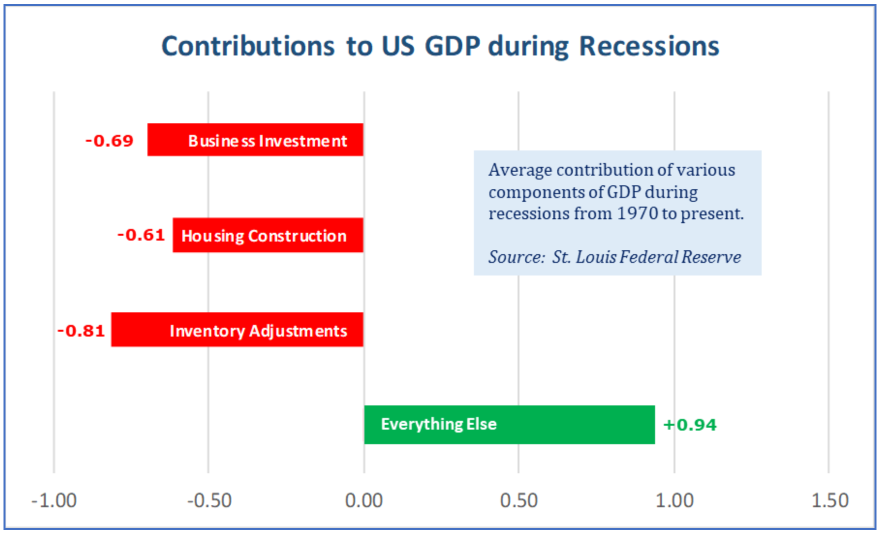
[1] Our economies are quite different, but it's worth noting that Australia has not experienced a recession in nearly thirty years. The Aussie economy happens to be weakening right now but the point is simply that expansions can go on for a very long time.
[2] The Bureau of Economic Analysis calculates these "contributions" to be additive. For example, using the quantities above: -0.69% + -0.61% + -0.81% + 0.94% = -1.17%, which is a rounding error away from the average GDP growth of -1.18%. In calculating these averages, some judgment calls were required as to which quarters to include since recessions are officially demarcated by month not quarter.

undersupply of housing. Homebuilding would have to accelerate sharply and stay there for a couple of years just to get supply in balance. Labor shortages and other supply constraints have been keeping homebuilding relatively flat. But with full employment, rock-bottom interest rates and undersupply, demand is likely to be solid enough to prevent any material decline.



Inventory adjustments are likewise ill-poised to have a major negative effect on growth. In part that's because manufacturing is a much smaller part of the U.S. economy than it was twenty, thirty or forty years ago. Further, with the advent of "just-in-time" production, it's much less common for manufacturers to allow production to get way ahead of demand. When production cuts come these days they tend to be pretty modest.

As the chart shows, without the negative effects from declines in housing construction and inventory building, the average recession over the last fifty years **wouldn't have even been a recession**. At some point, there will be another downturn, but it could be many years off, especially if the U.S. and China strike a trade deal. On that score, we take some comfort in the upcoming presidential election. Imposing a 25% tariff on all Chinese goods, as President Trump has threatened, would wreak havoc with global supply chains and almost certainly hamper business investment, which, as shown on the previous page, tends to decline sharply during downturns. That still might not be enough to tip the U.S. economy into a recession, but it certainly wouldn't help the President's reelection prospects, something likely to be on his mind as 2020 nears. Even if political considerations don't lead to a trade deal, Trump may find reasons to punt on additional tariffs, leaving that decision for the next administration, his or someone else's.

Speaking of politics, Congress will face yet another budget (and debt ceiling) deadline this fall. Failure to agree on a budget would trigger deep automatic spending cuts, which would be a material blow to the economy (federal spending makes up a pretty significant portion of "everything else" in the chart). Fortunately, the only folks in Washington who would benefit from a budget train wreck would be Democratic presidential candidates. The field is enormous but doesn't include quite enough members of Congress to swing a vote. The same logic applies to increasing the debt ceiling limit. Failure to do so would be a huge shock to capital markets, not something any incumbent—congressional or presidential—wants to happen on their watch.

Even if a trade war escalation, automatic federal spending cuts and a debt ceiling breach are all avoided, what about that inverted yield curve, which (as you may have heard) has a strong track record in forecasting recessions? The historical track record speaks for itself, but there is something different about this inversion, namely an incredibly persistent lack of inflation, which continues to remain below the Fed's 2% target. In normal times, the Fed's rationale for cutting interest rates is almost exclusively based on a softening economy. And that is why an inverted yield curve, which can only happen if markets expect lower interest rates in the future, is associated with recessions. Right now though, if the Fed cuts interest rates later this month, it may be as much about pushing inflation up as worrying about a softer economy. Looking at it another way, with seemingly very little risk of overshooting on inflation, and some possibility of the trade war heating up, why not cut rates?

If the trade war does escalate, China will be much more exposed than the U.S. In fact, global companies are actively working on moving more of their supply chains to countries like Taiwan and Vietnam, and that trend is unlikely to end even if some sort of deal is struck. Europe, especially Germany, which is highly dependent on exports, would also suffer in the event of an escalation. The only good news in China and Europe regarding intensification of the trade war is that there has been ample warning; policymakers have surely been updating contingency plans. We were particularly heartened by the nomination of Christine Lagarde to succeed Mario Draghi as head of the European Central Bank. More to the point, we were relieved that Germany's Jens Weidmann was not chosen. Ever since the hyperinflation of the 1920s, Germans have always seen runaway inflation around every corner. Weidmann, whom many expected to get the nod, would likely have pushed for a more restrictive monetary policy, regardless of the risks. A mild recession in Europe is still a distinct possibility, but Lagarde will be at the ready with a very accommodative policy response.

We don't mean to sound Pollyannaish. Our point is simply that investors who get overly defensive in anticipation of a downturn may become frustrated. U.S. stock prices are elevated, but as we have pointed out ad nauseum in these pages, they are supported by extremely low interest rates. In a world where you have to stretch to get a four percent yield on an investment grade bond, blue-chip stocks with a dividend yield of three percent and a chance of long-term share price appreciation look pretty good. That said, it is certainly true that U.S. stocks are quite expensive by historical standards, all the more so if you take into account that corporate profit margins are at all-time highs and may not be sustainable. Even if a recession and bear market aren't in the offing, the double digit returns of recent years are probably a bit much to ask for going forward. Investors anticipating mid-single digit returns over the medium-term investment horizon are less likely to be disappointed.

For investors with diversified portfolios, opportunities for better returns may lie in European and emerging markets stocks even if the economic challenges are somewhat greater. From our perspective, the risks in foreign markets are already priced into international stocks at a time when the global economy may be stabilizing. If the global economy improves, with a pause in the trade war and the success of China's fiscal and monetary measures being key to that outcome, it would not be surprising to see solid global stock market returns, but with outperformance coming from more attractively valued international and emerging markets stocks.

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Boston, MA

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