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# QUARTERLY ECONOMIC REVIEW AND OUTLOOK
## THIRD QUARTER 2019

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### Summary and Major Conclusions:

*Market obsession over an inverted yield curve is greatly exaggerated. The closely watched spread in market yield between ten-year and two-year Treasury notes is no longer negative. More importantly, the yield curve from five years to thirty years is in a steep upward slope. Finally, an inverted yield curve is first and foremost a symptom of monetary tightness, which is currently far from the case. The bottom line is that the yield curve is distorted due to unprecedented monetary policies along with negative investor psychology and is not signaling a recession.*

- The US economy expanded at an estimated 2% annual rate in the third quarter, roughly comparable to GDP growth in the previous quarter and led once again by strength in the consumer and services sectors. Manufacturing and capital formation continue to weaken.

- The dominant external force affecting the world economy in the quarter was the ongoing trade war between China and the US, which has escalated in recent months. Protectionist policies have resulted in a contraction in world trade and an outright recession in manufacturing worldwide.

- Heightened uncertainty caused by trade policy has produced a plunge in business confidence, constraining business investment in the US, GDP growth in Europe, and consumer spending in China. The trade war has subtracted an estimated 1% from world GDP over the past year.

- The US economy has been engaged in what can best be described as a tug-of-war over the past year. Favorable financial conditions have been offset by powerful economic pressures emanating from the trade war between China and the US.

- The result has been a bifurcated domestic economy, whereby strength in consumer spending and services has been offset by declines in manufacturing and export trade.

- There appears to be a growing consensus among economists that a world recession is likely within the next 12 months. Many economists have downgraded their forecasts from continued sluggish growth to an outright recession, reflected in a collapse in investor confidence.

- A close examination of the traditional leading indicators of recession strongly suggest that an economic downturn in the next 12 months is unlikely. Inflationary pressures are minimal and the Federal Reserve is in the midst of a rate-cutting cycle.

- Credit availability typically tightens a year or more prior to recessions. Currently, the supply of credit is abundant, and credit is available to virtually all borrowers on very favorable terms.

- The quality of debt on balance sheets of both lenders and borrowers always deteriorates in the years leading up to recession. Delinquencies, defaults, and credit losses have been stable in recent years at historically depressed levels, with no evidence of deterioration.

- There are no signs of imbalances or excesses in spending: Residential construction remains depressed, while inventory-building has not been excessive. Business investment spending remains weak because of uncertainty regarding trade policy.

- Market obsession with an inverted yield curve is misguided. The yield spread between two-year and ten-year notes has shifted from negative to positive. More importantly, the yield curve from five years to 30 years is in a steep upward slope.

- It is highly unlikely that the current slump in manufacturing will contaminate the healthy sectors of the economy. There is also a low probability that weakness outside the US will trigger a recession in the domestic economy. There has never been a US recession caused by economic weakness in the rest of the world.

- My forecast assumes that a trade agreement between China and the US is reached prior to yearend. A rollback of tariffs would have an immediately favorable impact on business confidence in the US and consumer confidence in China.

- China's economy continues to weaken on a sequential basis, and is expanding at its slowest pace in decades. Policymakers will continue to provide additional stimulus until there is a visible rebound in GDP growth. A sustained rebound in Chinese domestic demand is needed to boost exports from Europe and Asia.

- The Federal Reserve is likely to lower interest rates to 1.75% before yearend, down from 2% currently, and hold rates steady through 2020. A resumed tightening cycle is likely to begin in 2021. The Fed's ultra-accommodative policy will provide a modest boost to the economy.

- The current economic slowdown that began roughly one year ago should end within the next three to six months, assuming a de-escalation of trade tensions. US real GDP could slow further in the fourth quarter, prior to a moderate rebound in the first half of next year and more vigorous growth later next year.

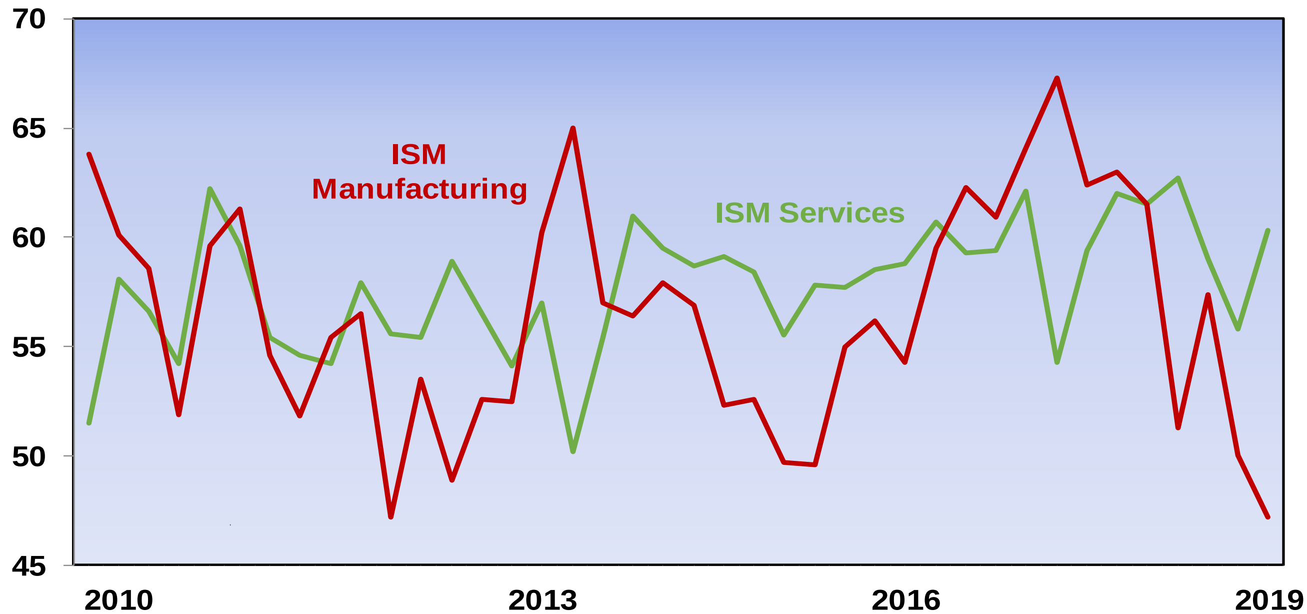
- Full year GDP could accelerate to 2.75% in 2020, up from 2.2% this year. Economic sectors exhibiting the fastest growth in 2020 include personal consumption (+2.5%), business investment (+5%), and residential construction (+8%). In my judgment, the probability of recession is less than 25% over the next year.

- My forecast assumes a solid rebound in corporate earnings in 2020. Following zero growth this year, company profits could increase by 10% next year on revenue growth of 5% and a moderate widening in profit margins.

- Currently at 1.6%, core consumer inflation should move gradually higher over the next two years, ending next year at 2.2% and 2021 at 2.5%. The unemployment rate, currently at 3.7%, should drift moderately lower in coming months, ending 2020 at 3.5%.

- The attack on Saudi Arabia's oil infrastructure raises geopolitical risks exponentially. Retaliation by the Saudis — culminating in a war with Iran — could result in mutual destruction, triggering a spike in world oil prices to well above $100 per barrel. The odds of a world recession would increase significantly under this disaster scenario.

Chart 1: Large Divergence Between US Manufacturing and Services Sectors
Purchasing Manager Surveys, Manufacturing and Services
Source: Institute For Supply Management (ISM)




## ECONOMIC REVIEW

The US economy expanded at an estimated 2% annual rate in the third quarter, roughly comparable to GDP growth in the previous quarter and led once again by continued strength in the consumer and services sectors. As in Q2, a slower pace of inventory investment subtracted from GDP. Consequently, real final demand (real final sales) expanded at a 2.5% annual rate, slightly less than the 3% pace in Q2, but still very impressive considering the underlying headwinds to growth.

**Tariff War**: The dominant external force affecting the world economy in the quarter was the ongoing trade war between China and the US, which has escalated in recent months. Protectionist policies have resulted in a contraction in world trade, an outright recession in manufacturing worldwide, and depressed business confidence. Heightened uncertainty caused by trade policy has discouraged business investment in the US, GDP growth in Europe and Japan, and consumer spending in China. The trade war has subtracted an estimated 1% from world GDP over the past year.

**Bifurcated Economy**: The US economy has been engaged in what can best be described as a tug-of-war over the past year. In effect, favorable financial conditions have been offset by economic and financial pressures emanating from US trade policy. The result has been a bifurcated economy, whereby strength in consumer spending and services has been offset by weakness in export trade and manufacturing (see chart 1).

Chart 2: Prices of US Imported Goods Falling at a 2% Annual Rate
Price Index for US Imports, Annual % Rate
Source: Bureau of Labor Statistics

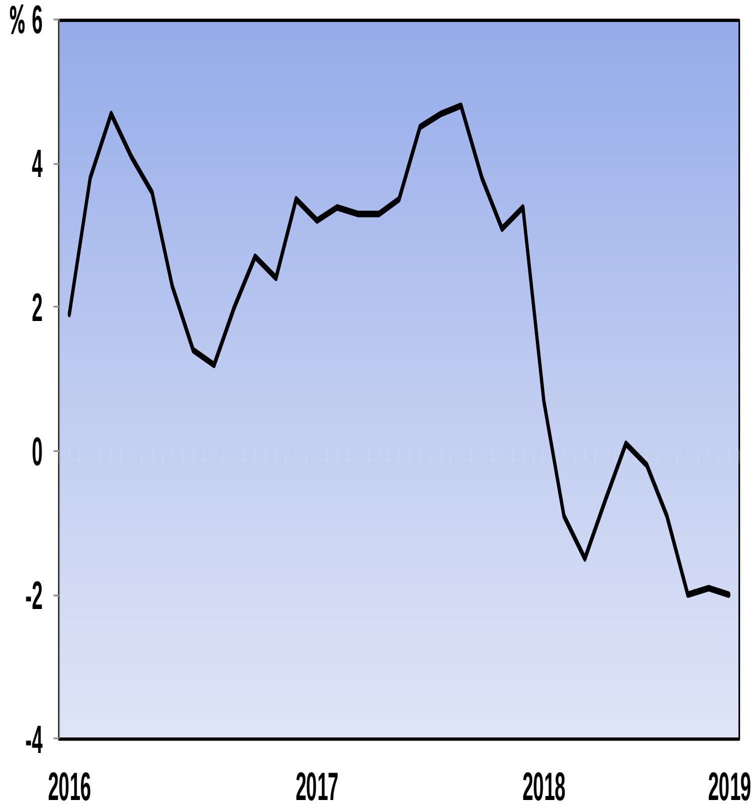
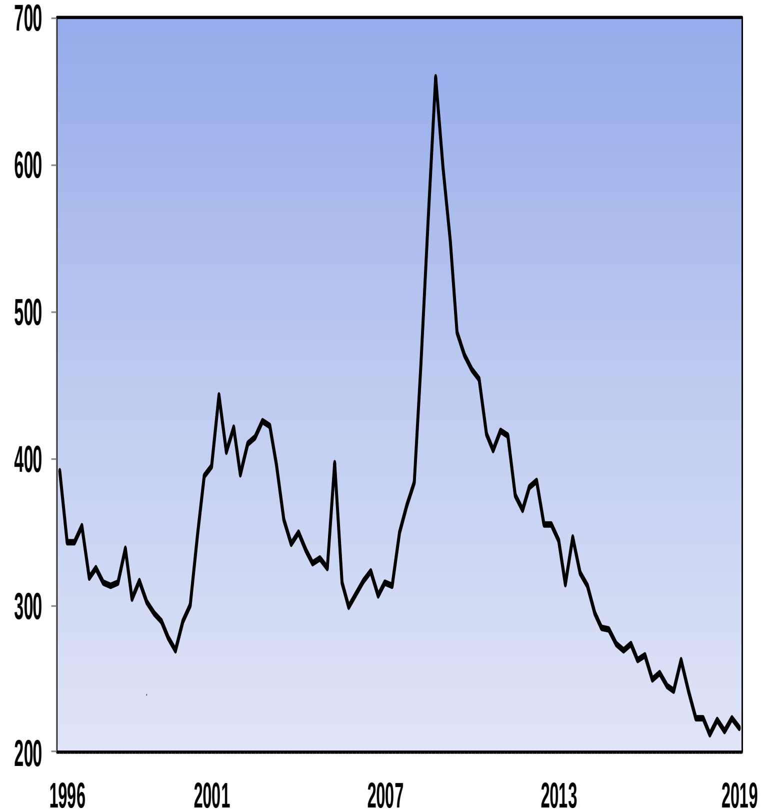



Chart 3: Weekly Jobless Claims Stable at a 50-Year Low
Initial Claims for Unemployment Insurance, Thousands
Source: Department of Labor




**Inflation and Employment**: The news on both inflation and employment have been positive. Core consumer inflation is rising at a 1.6% annual rate, down from a recent peak of 2.1%, while producer prices are increasing by only 1%. Prices of imported goods are ***falling*** at a 2% annual rate — the result of deflationary conditions in many foreign economies — along with a super-strong US dollar (see chart 2).

- **Labor Markets**: Although hiring has slowed somewhat in recent months, business demand for labor remains strong. Nonfarm payrolls rose by an estimated 155,000 in the third quarter, down from an average 182,000 over the past year and 192,000 over the past two years. Initial claims for unemployment insurance are at a 50-year low. Monthly data on both job openings and hiring remain near all-time highs (see chart 3).

**Corporate Earnings**: Following a very strong 2018, corporate earnings have been on a plateau in most recent quarters. The third quarter appears to be a repeat of Q1 and Q2, with revenue growth of 3%, a moderate erosion in profit margins, and earnings per share (EPS) growth of only 1%. The wide disparity in strength between domestic and foreign earnings continued in the quarter. Based upon an analysis by FactSet, domestic earnings rose by an estimated 5% during the first half of the year, while foreign-based earnings *declined* by 8%.

Chart 4: Plunge in Inflationary Expectations During the Past Year
Market-Implied (%) Expectations for Inflation
Treasury-Inflation-Protected-Securities, Ten-Year Maturity
Source: US Treasury


**Global Economy**: Economic activity outside the US has exhibited even greater weakness, as the trade war has had a more profound impact on foreign economies. Recessionary conditions have spread to Europe, Asia, and Latin America, with numerous countries on the brink of recession, including Germany, Italy, Japan, Korea, Brazil, Mexico, and the UK. *The common denominator among these economies is a heavy reliance on exports and world trade*. The global economy will continue to weaken and deflationary pressures will continue to build until there is a rollback in tariffs.

## ECONOMIC OUTLOOK

There appears to be a growing consensus that a world recession is likely within the next 12 months, with many economists downgrading their forecasts from continued sluggish growth to outright recession. There has also been a proliferation of media reports describing why a recession is inevitable within the next year. And up until very recently, financial markets have been screaming recession.

## UPDATING THE RECESSION CHECK-LIST

A close examination of the traditional leading indicators of recession lead to the conclusion that an economic downturn in the next 12 months is highly unlikely.

1. **Inflationary Pressures**: All recessions since 1960 have been preceded by a rising trend in inflation. The current rate of core consumer inflation (+1.6%) has actually ***declined*** from its interim peak of 2.1% one year ago. Leading indicators of inflation are tame. Inflationary expectations are under good control (see chart 4).

Chart 5: Yield Curve Upward Sloping From Five to Thirty Years
Term Structure of Interest Rates
US Treasury Market, September 24, 2019
Source: Federal Reserve

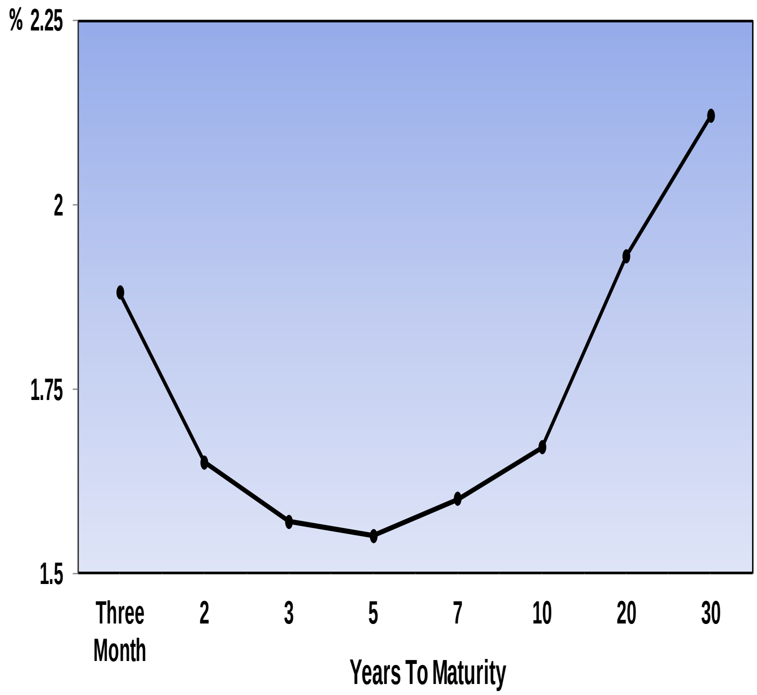
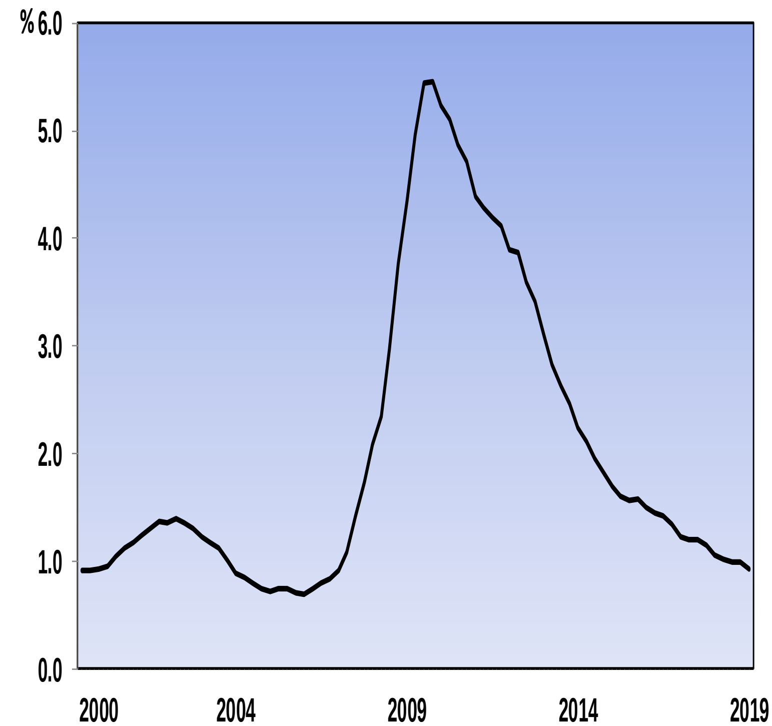



Chart 6: Bank Credit Losses at a Ten-Year Low
Nonperforming Loans as a Percent of Total Bank Loans
Source: FDIC




2. **Financial Conditions**: Credit availability typically shrinks a year or more prior to recessions. Currently, _the supply of credit is in abundance and credit is available on favorable terms to virtually all borrowers_. Banks have almost unprecedented capacity to make loans and have recently eased lending standards.

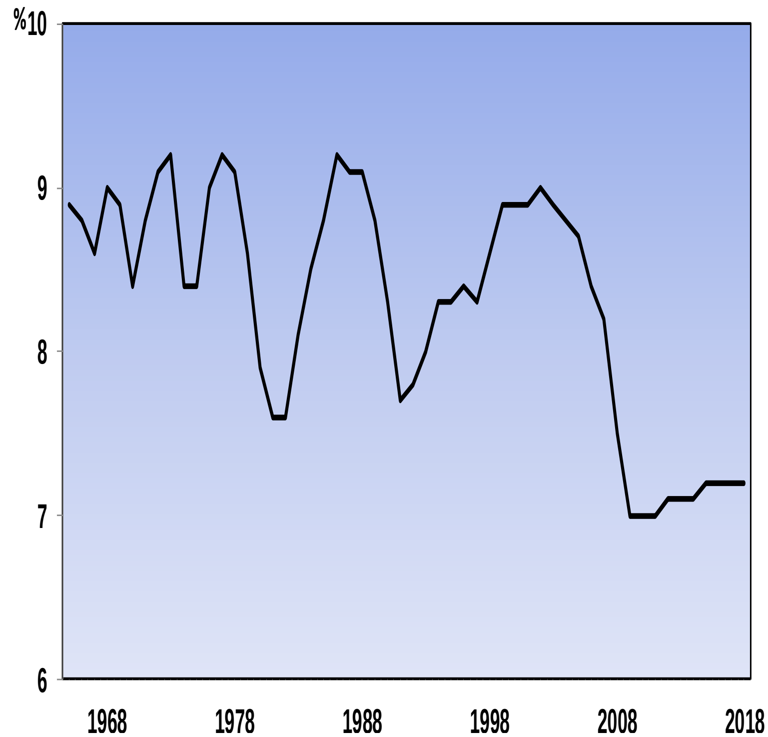
3. **Monetary Conditions**: In an environment of very low inflation, the Federal Reserve is in the process of ***cutting*** short-term interest rates. All previous recessions of the past sixty years have been preceded by a sustained ***tightening*** in monetary policy. The Fed is unlikely to shift from easing to tightening until after the 2020 election.

4. **The Treasury Yield Curve**: Market obsession with an inverted yield curve has been exaggerated. The closely watched spread in yield between ten-year and two-year Treasury notes is no longer negative. More importantly, ***the yield curve from five years to thirty years is in a steep upward slope***. The bottom line is that the yield curve is distorted because of unusual monetary policies and investor psychology and is not signaling a recession (see chart 5).

5. **Credit Problems**: The quality of debt on balance sheets of both lenders and borrowers always deteriorates in the years leading up to recession. The current cycle has been unique in that delinquencies, defaults, and credit losses have been stable, with no evidence of deterioration (see chart 6).

Chart 7: Unprecedented Weakness in Household Credit Growth
Annualized % Growth US Household Debt Outstanding
Source: Federal Reserve


Chart 8: Consumer Purchases of Durable Goods Depressed Since 2008
US Consumer Spending on Durable Goods as a Percent of US GDP
Source: Bureau of Economic Analysis

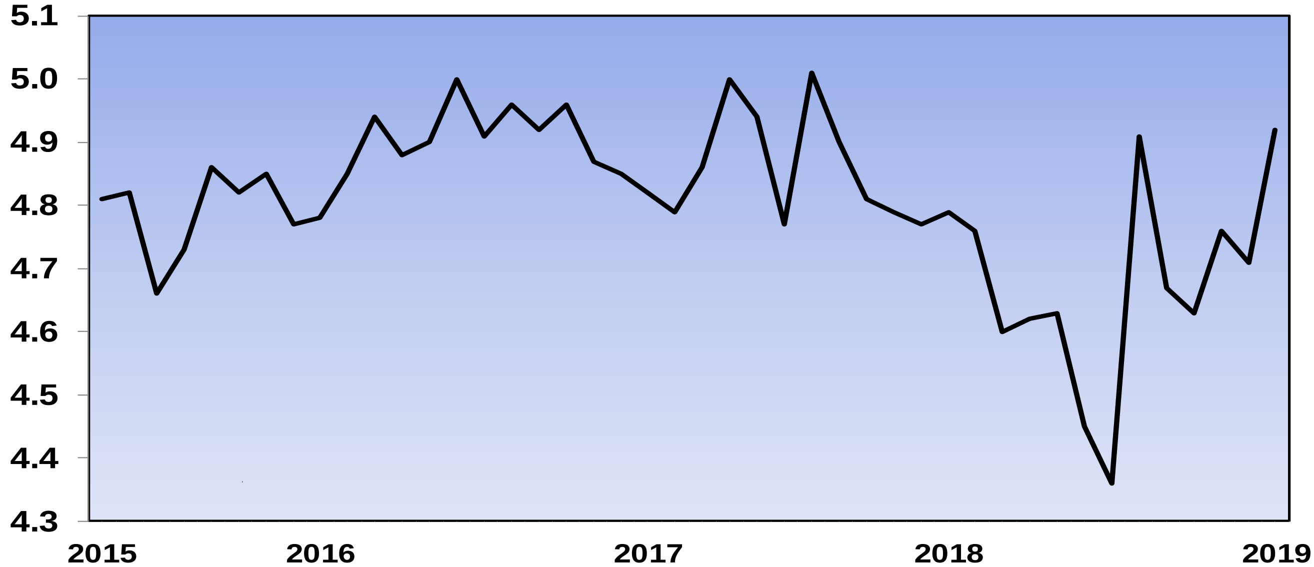



6. **Financial Market Excesses**: Recessions have always been preceded by a boom in credit demand. *In the current cycle, an unprecedented deleveraging cycle has acted as a massive constraint on credit creation*. Annual growth in household debt (+3%), residential mortgage debt (+2.5%), and bank credit (+3%) is at the slowest pace since 1950. Corporate debt is expanding at a somewhat more rapid pace of 6.5%, but still below the double-digit pace that preceded all previous recessions (see chart 7).

7. E**xcesses in Spending and Investment**: Unrestrained spending on housing construction, household durable goods, business inventories, and plant and equipment has always sowed the seeds for the next recession. There are no signs of imbalances or excesses in spending: Residential construction and purchases of consumer durables remain depressed, while inventories are under good control. Business investment spending remains depressed because of profound uncertainty regarding trade policy (see chart 8).

In conclusion, none of the usual leading indicators of recession are flashing red, suggesting that the next recession is not imminent. *In principle, recessions result from imbalances and excesses within the real economy and financial system; a rigorous analysis of each reveals an economy and financial sector in healthy balance*. In my judgment, the probability of recession over the next year is less than 25%, but should drift higher beginning one year from now.

Chart 9: Rebound in Single-Family Housing Market Appears Sustainable
Annualized Sales of Existing Single-Family Homes, Millions
Source: National Association of Realtors




## ECONOMIC REBOUND EXPECTED IN 2020

The most likely scenario is that the current economic slowdown will persist for the remainder of this year, but give way to accelerating economic growth over the course of the next year. <u>There is a confluence of five powerful expansionary forces that should coalesce to spark an acceleration of economic growth in 2020</u>:

1. **A negotiated truce on trade between China and the US**. As discussed below, I believe that there is a meaningful probability of a trade agreement prior to yearend. A rollback in tariffs would immediately boost business confidence in the US and consumer confidence in China. <u>*Within the US, business capital investment, housing, employment, and company earnings would be the prime beneficiaries of a negotiated trade deal*</u>. Within China, consumer spending and exports would benefit most.

2. **The lagged effects of the Federal Reserve's rate-cutting cycle.** In principle, changes in monetary policy impact the economy with a lag time of six to nine months. The Fed's rate-cutting cycle that began in July should have a moderate effect on economic growth beginning in the first half of next year.

3. **A sustained rebound in housing construction.** The housing market is the most sensitive economic sector to changes in credit conditions. The steep decline in mortgage rates has already sparked a recovery in housing sales and new construction, and momentum is likely to build with a further time lag (see chart 9).

4. **The end of the current global inventory cycle**. The worldwide recession in manufacturing is a result of two factors: (1) Spreading trade protectionism and shrinking world trade; and (2) A negative inventory cycle, as producers attempt to bring excess inventories in line with sales. Factory data support the conclusion that the inventory destocking phase is nearing an end.

5. **Increased monetary and fiscal stimulus in China**. The Chinese economy continues to weaken on a sequential basis, and is expanding at the slowest pace in nearly three decades. Despite the desperate need for policy stimulus, China's leaders have been constrained by already high corporate debt levels and imbalances within the real estate sector. *However, with the economy nearing a tipping point, it seems reasonable to assume that policymakers will be compelled to implement more aggressive stimulus measures in coming months*.

***The key point is that a convergence of these five powerful forces is expected to occur during the early months of next year, culminating in a self-reinforcing process that will trigger a recovery in US and world economic growth as the year unfolds.***

## CRITICAL QUESTIONS

There are five questions most pertinent to the likelihood of a US recession:

**[1] Will weakness in the manufacturing sector infect the healthy sectors of the US economy?**

Because of the unique composition of US GDP, it is highly unlikely that the current slump in manufacturing will contaminate the healthy sectors of the economy. At only 12% of GDP, manufacturing is dwarfed by personal consumption expenditures, which comprise nearly 70% of GDP. Spending on services (including consumer services) comprises 80% of GDP.

Aggregate spending by the household and service sectors is expected to grow at a minimum 2.5% annual rate over the next year. Consequently, a manufacturing-led recession is statistically unlikely and would only occur in the event of a total collapse of the factory sector, which seems unlikely.

**[2] Will profound weakness in the global economy trigger a recession in the domestic economy?**

There is a low probability that weakness outside the US will trigger a recession in the domestic economy. The US is a relatively closed economy, with only 13% of GDP derived from export trade. Moreover, the US business cycle leads those in the rest of the world. There has never been a US recession caused by economic weakness in the rest of the world.

**[3] Will the Federal Reserve's rate-cutting cycle have a positive impact on the economy?**

The simple answer is yes — further easing of monetary policy should help the US economy. That said, it is important to qualify the positive effect on the domestic economy, for the following reasons:

- **Time Lags**: Changes in monetary policy affect the economy with a time lag of six to nine months. Therefore, rate cuts between July and October are unlikely to be reflected in faster economic growth until the first half of next year.

- **Credit Conditions**: Monetary policy supports economic activity by enhancing liquidity conditions and by improving the availability of credit. However, *the availability of credit is already abundant, such that an easing in monetary policy would likely have minimal effect*.

- **Trade War**: Rather than credit conditions, the real headwind to healthy economic growth is the escalating trade war between China and the US. *Because a transmission mechanism between monetary policy and trade does not exist, monetary easing would be of minimal benefit under current circumstances*.

There are three channels through which monetary easing could help the economy: (1) An increased sense of confidence and reassurance that policymakers are prepared to act to support the economy; (2) Restoration of a normal upward-sloping yield curve; and (3) The potential for lower US interest rates to promote a decline in the US dollar, which would be an expansionary force for the world economy.

**[4] Will China and the US agree to an interim trade deal before yearend?**

The consensus forecast is that reconciliation between China and the US is not imminent. This perception might prove to be correct but an alternative scenario is also possible, as economic and political pressures in both countries continue to build. *Both economies are feeling the effects of the tariff war*: Chinese exports are declining, retail sales and capital investment in manufacturing are weak, and the unemployment rate is rising. *China's exports to the US are declining at a 16% annual rate*.

- **Growing Political Pressures**: At the same time, while the direct hit to the US economy has been less severe, political pressures on the Trump administration are beginning to intensify. In particular, *Trump is growing increasingly concerned regarding the decline in his approval rating along with the steady erosion in support among his Republican base*. There are strong political reasons suggesting that he could feel compelled to agree to a truce prior to yearend.

The bottom line is that the economic interests of both China and the US would be best served by a de-escalation in tariffs that culminates in an interim truce. Growing domestic political pressure on President Trump increases the odds of an agreement prior to yearend. The critical question pertains to timing: Will an inevitable deal be consummated in time to save the world economy from recession?

**[5] Will Saudi Arabia retaliate against Iran, culminating in an all-out war?**

The attack on Saudi Arabia's oil infrastructure destroyed about half of the kingdom's production capacity. While restoration to full capacity should occur faster than initially expected — with world supply and demand returning to balance within weeks — longer-term geopolitical risks have increased exponentially. Retaliation by Saudi Arabia — culminating in an all-out war with Iran — could result in mutual destruction, triggering a spike in world oil prices to well above $100 per barrel. The odds of a world recession would increase significantly under this disaster scenario.

## ECONOMIC FORECAST

The slowdown that began roughly one year ago should end within the next three to six months, assuming a de-escalation in trade tensions. My forecast assumes GDP growth of 2.5% in the first half of next year, followed by an acceleration in growth to near 3% during the second half. In my judgment, the probability of recession is less than 25% through the end of 2020. Economic sectors exhibiting the fastest growth in 2020 include personal consumption (+2.5%), business investment (+5%), and residential construction (+8%).

My forecast assumes a solid rebound in corporate earnings in 2020. Following zero growth this year, company profits could increase by 10% next year, on revenue growth of 5% and a moderate widening in profit margins. Inflation should move gradually higher over the next two years, ending next year at 2.2% and ending 2021 at 2.5%, consistent with its tendency to lag the overall economy. The current unemployment rate of 3.7% should drift moderately lower in coming months, ending 2020 at 3.5%.

World economic growth will continue to weaken until the trade dispute is resolved. Non-US economies are far more dependent upon world trade and have been impacted more severely by the worldwide slowdown in manufacturing. *As is always the case, a recovery in the world economy will follow that in the US*. *The world economy is also dependent upon a rebound in Chinese domestic demand*, which should take hold early next year as the government delivers more monetary and fiscal stimulus to its economy. Following growth of nearly 3% in 2018, world GDP should increase at only a 2.5% pace for all of this year, followed by an acceleration to 3% in 2020.

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