MARKET INSIGHTS

Notes on the Week Ahead

November 4, 2019

A Sudden Change in Seasons: Investing in a Slower-Growing Economy

Halloween in Massachusetts was warm and blustery and the trick-or-treaters dodged rain showers as they gathered in their annual haul. But later that night, the wind strengthened and changed direction. The next morning, it blasted and roared through the trees and, by the afternoon, the oaks were laid bare, having deposited a thick carpet of dead leaves on the grass and roads below. In one day, we had transitioned from fall to winter.

Last week, the U.S. economy also saw a sudden and definitive transition and settled into a path of slower growth.

The 3rd Quarter GDP report was largely in line with expectations, with real output rising 1.9% annualized for the quarter and 2.0% year-over-year. This has essentially returned economic growth to the path it was on in 2016, before the passage of the 2017 tax cut.

Data due out this week should point to a similar pace in the fourth quarter. In particular, Monday's Light Vehicle Sales numbers and Tuesday's surveys of Non-Manufacturing activity should show steady momentum entering the fourth quarter, with the possibility of a slight uptick in year-over-year growth to 2.2%, reflecting a weak quarter a year ago. However, comparisons get tougher in early 2020 and year-over-year real GDP growth should retreat to just under 2.0% and stay there for the rest of the year.

Last Friday's jobs report, while showing a stronger-than-expected 128,000 rise in payroll jobs in October, also saw the unemployment rate tick up to 3.6%. This is down just 0.2% year-over-year and suggests that, while the labor market is in very good shape, further significant declines in the unemployment rate are unlikely from this point.

This week's JOLTs report will be important in filling in the rest of the picture on employment. Job openings have fallen from a peak of 7.6 million last November to 7.1 million in August. These openings may have fallen below 7 million in September as businesses adjusted to both the current difficulty of finding qualified workers and the future prospect of slower revenue growth. This may foretell slower job growth in the months ahead.

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Another aspect of the slower-growing economy is lower productivity growth. On Wednesday, the labor department will report on Productivity and Costs. We believe output per hour in the non-farm business sector rose by 0.7% annualized in the third quarter and by 1.6% year-over-year. However, a broader measure, which includes both the government sector and changes in the average workweek, namely, real GDP per worker, fell by 0.7% in the third quarter and is up just 0.8% year-over-year. This number may edge back up to 1.0% over the next few quarters. However, with real business fixed investment down for two consecutive quarters, there is little reason to expect a late-cycle surge in productivity.

A lack of productivity growth does not appear to be impeding wage gains. The wages of production and non-supervisory workers have been up roughly 3.5% year-over-year for four consecutive months and, in a low inflation environment, workers are finally stringing together a few quarters of significant real gains in compensation. This, in turn, has a number of important impacts in a slow-growing economy.

First, it is continuing to support consumer spending. While job growth has slowed, gains in real wages should contribute to a roughly 2% gain in real disposable income in the year ahead, allowing consumer spending to rise at a similar pace. This is an important bulwark against any threat of recession.

Second, rising wages will challenge corporate profitability. We estimate that a combination of rising compensation expense and slow productivity growth should have boosted unit labor costs by 2.5% year-over-year in the third quarter with further substantial gains likely in the year ahead.

So far, in this earnings season, with 77% of S&P500 market cap reporting, operating EPS is still down 3.6% year-over-year, and, although we expect this number to improve a little over the next few weeks, it is now unlikely to turn positive. Another 90 S&P500 companies are set to report this week which should give us a better handle on this question. More broadly, while the fourth quarter should see a year-over-year gain in earnings given an easy comparison with 2018, earnings growth in 2020 is likely to be low single digits at best, as companies are squeezed by slower-growing revenues and faster-rising labor costs.

Labor costs will also factor into the Fed's thinking.

While last Wednesday's FOMC statement seemed a little ambiguous on the issue of further rate moves, Chairman Powell's comments in his post-meeting press conference left little doubt that the Fed now believes it has wrapped up its "mid-cycle adjustment". In particular, the text of the FOMC statement dropped a commitment to "…act as appropriate to sustain the expansion", an omission that many observers had predicted and thought would signal no further change in interest rates at the FOMC's next meeting in December.

However, in his press conference, Chairman Powell went further to say that the current stance of monetary policy "was likely to remain appropriate as long as incoming information about the economy remains broadly consistent with our outlook of moderate economic growth, a strong labor market, and inflation near our symmetric 2 percent objective". This, combined with other remarks he made at his press conference, seems to imply that the Fed would be quite happy to make no further moves in interest rates either this year or next.

One factor that could obviously shake them from this course would be a material decline in inflation. However, with labor costs putting upward pressure on inflation, this seems unlikely.

In summary, we appear to have settled into a path that is low and steady with respect to economic growth, inflation, earnings growth, and interest rates.

As we transition from fall to winter, I'm getting ready to train for another Boston marathon with the Dana Farber Marathon Challenge Team. As I do so, and think of running through ice and snow in the months ahead, I'm reminded of what our coach said to us last year: "There is no such thing as bad running weather. There is just weather for which you are badly prepared".

As the economy transitions to a path of slower growth, investors have a similar need to be prepared by tempering their expectations of the return on traditional U.S. assets and having the discipline to look for better returns through overweighting undervalued sectors and maintaining appropriate global diversification.

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