Newsletter

State of the Economy September 2019

Fears of an imminent recession picked up during the 3rd quarter. As the White House and China continued to negotiate, a trusted barometer flashed a warning the economy may be headed for troubled waters. The yield on the 10-year treasury dipped below the yield on 2-year note during the second week of August. This phenomenon has preceded each of the past six recessions and caused many investors to worry about the future of the economy. Investor fears led to a sharp decline in the market but have since recovered close to all time highs as positive trade war and economic news have recently righted the ship.

The market continues to rebound even as political headwinds remain common place. The trade war news with China seems to fluctuate week to week with the latest pointing towards another meeting in October. On Tuesday, Nancy Pelosi announced an impeachment inquiry into President Trump amid alleged abuses of power. As the political uncertainty looms in the background, the underlying economy is still strong even if it is slowing down. The unemployment rate is hovering at a historic low of 3.7% with reports indicating that labor scarcity being the greatest problem companies are facing. The consumer spending numbers in the U.S. had their biggest gain in 4 years during the 2nd quarter. And, the recent gross domestic report showed the pace of growth slowed from the start of the year, but remained solid overall.

A divided Federal Reserve cut its benchmark interest rate by a quarter percentage point for the second time in as many months. The decision was implemented to help cushion the economy against a global slowdown. Federal Reserve Chairman Jerome Powell left the door open to additional rate cuts and repeatedly cited the costs of trade-policy uncertainty as a factor. Fellow board members were split on the decision and reluctant to make predictions about the future, too. The Fed's hesitant stance was not cheered by everyone as investors hoped for a more aggressive outlook toward rate cuts. President Trump lashed out at Mr. Powell as well expressing his disappointment with the lack of support the Fed has provided the market.

The global slowdown continued overseas as the European Central Bank cut its key interest rate and launched their largest dose of monetary stimulus in 3 1/2 years. The surprise decision was designed to lay the groundwork for a long period of loose monetary policy. Outgoing President Mario Draghi blamed a longer-than-expected slowdown in the eurozone and persistently weak inflation. Similar to the Federal Reserve, the ECB was divided on the outcome as officials questioned how long can the ECB purchase bonds without significantly enlarging the pool of assets it can buy. The aggressive move was also attributed to the trade dispute between the U.S. and China which has weighed on their economy. On Monday, data was released showing the manufacturing activity in Germany dropping to its lowest level since the financial crisis and its service sector declining to its slowest pace in nine months. Hopefully, the stimulus package has arrived just in time to combat some of these issues.

As recession fears mount, it is important to take a look back at history. An inverted yield curve has preceded each of the past six recessions but the lead times are long (around 21 months) and stocks have gained an average of 22% before the economy finally rolled over. According to data from the Dow Jones, following the past 5 yield curve inversions, the S&P 500* averaged a 2.5% return over the next 3 months from the point of inversion. One year later the return was nearly 13.5% and three years later it was over 16%. With regard to recession results, there have been 9 recessions since 1955 including 2008's decline. If you exclude 2008 as being an aberration, the overall return was actually modestly positive.

I sense the market is at least a year away from facing its next recession. Even as the U.S. economy holds strong with positive consumer sentiment, I suspect it will be too much to ask for the Federal Reserve to help fend off trade wars, political uncertainty, and worst of all a slowing global economy.

It is human nature to have recency bias towards 2008 and run when there is fear. Investors that hang on and work on these concerns will be able to withstand the next big drop in the market leading to better overall returns in the long run.

Sincerely,

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