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Fourth Quarter 2018 Outlook and Commentary

In late September the U.S. Commerce Department announced that GDP expanded at a robust 4.2% in the second quarter, the fastest growth rate in nearly four years. At the same time, the unemployment rate has remained under 4% since April. This is only the second time since 1969 that GDP has come in over 4% with a sub-4% unemployment rate. With the economy firing on all cylinders, it is perhaps no wonder that U.S. stock market indices climbed to record levels in late September. While the recent strength of the economy is certainly good news, the most relevant question for investors is how long the good times will last[1]. And on that question we have become more cautious as the year has progressed. Increasingly we fear that the U.S. economy may be at or near a peak.

To be sure, a moderate economic deceleration would hardly be a bad thing. In a perfect world (at least for investors), the economy would settle into a growth trajectory of around 2.5%, unemployment would tick up a bit to keep wage increases under control, and core inflation would stabilize at around 2.0%. Sometime next year, with short-term interest rates perhaps a full percentage point higher, the Fed could declare victory and stop raising interest rates.

This lovely scenario, where a rate hike cycle slows the economy without tipping it into a recession, is known as a "soft landing." Unfortunately, soft landings, the dream of every Federal Reserve chair, have proven to be rather elusive. More often than not, rate hike cycles end up overshooting and triggering a recession. By our count there have been fifteen sustained rate hike cycles over the last sixty years. Eleven times the rate hikes led to recession. A soft landing was achieved only three times for a success rate of 20%[2].

Of course this less than stellar track record doesn't guarantee Fed Chair Jerome Powell won't pull off a fourth soft landing. After all, the Fed expects to stop lifting rates some time in 2020 with the fed funds rate just shy of 3.50%; relative to past rate hike cycles, that's pretty low. But relative to zero (where the Fed started three years ago), it's over three full percentage points in rate increases.

Meanwhile, the Fed is unwinding its program of bond purchases (quantitative easing), putting further pressure on interest rates. Perhaps the economy is strong enough to withstand all of this, but with interest rates peaking a year or so from now at the same time the benefits of last December's tax cuts are wearing off, that's far from a sure bet.

Just to get all of the bad news out of the way, of the eight recessions[3] over the last sixty years all but one was associated with a bear market, a stock market decline of at least 20% from peak to trough. The phrase "peak to trough" is critical. In 2011 the S&P 500 index declined by 22% between April

[1] For those who need to be convinced that great economic data doesn't always portend great future investment returns, consider the last time GDP growth was 4%+ with a sub-4% unemployment rate: April of 2000.
[2] The remaining rate hike cycle in 1971 failed to cool off the economy, requiring rates to be lifted again beginning about six months later. Not a recession, but a failure of a different sort.
[3] Eleven rate hike cycles led to recessions, but in some cases they were bunched closely together and more than one rate hike cycle contributed to the same recession. Hence, eight recessions.

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29th and October 3rd, but delivered a total return of +2% for the full year. Even if you were looking at your portfolio quarterly you would have "only" seen a decline of 14%.

It's also important to put the word "recession" in perspective. The Great Recession of 2008-2009 was especially nasty: it lasted for nineteen months, with economic output declining by 5.1% and the unemployment rate more than doubling from 4.4% to 10.0%. If the Great Recession was a Category 4 hurricane, the recession of 2001 was a gentle breeze with a bit of rain. That one lasted nine months, with GDP declining by 0.3% and unemployment climbing from 3.9% to 6.3%.

The next recession seems likely to look a lot more like 2001 than 2008, primarily because two of the major culprits in severe recessions of the past don't appear to be much of a threat. Twentieth century booms and busts were largely driven by big swings in manufacturing inventory. In part that's because the lead time to adjust production was much greater back then; imagine driving a car with a several second delay on the gas pedal and the brake. When sharply rising inventory signaled manufacturers that they had pushed too hard on the gas, companies tended to slash production to reduce inventory. Production cuts meant big layoffs, which pushed demand down further, resulting in a recession. By the time policymakers responded with lower interest rates and/or increased government spending, the economic damage tended to be quite significant.

As manufacturing is now a much smaller part of the U.S. economy, and with the advent of "just-in-time" production (better brakes and gas pedals), the impact of the inventory cycle is dramatically less than it was in decades past. All of this was true ten years ago of course. But in that case there had been an explosion of housing debt and a massive oversupply of housing. Housing construction constitutes a relatively modest portion of GDP—typically 3-5%—but it can swing wildly. When homebuilding collapsed beginning in 2007 it was directly responsible for a four percentage point decline in GDP. That was extreme, but it's not uncommon for a falloff in homebuilding to account for declines of one-and-a-half to two percentage points in GDP. When you add the indirect effects (think of plunging furniture sales and unemployed carpenters), the result can be dramatic. It's hard for that to happen though without an oversupply of housing, and for the last several years, the U.S. has had an <u>undersupply</u> of housing. Homebuilding would have to accelerate sharply and stay there for a couple of years just to get supply in balance.

Just as the ingredients for a severe recession don't appear to be in place, the factors underlying some of the nastiest bear markets seem to be missing as well. The worst bear markets of the last seventy years were primarily based on: runaway inflation driving up interest rates and eating away at corporate profits in the early 1970s, extreme valuations during the tech bubble of the late 1990s and a near-collapse of the financial system just over ten years ago. None of those factors seem to be in the offing[4]. In fact, if we have a bear market sometime in the next two or three years, moderate inflation and low interest rates could offer downside protection. Even a mild recession would cause the Fed to lower interest rates. If that were paired with a 20% decline in share prices, dividend yields on many blue-chip stocks would once again exceed yields on corporate bonds, driving investors back into the stock market.

To sum up: the Federal Reserve is in the midst of a sustained rate hike cycle, during which short-term rates are likely to have risen by over three percentage points by the end of 2019. Most sustained rate hike cycles trigger a recession and most recessions are associated with stock market declines of 20% or more. All of that is the bad news. The good news is that (a) the typical ingredients for a severe recession don't appear to be in place, (b) the factors that would lead to an especially severe bear market aren't evident and (c) sharp stock market declines are often followed by quick recoveries.

[4] To be sure, some sort of localized financial crisis is possible. Italy's outsized government debt and very high levels of private sector debt in China are troubling, for example. But it seems unlikely that a blow up in Italy or China would shake the foundations of the global financial system as happened in 2008.

All of this is, it should go without saying, speculative. It's hard to know what will happen to the stock market next month, never mind next year or two or three years from now. But with the age of the bull market and the economic expansion, and considering that we are in the midst of a significant rate hike cycle, it's important to consider some of the possibilities discussed above.

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It might seem odd that we've gotten this far without mentioning tariffs, one of the factors that led to last week's stock market turmoil. It's not that we have no concerns on these matters, but the most likely scenarios don't significantly alter the picture painted above.

On tariffs, the news is in some ways better than it was just a few months ago. In June, President Trump seemed determined to fight a three front trade war, threatening massive tariffs on trading partners in North America, Europe and Asia. Since then, the administration struck a deal (that may or may not be approved by Congress) to tweak and rename NAFTA, perhaps presaging a deal with Europe that similarly preserves the status quo with minor changes. It now appears that the President's trade rhetoric and policies are aimed almost exclusively at China[5]. Even a 25% tariff on all imported Chinese goods (as has been threatened) would not have a dramatic direct effect on the U.S. economy. To be sure, it would be moderately inflationary, perhaps forcing the Fed to be more aggressive with interest rates. It would also have a pretty significant impact on the Chinese economy which could lead to indirect consequences, none of which would be positive (and which markets likely had in mind last week). And the longer the trade battle with China goes on, the greater the risk of undermining U.S. business and consumer confidence (which by many measures remain near all-time highs). On the other hand, we have a hunch that the administration's tone with China could change after the midterm elections, once the political benefits of being tough with Beijing have faded. In any event, tariffs on China alone seem unlikely to cause dramatic economic upheaval. They do add, however, to the risk that the U.S. economy, which looks so strong today, could slip into a recession sometime over the next two years or so, a possibility we all ought increasingly to keep in mind.

One place where tariffs have already had a negative effect is emerging markets (EM) stocks, as reflected in a twenty five percent decline in the MSCI EM index from its late January high. The EM bear market is a result of several factors beyond trade tensions, including a strong U.S. dollar and debt/currency crises in Turkey and Argentina. With Turkey comprising one percent of the EM index (Argentina isn't even <u>in</u> the index), investors are apparently fearful of the problems in Turkey and Argentina spreading. It's not at all clear, though, that they will. Emerging markets economic growth continues to outpace the rest of the world; corporate earnings are strong; and governments have on the whole been much more prudent than in decades past. While further problems in emerging markets can't be ruled out, the divergent trajectories of the respective stock markets suggest that fears of a widespread EM financial crisis are overdone at the same time that the risks of a U.S. recession in the next two or so years may be underappreciated.

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[5] Considering China's bad behavior with regard to American intellectual property and President Xi's determination to see China establish a dominant position over the next decade in advanced industries like robotics, aviation, and electric cars, confronting China makes a lot of sense. In the near term, escalating tariffs won't help the U.S. economy or the stock market, and would certainly increase the odds of a recession. But if it eventually forces China to adopt less aggressive practices with respect to trade and domestic investment (a huge if), it may be worth the price.

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