MRP MCALINDEN RESEARCH PARTNERS | JOE MAC'S MARKET VIEWPOINT

Receding Recession Fears

Market Viewpoint: October 31, 2019

Summary: Recession fears still abound, but have certainly eased over the last month as GDP growth has not slowed as much as Wall Street expected. Additionally, the Federal Reserve has now trimmed rates 3 times in a row and restarted a form of "QE-Lite". This has led to the steepening of a previously inverted yield curve, and we believe a re-ignition of inflation is back on deck. While the strong Dollar continues to play a role in dampening manufacturing and corporate earnings, US real rates and the greenback's base effect are likely to diminish in 2020. Therefore, any moderate weakening of the greenback could actually boost profits and exports in the year to come!

Recession? Did someone say recession? Not us! To be sure, the US will experience another recession someday. Many are worried about it hitting soon, a few are hoping for it, and some data are pointing to it. According to Google Trends, search engine queries for "recession" topped out in August, but searches still remain well above the average of the last 3 years. Nonetheless, as argued below, consumer confidence, the buoyant stock market, and a dovish Fed all suggest the economic expansion will continue expanding for at least the next year or two.

Clearly, capital spending and other business investment have slowed. But the US consumer remains the engine of continued expansion, the stock market has been hitting new highs, and the Fed, if anything, is about to get even easier. Still, a cacophony of experts continues to issue Cassandra-like warnings. Bloomberg, for example, recently proclaimed that some indicators are "flashing warning signs with the chances of a US recession now at 27%. Meanwhile, Moody's says risks of a global recession are "awfully high". The New York Fed's latest reading on the probability of an oncoming recession, calculated by the spread between the 10-year treasury rate and 3-month bill rate is near a decade high, just below 35%.

Economic Growth + Manufacturing Slowdown & Retail

Other forecasts, though, are more measured. In Early October, IMF Managing Director Kristalina Georgieva stated that the fund expects "slower growth in nearly 90% of the world. The global economy is now in a synchronized slowdown. This means that growth this year will fall to its lowest rate since the beginning of the decade". Reuters reports she also noted that the cumulative effect of trade conflicts, headlined by the US and China's ongoing battle, could mean a $700 billion reduction in global gross domestic product (GDP) output by 2020, or around 0.8%. The Secretary General of the Organization for Economic Cooperation and Development (OECD), Angel Gurria, parroted the IMF's sentiment this month, noting the trade war has already shaved a whole percentage point from global GDP.

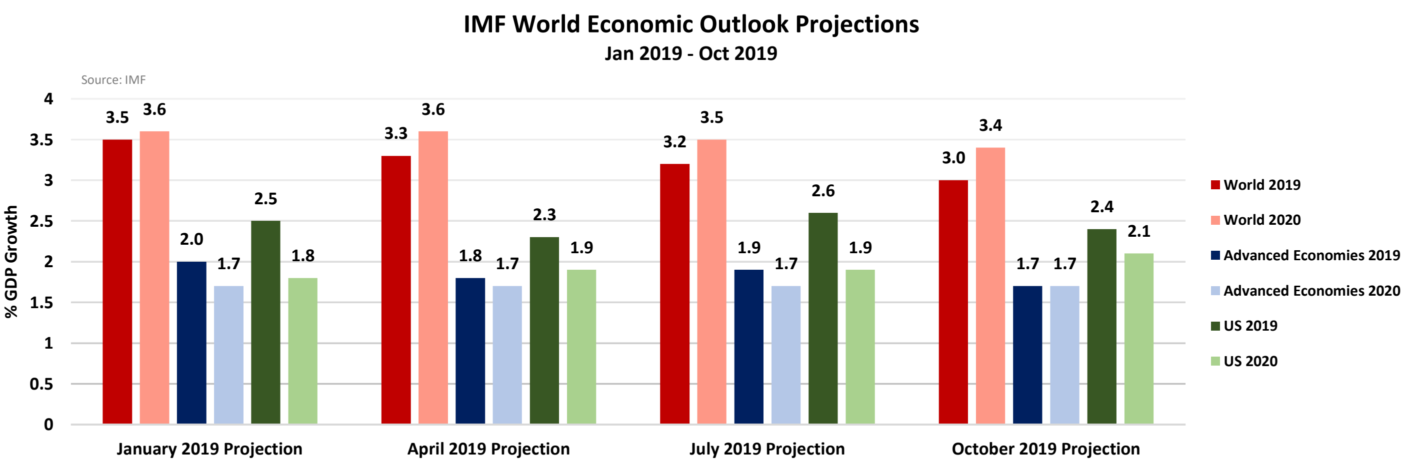
Goldman Sachs, however, has come to a milder conclusion, predicting the trade war would lower US growth by only 0.25% and stating that the trade war is "kicking the tires" of growth but appears unlikely to spark a recession, barring a "large further escalation".

Judging by the latest GDP reading, that slowdown in US GDP growth may already be bottoming out.

Joseph J. McAlinden, CFA, is the founder of McAlinden Research Partners (MRP) and its parent company, Catalpa Capital Advisors. He has 50 years of investment experience. Mr. McAlinden founded Catalpa Capital in March 2007 after leaving Morgan Stanley Investment Management where he had spent 12 years, serving first as chief investment officer and later as chief global strategist. During his 10 year tenure as chief investment officer, he was responsible for directing MSIM's daily investment activities and oversaw more than $400 billion in assets. As chief global strategist, he developed and articulated the firm's investment policy and outlook. Prior to Morgan Stanley, Mr. McAlinden held positions as chief investment officer at Dillon Read and as President & CEO of Argus Research.

The Commerce Dept. clocked Q3 economic activity at an annualized rate of 1.9% in the third quarter, beating most estimates of 1.6% - 1.7%, and down only slightly from the 2% pace of the second quarter.

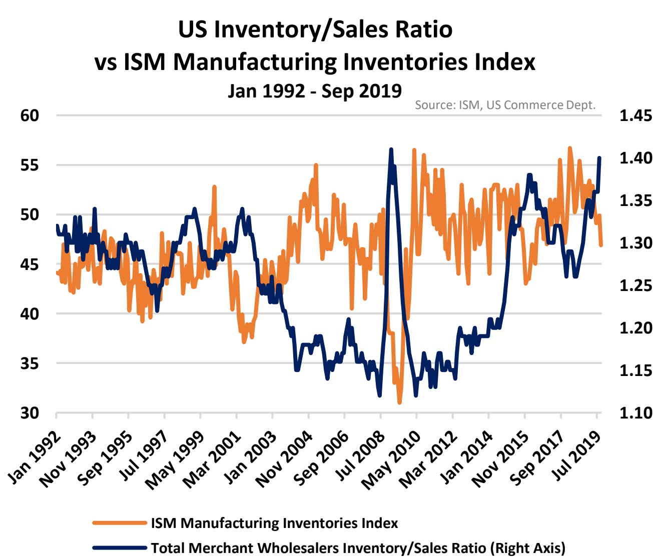
Though the IMF's quarterly World Economic Outlook, did indeed contain a myriad of downward revisions for growth expectations around the world, no major recessions are in the forecast. Advanced economies are now expected to grow only 1.7% in 2019, down from previous estimate of 1.9% back in July. The US fell in line with an equal decline in expected growth for the year, down to 2.4% from 2.6%.



While the bank has emphasized this projected slowdown, their longer-term outlook is more optimistic as world output is expected to jump from 3% in 2019 to 3.4% in 2020. The US's 2020 growth forecast was actually upgraded by the IMF this time around, climbing to 2.1% from July's estimate of just 1.9%.

Much has been made of bombastic recession predictions in the coming year, but investors would be hard-pressed to find supporting data behind most of them. However, one place where the data has become worrying is manufacturing; a sector whacked the hardest by tariffs and slumping developed markets.

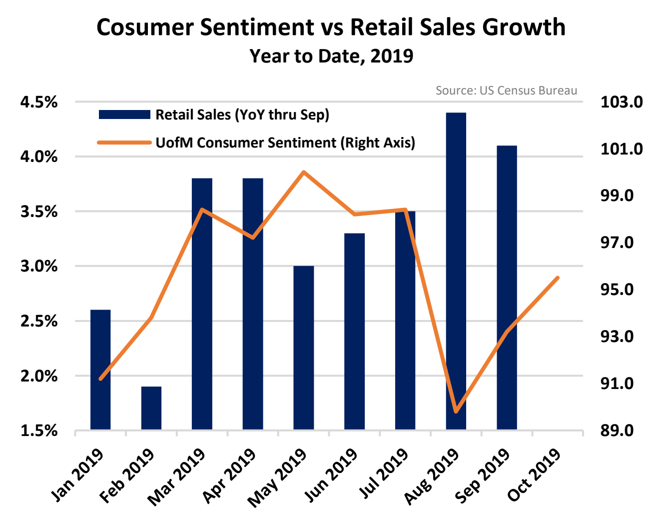
As MRP has highlighted previously, the strength of [the Dollar can explain at least part of the slowdown in US manufacturing], given the increasing exchange rate of the US Dollar versus some of the US's largest trade partners' currencies. Overall industrial production, which includes output of factories, mines and utilities, dropped 0.4% in September and declined 0.1% from a year earlier, the first year-over-year decrease since 2016. While growth has been trending downward since Summer 2018, output was likely pushed into reverse by the nationwide GM autoworkers strike; a rebound is likely in next month's data following the conclusion of the strike.



The ISM's purchasing manufacturing index (PMI) dipped below 50% in August, signaling a contraction in manufacturing activity for the first time since 2009, and then fell even further in September. However, it is worth noting that IHS Markit's measurements not only indicated that US manufacturing is still expanding, but that their PMI data hit a 5-month high in September. While differences in the survey can be chalked up to divergencies in weighting of component questions, the 2019 trend of US manufacturing is still unanimously pointing downward.

On a regional basis, results have been more mixed. The needle may be pointing toward a more optimistic outlook for New York, Virginia and other states along the east coast as the Fed's Empire State and Richmond Manufacturing indexes each rebounded by 2 and 17 points, respectively, from the prior month, beating analyst expectations. However, industrial data from the Midwest has suffered. The Fed's Dallas Manufacturing Index, as well as the Chicago PMI, showed a decline into contraction for both regions.

A final piece of concerning data for manufacturing is the rising inventory to sales ratio, which had eased between 2016 – 2018, signaling strong aggregate demand. Although total inventories are in decline, the ratio continues to rise, signaling that sales are falling at a faster rate than the inventories. Since the two data points can be observed to run inverse to one another, especially strong drawdowns in inventories alongside a rising inventory to sales ratio can sometimes be an indicator of impending recession – as it was in 2001 and 2008. While we have not yet seen an especially strong move in either data point yet, this relationship should be monitored by investors.



Although manufacturing only accounts for about 12% of US economic output these days, per the Bureau of Economic Analysis, it could still threaten to spill over to consumer and services sectors of the economy.

Some analysts fear that we've already reached this point following weaker data for retail sales in September. Consensus estimates expected monthly retail sales to see 0.3% growth, but revenues actually declined 0.3%, setting off a wave of panic across the financial media. Those results could be evidence that US consumer spending has begun to weaken, but it may also be just an outlier in the data due to an earlier than usual Labor Day causing August to soak up earnings from Labor Day discounts. On an annual basis, sales appear to be much more robust, tipping 4.1%, the second strongest month of the year for that data point. Additionally, The University of Michigan's consumer sentiment index contrasts with the retail sales data, jumping to a three-month high of 96 in October's preliminary reading. Bloomberg reports their index of consumer comfort rose to a record high in the second week of October.

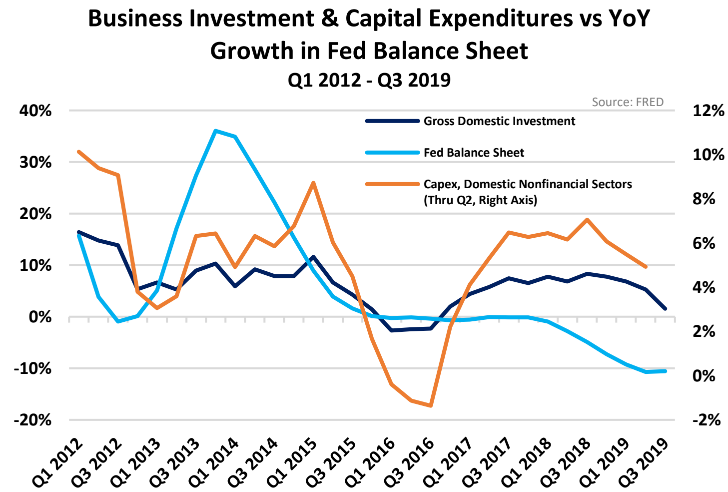
So, while the manufacturing slowdown is worrying, it may be a bit too early to say services are being dragged down with it.

While the US may have has just entered their own manufacturing decline, most of the world crossed that threshold earlier this year. JPMorgan Global Manufacturing PMI came in at 49.7 in September recovering a bit from 49.5 in August, but it was the fifth consecutive month of sub-50 results. The last time the index was in contraction for such a stretch of time was in the six months to November 2012.

IHS's flash eurozone manufacturing PMI fell below analyst expectations to an 83-month low of 45.6 in September, dragged down by tepid readings in Germany, Spain, and Italy. While French industrials have managed to stay above water, following 2 strong quarters, ING notes that France is unlikely to escape from the broader European slowdown in Q3, due to declining capacity utilization and weaker production in August.

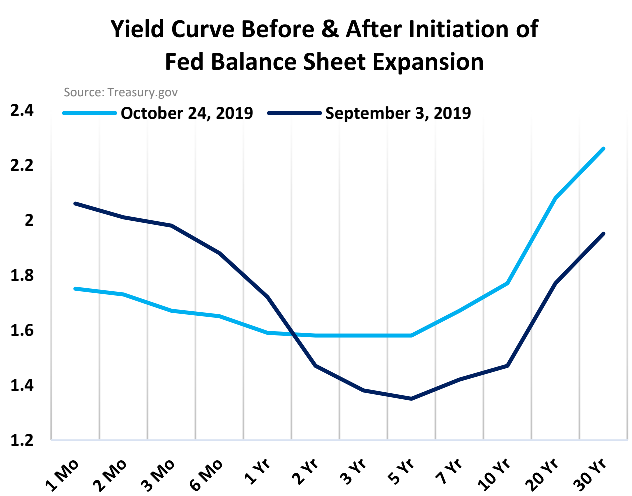
The story is much the same in most of Asia. FX Street reports 5 out of 9 Asia PMIs remain in contraction, a slight improvement from the prior month, with data out of Taiwan improving after 11 months in contraction. China has also been a bright spot in the East as the Chinese factory PMI beat analyst expectations, coming in at 51.4 for September – the highest reading since February 2018 – marking the second consecutive month in positive territory.

Growth figures in both US domestic investment and capex have slipped to multi-year lows, creating serious concern for investors. In the second quarter, growth in domestic business investment declined to just 1.7%, down from almost 8.3% this time last year, which led to real GDP growth above 3% for the first time since 2015. Capex growth has also slowed, down to 4.9% in Q2 from 6.1% in the year ago period. According to Refinitiv, Capex is expected to slow even further to just 3.0% in the third quarter. Reuters reports that estimate drops to 1.1% in the fourth quarter, and year-over-year declines are projected in some quarters of 2020.



Monetary Policy

Along with downplaying recession fears, Goldman also noted the Federal Reserve's recent interest-rate cut has offset damage to growth brought on by tariffs. Indeed, the Fed has cut rates by 25bps in each of their last 3 meetings, but the official statement from the latest meeting of the FOMC this week indicated that trend is not likely to continue. The statement removed September's reference to "the future path of the target range for the federal funds rate" while Fed Chairman Jerome Powell followed up that sentiment in a post-meeting press conference, noting the "mid-cycle" adjustment he has been talking about for the past five months is likely at an end.



One of the major concerns the Fed sought to address with their dovish policy over the last few months was the inversion of the yield curve, the state of short-term Treasuries yielding more than longer-term, often a predictor of oncoming recession. After just about 2 months of the Fed's return to balance sheet expansion, the central bank has already succeeded in pulling short-term yields back down to earth and steepening the longer end of the curve.

While lower interest rates have yet to deliver a turnaround in capex markets, the Fed's new pledge to resume purchases of treasury securities might provide the needed boost.

Powell has denied this is another episode of quantitative easing (QE), which is somewhat of a half-truth. The Fed will indeed provide monetary stimulus, buying about $60 billion of Treasury bills per month into Q2 2020, but the purchases are meant to sure up levels of reserves in the repo market, which suffered from a series of shortages last month. So, the purpose of the stimulus is more of a money market operation, as opposed to a means of spurring economic growth – the traditional purpose of QE. Most likely, Powell has also chosen to downplay the QE narrative so that it doesn't appear he's caving to political pressure from President Trump – a vocal proponent of renewed stimulus.

Analysts at JP Morgan, though, believe the injections will not be enough to soothe the repo market, a source of short-term (usually overnight) lending, that saw rates jump as high as 10% in September when banks' excess reserves ended up in very short supply. The Fed was forced to repeatedly engage in open market operations over the course of more than a week to make sure there was adequate liquidity in the repo market. In a note, cited by Business Insider, the new funding provided by the new round of stimulus directly caters to primary dealers — banks approved to purchase and borrow directly from the Fed — while non-primary dealers are left with little additional liquidity. The non-primary firms "are the most acute source of stress in repo markets" and are set to take on additional burden as new reserves pile up with the firms that need them less.

The Fed has now decided to raise the minimum size of any repo operations to $120 billion, from what had been at least $75 billion. Longer-term repo operations are now scheduled to carry over into November.

CNBC reports that another shortage in reserves caused repo rates to rise again in Mid-October, though not nearly as much as in mid-September. If weekly purchase of $60 billion in treasury bills are not enough to keep money markets under control and well-supplied without ongoing operations, it could be a sign of growing addiction to stimulus. While it may simply take a bit of time to adequately resupply reserves, some are concerned about year end, when banks are more focused on shoring up their liquidity mandates than keeping cash flowing in the overnight markets.

Valuations

Meanwhile, down on Wall Street, the aged bull market continues. Valuations are somewhat lofty, particularly in the face of an earnings growth slowdown.

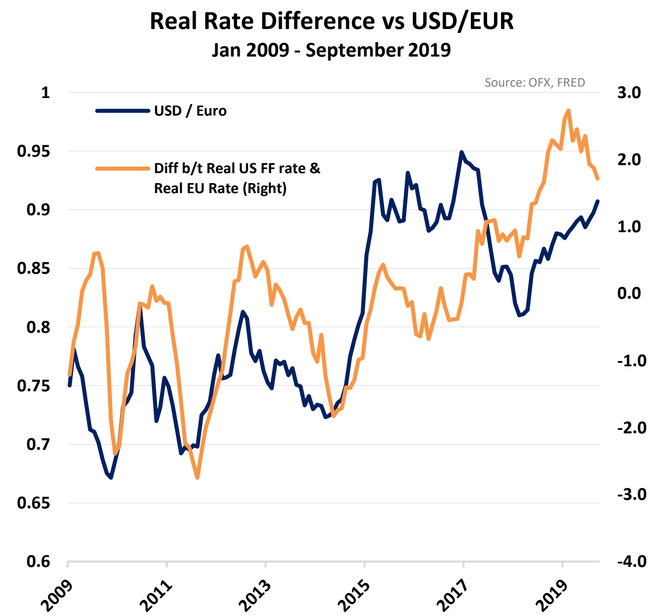
The price to earnings ratio (P/E) of the S&P 500, as of the end of the second quarter, came in around 21.75, 31% higher than the mean P/E of 16.6 over the last century. With half of S&P 500 companies reporting earnings thus far, S&P Indices estimates the P/E to rise even further to 22.21 for the third quarter. S&P 500 operating earnings for 2020 are currently expected to come in around $178.32. Multiplying these earnings by the long-term P/E puts the price of the S&P 500 at 2,966.24 – about 0.7% below the current price level. So, if the market were to revert to its fair value, we'd be likely to see very flat growth over the next year.

WSJ reports that corporate profits are estimated to have shrunk by 4.6% for the third quarter from a year earlier, according to a FactSet consensus of analysts' estimates. Of the 75 companies to report so far, earnings are down 4.8% from a year earlier. That followed contractions of 0.3% and 0.04% in the first and second quarters, respectively.

The currency translation effect, which MRP has been hammering home for over a year now, continues to play a role in this ongoing earnings recession. Due to the stronger US dollar throughout 2019, US companies that did significant business overseas saw earnings growth discounted when other currencies were translated into dollars. The Wall Street Journal reports that at least 16 companies in the S&P 500, including Delta Air Lines Inc., Johnson & Johnson and General Mills Inc., have already blamed a strong currency for denting profits. Considering that less than 20% of S&P 500 firms have reported earnings thus far, many more are expected to see a similar bite taken out of profits earned overseas.

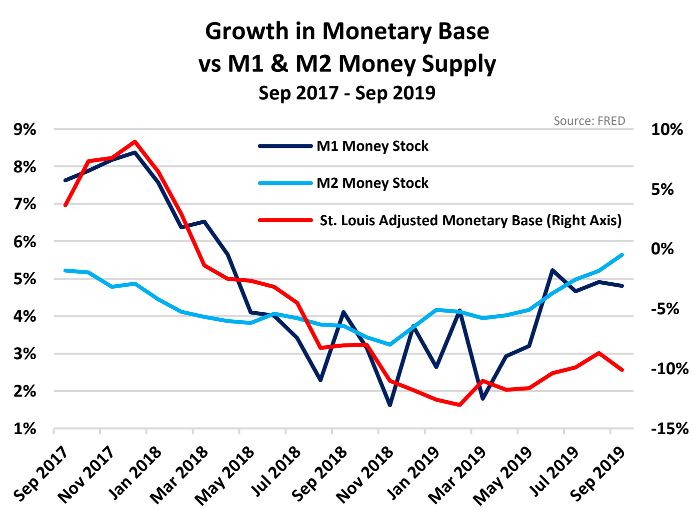
However, because this Dollar strength has persisted for so long, its negative effects on earnings have begun to diminish. In fact, any moderate weakening in the Greenback through 2020 could reverse this trend and begin boosting overseas profits for US companies.

As explained last month, MRP does expect the Dollar to begin weakening in the coming months, given a falling Fed Funds rate and rising inflation which will diminish US "real rates": the difference between the interest rate of a currency and the inflation in that county's economy. However enticing a short-term yield may be, it doesn't buy much if the purchasing power of the currency diminishes by more than the interest earned. Therefore, since the US had some of the highest short-term rates in the world through 2018, accompanied by relatively tame inflation, Real rates were likely a strong pull for investment in USD.



Comparatively high interest rates, though, now give the US much more room to apply accommodative monetary policy, while other economies like the Eurozone and Japan are already in negative territory and cannot decrease their own rates at the same pace as the US.

The power of real rates is very pronounced when comparing the difference in US real rates to real rates for the Eurozone. When this difference tightens, as it has recently, following Fed easing and a jump in inflation, it has historically correlated with a weakening of the Dollar and a stronger Euro. MRP believes this will be the case in the coming months



Lower rates, combined with a declining base effect in energy prices, should also contribute to a weaker Dollar via rising inflation. The size of the US monetary base has been shrinking for many years, but the decline has slowed through 2019 as growth in the M1 and M2 money supplies has been rising progressively through the year. A new round of stimulus is likely to feed through to the money supply, putting upward pressure on price growth.

The Core CPI, which excludes prices of food and energy, reached a multi-year high in August, but the base effect of strong energy prices in the previous year have continually subdued the headline CPI. Right at the end of October 2018, though, the price of crude oil began its descent into its steepest crash of all time. Because of this, as long as energy prices remain stable through the end of the year, we should finally see the headline CPI numbers improve and make a strong move upward through the end of the year and, in turn, pushing down real rates on the US Dollar.

Sustained higher inflation throughout 2020 could also influence a return to rate hikes, in turn, pushing bond prices down and treasury yields higher. As we mentioned earlier, the Fed's "QE Lite" has managed to steepen the yield curve, but an acceleration in economic growth, a pick-up in inflation, and a weaker Dollar, all signals of confidence returning to the economy, would start pushing longer-term rates higher.

While growth in the Core PCE eased back to 1.7% in September, down from a 2019 high of 1.8% in August, we believe the effect of 3 consecutive rate cuts will begin feeding through to inflation, pushing the index higher, toward the Fed's 2% target, through 2020.

Currently, the Fed's most recent Dot Plot (from the September FOMC meeting) points to a median expectation of the Fed Funds rate rising to 2.125% by the end of 2021, which would indicate at least 1 rate hike in the post-election year. While it is reassuring that the Fed does see an end to the ongoing economic turbulence, it is a bit difficult to look that far down the tunnel, considering an extremely significant Presidential election stands between then and now.

Easing trade tensions should also work to re-ignite GDP growth. Earlier in the month, the US and China announced an oncoming "phase one" deal as part of a larger agreement to be made in the future. While no permanent solution is in place yet, China expects to begin ramping up purchases of US agricultural goods with a goal of reaching pre-trade war levels by the time the 2020 election rolls around. More importantly, this agreement essentially puts any escalation on ice for the time being. The Trump administration showed good will toward negotiations by suspending a planned tariff hike on $250 billion in Chinese goods earlier this month. Sources at CNBC report that The U.S. and China made progress toward finalizing some parts of a phase one trade deal last week.

Time Between Market Peak and Initiation of Recession (Source NBER, FRED)	
December 6, 1952 - July 1953	6 Months
August 6, 1956 - August 1957	11 Months
August 3, 1959 - April 1960	7 Months
November 29, 1968 - December 1969	11 Months
January 11, 1973 - November 1973	10 Months
October 5, 1979 - January 1980	3 Months
November 28, 1980 - July 1981	7 Months
June 4, 1990 - July 1990	1 Month
March 24, 2000 - March 2001	11 Months
October 9, 2007 - December 2007	2 Months
Average	**6.9 Months**

While the direction of trade negotiations has been nearly impossible to predict, it seems this is the closest the US and China have been to progress in some time.

With the stock market hitting all time highs almost daily, it's worth taking a final look back at what that means for the imminence of a recession. Across the last 10 recessions, going back to 1953, the average time between a peak in the S&P 500 and the beginning of a recession is just about 7 months. While the range of that intermediate period is pretty wide, covering anywhere from 11 months to only 1 month, the median also comes in at 7.

While investors should also consider a degradation of data in other parts of the economy, a drought of new highs in the market is clearly something that should be considered if and when it occurs and drags on for several months.

In 2020 we expect to see a reacceleration of earnings growth, largely offset by some P/E contraction – particularly if longer-term rates continue to climb. So, while we don't see any major corrections in the immediate future, we also don't expect another leg up for the S&P 500. The broad indexes should trade moderately higher, with increasing volatility until after the Presidential election.

Joe Mac