All Eyes on the Fed

The stock market rebound from February's brief dip into correction territory continued through the end of the third quarter, with the S&P 500, Down Jones Industrial Average and NASDAQ Composite up 8.99%, 7.04% and 16.56% respectively.

In our last quarterly newsletter, we contemplated the potential recessionary warnings of a flattened yield curve and focused on the growing propensity for Federal Reserve policy error and tariff-induced trade war as the two most likely culprits for an economic downturn. Given the sharp drop in equity prices as the fourth quarter commenced, it is worth revisiting this topic to get a better handle on whether the present volatility represents a normal and very healthy corrective phase or perhaps the beginning of a bear market decline commensurate with a looming recession. Let's evaluate the facts.

After surging in recent weeks to 3.25%, the yield on the ten-year Treasury has settled in just over 3.1% in a pronounced flight-to-safety trade. With the yield on one-year Treasury bills now at 2.64%, the spread between ten-year and one-year Treasuries stands at 0.46%. The yield on thirty-year Treasuries is now at 3.3%, indicating a spread of only 0.66% between thirty-year and one-year Treasuries. The spread between maturities remains consistent and the curve has flattened further since our last report. Despite this potential flag of lurking recession, the data point to an economy firing on (most) all cylinders.

Employers added another 134,000 jobs in September, bringing the unemployment rate down to 3.7% and its lowest level since December 1969. This was a record 96^{th} consecutive month of job gains and wages rose 2.8% from a year earlier. Led by healthy consumer spending and record-high performance from the service sector, third quarter GDP seems poised to approximate the robust 4.2% growth rate observed in the second quarter. Meanwhile, while year-over-year core inflation has finally reached the Fed's 2% target, this should be viewed as successful Fed engineering from the depths of the Great Recession's seemingly bottomless deflation spiral.

Household net worth recently hit an all-time high and the percentage of liabilities to total assets fell to a three-decade low. Total household net worth is now hovering near $100 trillion, up over 50% from pre-2008 highs, while liabilities are up only 7% during the same period. Household debt now represents 65% of GDP compared to 87% of GDP in 2009. With wages steadily rising and household net worth elevated, it is no wonder that consumer spending, responsible for two-thirds of U.S. GDP, continues to thrive. With interest rates on the rise, rate-sensitive industries such as autos, housing and construction have cooled off considerably. Indeed, 30-year fixed mortgage rates have reached the psychologically significant 5% threshold and may exacerbate an already slumping housing market. Should housing and stock market prices deteriorate further as interest rates climb, declining net worth may curb consumer enthusiasm.

Buoyed by strong earnings growth, reduced tax rates and repatriated overseas cash, Corporate America remains financially strong. Goldman Sachs recently estimated that S&P 500 companies are on pace to spend over $2.66 trillion this year on capital expenditures, research and development, buybacks and dividends. This is up 19% from last year and Goldman further estimates that cash spending will increase by another 13% next year to $3 trillion, with approximately half of the total returned to shareholders though buybacks and dividends. Adjusted for inflation, the projected buyback volume for 2019 will surpass the previous high set in 2007. Implying room for further share repurchases, S&P 500 companies used 72% of total cash flow for buybacks in 2007 compared to only 35% today.

Finally, after nearly a decade of stress tests and unprecedented post-crisis regulatory reform, the U.S. banking sector represents a collective Fort Knox of strength. While consumers, corporations and banks are all in wonderful present shape, it remains to be seen whether hindsight and continued Fed rate hikes will ultimately reveal a peaking of the economic cycle.

Fed rate hikes to-date and the ensuing strong dollar have already served to expose weakness overseas, especially pronounced in emerging markets. The MSCI Emerging Market Index recently entered bear market territory and is now down 20% from its late January high. Argentina, Turkey, South Africa, Pakistan, Philippines and Indonesia have all experienced declining economic conditions characterized by weakening currencies, higher inflation, capital flight and ballooning costs to cover interest on dollar-denominated debt. The Chinese stock market has similarly plunged by 20% as the world's two largest economies seem poised to engage in economic cold war.

While the immediate economic impact of threatened tariffs seems negligible (total imports from China amount to less than 3% of U.S. GDP), the longer-term implications are difficult to determine. Direct investment from U.S. companies to China approximates $850 billion from 2000 through 2017 and is likely to surpass $1 trillion in cumulative investment since 2000 in the coming year. Should China and the U.S. economically disengage, the unwinding of this massive investment will be disruptive and expensive as companies build new capacity elsewhere and write down Chinese investments. Recent trade agreements between the U.S. and neighbors Mexico and Canada give credibility to the Trump negotiating playbook and may offer a ray of hope for potential trade talks with China. Perhaps influenced by the ongoing slump in the stock market, President Trump and President Xi recently agreed to meet at the G-20 summit in Argentina next month.

Ten-year bond yields in Italy recently spiked to 3.6% and now stand at the highest level since 2014, stoking renewed fears of euro instability. With Brexit looming, climbing Italian yields and ten-year German bund yields still below 0.50%, the United States would seem to have a clear upper hand in continuing trade talks with our European allies. Meanwhile, ten-year Japanese government bonds now offer a scant 0.15% yield. The supertanker U.S. economy represents 25% of the $80 trillion global economy and is clearly the cleanest shirt in an otherwise dirty global laundry basket.

All eyes are truly on the Federal Reserve. President Trump's recent rant against "loco" Federal Reserve policy smacks of Jim Cramer's now infamous rant against the "know nothing" Fed from 2007. Indeed, Cramer seemed to echo Trump's comments in recently stating that the "economy is not as good as Jay Powell thinks it is". Much of the criticism of Chairman Powell and the Federal Reserve stems from Powell's recent testimony that Fed policy is still a "long way from neutral". With the rate-sensitive auto, housing and construction industries already in decline and inflation muted, markets would seem to be better served by a more data-dependent and less methodical pace of future hikes. Heightened stock market volatility is telling us that the propensity for Federal Reserve policy error and overstep has increased markedly. Navigating a soft landing in this unprecedented era of quantitative tightening will be made even more challenging by the collateral damage being imposed on foreign markets by Fed policy.

The ongoing U.S. economic expansion is poised to become the longest running in U.S. history next summer. As the markets adjust to normalization of interest rates, the underlying economic data seems strong enough to delay the threat of imminent recession. Meanwhile, the S&P 500 now trades at a more reasonable 15.5x 2019 expected earnings. While present forecasts imply a multiple for the S&P 500 at only 14x 2020 earnings, we believe that these forecasts may prove too optimistic given the international backdrop and likelihood for the U.S. economy to gradually soften.