Economic Outlook

Economy

POSITIVES

- Oil prices lower
- Commercial loan standards easing

NEGATIVES

- Tariffs hurt profits
- Tax cut earnings boost starting to fade
- Key industries struggling (autos, housing)

Like the planet, typically the economy goes through different seasons. These follow a logical progression with spring followed by summer and so forth. One key difference is certain unusual and impactful events like Pearl Harbor or the Federal Reserve's (Fed) Quantitative Easing* program can move the needle and change the economic season.

So what are some of the relevant seasons today?

One such area is early fall. Early fall typically produces solid economic growth. However, a couple of key industries like autos and housing begin to lag.

After early fall is late fall. Here things start to get frosty as winter is coming, but not yet arrived. We usually see recession tripwires being hit, like an inverted yield curve (where short term rates are higher than long term rates) or rising jobless claims after a multi-year low.

Finally, let us consider winter. Typically this is defined as a broad contraction or a recession. This allows the economy to reset for future growth.

We find strong evidence we are presently in early fall. The economy is still growing, but some industries are showing troubling trends. One example is New Homes Sales. Since their peak in late 2017, they are down over 20% (source Bloomberg). Auto Sales, another key component, are also down.

Today's environment does have a few positives. Oil prices are lower and act as a small tax break. Additionally, bank lending standards for commercial and industrial applicants have been easing.

Still, for this cycle, it is reasonable to believe peak economic growth has passed.

Stocks

POSITIVES

- Economic growth still in place
- Less bullishness
- Divided government

NEGATIVES

- Slowing earnings growth
- FANG mania cresting
- Stocks still expensive
- Growth stocks starting to lag

Growth stocks have led the market the last 11 years, longer than any other period in history. The market has been upside down, with shares in companies with no earnings rising explosively while those with earnings doing little to nothing. We have also experienced a mania in the FANG stocks (Facebook, Amazon, Netflix and Google). We feel all of these are unsustainable and may change in the coming year.

Common sense investing is out of favor and we believe it is on the verge of a massive rebound. However, valuation levels do not yet reflect the lows usually seen in a bear market. For example, the Shiller Price Earnings Ratio*** is double what is usually seen at bottoms. As the economic season shifts into late fall, our research indicates large cap stocks should continue to outperform smaller stocks while Value stocks should outperform Growth. In addition, we believe Utility and Non-Cyclical stocks may hold up better while Technology and Cyclical stocks might be more volatile.

Overall, the market faces significant headwinds – slower earnings growth, fewer buybacks and Fed Quantitative Tightening (QT)****. We believe taking a conservative approach to equities makes sense until the next opportunity arises.

Conclusion for 2019 Economic Outlook

Bonds

POSITIVES

- Favorable risk/return profile for short term U.S. Treasury bonds
- Municipal bond yields attractive
- U.S. Treasury yields appealing versus other countries

NEGATIVES

- Corporate bonds are relatively unattractive today
- Low quality bonds at default risk

Corporate bond yields are less attractive than those of U.S. Treasury bonds. Corporate debt is near all-time highs. We would take a smaller allocation to this sector until the risk-return profile improves.

Recently, U.S. Treasury yields were the highest in the developed world. This may draw international investors.

Municipal bonds are attractive for taxable investors. While the yields available are not as high as they were a few years ago, the tax benefits are still substantial.

We believe short term bonds should continue to do better than longer term bonds as long as the economy remains in the early fall season. However, we believe the economy will gradually shift to late fall or even winter, which our research indicates is a better time for longer term Treasury bonds.

FOR BUSINESS EXECUTIVES

- Plan for volatile input costs
- Economy should grow but start to cool
- Recession risk rising
- Infrastructure spending likely from Washington
- Energy costs remain in check
- Tariffs will take a toll on profits
- Steady consumer spending despite high debt
- Weakening housing market, associated industries impacted

FOR INVESTORS

Stocks

- Major headwinds lead to higher volatility
- Shift from growth to value
- Maintain exposure to large cap stocks
- Favor more defensive sectors in economic late fall
- Avoid most expensive and tech mania stocks

Bonds

- Inflation not a major concern
- Bonds should recover from a tough 2018
- Corporate/High Yield bonds historically expensive
- Municipal bonds attractive
- Longer term high quality bonds offer opportunities when economy slows

**Quantitative Easing is a course of action undertaken by the Federal Reserve to increase the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.*

***Yield Curve is a line that plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.*

****Shiller Price/Earnings is a valuation measure applied to the U.S. S&P 500 equity market. *G4 nations comprise of Brazil, Germany, Indian and Japan.*

*****Quantitative Tightening is a contractionary monetary policy applied by a central bank to decrease amount of liquidity within the economy.*

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2019 Economic Outlook

A Long-Range Economic Look at the Year 2019