Notes on the Week Ahead

April 1, 2019

Water stop

In two weeks' time I will be running my third and, (I've promised my wife), final marathon, as I have finagled my way into the Gimpy Geezers' division of Dana-Farber's 500-strong Marathon Challenge team. It is truly an honor to run with such an inspiring group of people in such a worthy cause.

My training in recent weeks has involved long runs from various spots in the Boston area, almost always involving the four not-so-gentle hills of Newton. Each week, as I have labored up the last of these, the rather legendary "Heartbreak Hill", I have been comforted by the fact that close to the top, some of our wonderful volunteers have set up a water stop. I have found it to be an ideal spot for the contemplation of philosophical and physiological issues. In the valleys, you keep moving. However, after a steep ascent, it is often a good time to review where you are and where you go from here.

After a downhill cascade in the fourth quarter, global risk assets have staged a steep assent in the first quarter of 2019 and, this being the case, as we move into the second quarter, it seems like a good time for investors to think about the outlook.

One way to do this would be to consider five key questions:

(1) Is the U.S. economy just slowing down or is it stalling out?

(2) What's the Fed's next move?

(3) Are we in a profit's recession?

(4) Will the global economy revive in 2019? and

(5) What are the major risks?

Dr. David P. Kelly, CFA
Chief Global Strategist

J.P.Morgan Asset Management

On the first question, the answer seems to be that the economy is slowing but not stalling. Data due out this week, including Retail Sales and Durable Goods Orders for February should confirm a sharp slowdown in both consumer and investment spending in the first quarter. The swing factors on 1st quarter GDP growth, as usual, will be inventories and international trade. However, to the extent that these areas are strong in the first quarter, they should be weak in the second. Overall, we believe that real GDP growth will average under 2% in the first half of the year, cutting the year-over-year growth rate to 2.1% by the second quarter of 2019 relative to 3.0% year-over-year in the fourth quarter of 2019.

The reasons for the slowdown are easy to see. The boost to consumer spending from the 2019 Tax and Jobs Act is permanent. However, the boost to the growth rate of that spending could only ever have lasted a few quarters and has now apparently petered out. In addition, the slowdowns in global trade and manufacturing, reflecting weakness in China and trade conflict uncertainty, are likely having a negative impact on investment spending.

However, without some further shock, this is unlikely to precipitate a U.S. recession. The most cyclical sectors of the U.S. economy are home-building, auto sales, capital spending and inventories. These four sectors, which comprise just 21% of GDP, account for 66% of the volatility in real GDP growth over the past 50 years and all of them are either relatively subdued today or much less volatile than in previous decades.

In addition, contrary to some recent commentary, the Federal Reserve has very cautious in both the pace of its tightening and in the level of real interest rates it has produced. It is hard to imagine that any home purchase or investment spending project is being cancelled because interest rates are just too high.

For this reason, we expect, barring some shock, that real GDP growth will simply step down from 3% year-over-year to 2% but then sustain roughly this pace for the rest of 2019 and 2020.

On the second question, “what does the Fed do next?”, the most logical answer is nothing. The Fed has made it clear that they will be patient in making further moves on interest rates and there should be a relatively high bar to any further action. The economy is in a very good place overall, with both stable inflation and very low unemployment. Moreover, as will likely be further confirmed in Friday’s Jobs report, labor force growth is too slow to allow for sustained economic growth above 2% and monetary policy can’t fix America’s labor supply issues. If the Fed were to raise rates from here, they would run the risk of precipitating another equity market selloff such as we saw in the fourth quarter. But if they were to cut them, they could easily ignite recession fears. So the safest play for the Federal Reserve is to stick with the current range of 2.25% to 2.50% on the federal funds rate throughout 2019 and into 2020.

On the third question, “are we in a profit’s recession?”, the answer appears to be, not quite. Year-over-year growth in S&P500 operating earnings per share slowed very sharply from 32% year-over-year in the third quarter of 2018 to just 3% in the fourth. However, the fourth-quarter drop was exacerbated by some one-time accounting issues. Consequently, analysts are looking for low-to-mid-single-digit gains in year-over-year earnings for the first three quarters of 2019 followed by a pop in the fourth quarter. This forecast, while much less exciting than last year’s performance, makes U.S. equities look attractive relative to very low-yielding corporate and government bonds.

On the fourth question, "will the global economy revive in 2019?", manufacturing PMI data released overnight are generally encouraging, with improvements across many emerging market nations. There is little doubt that on-going trade tensions have slowed the pace of global manufacturing. However, manufacturing tends to have many mini-cycles, lasting just a few months, where production declines to clear inventories and then ramps up again. In addition, the global services sector appears to be doing much better. 2019 will likely be a weak year or the global economy. However, particularly if a trade deal is completed between the U.S. and China, manufacturing should do better as the year progresses and a global recession seems unlikely. This is important to ponder given that international stocks ended the first quarter at a significant discount both to their own historical valuations and U.S. valuations.

Finally, what are the risks?

The most obvious short-term danger is an escalation of trade conflict which would likely hurt both the global economy and global markets. In addition, a growing stockpile of low-quality corporate debt could exacerbate any economic downturn, although it is unlikely to trigger one. In the long run, the economy is also likely threatened by a growing budget deficit which will increasingly be financed by international investors.

For investors, these and other risks need to be weighed against more modest expected returns from major asset classes going forward. In the first three months of the year, the S&P500 produced a 13.6% total return, international stocks returned roughly 10% and bond yields fell across the developed world.

As in marathon running, if you go out too fast, you'll probably pay for it later and prospective returns for the rest of this year and beyond look more modest than they did three months ago.

Having said this, given low inflation across the developed world, Central Bank policy will likely continue to be easy for years to come. This should result in low short-term interest rates, making the case for a continued commitment to long-term assets.

As I reach the top of Heartbreak Hill in two weeks, I intend to keep running forward, however slowly. For investors, while the going will likely be tougher for the rest of the year than in the first three months, this is still a time to run with long-term assets rather than walk with cash.

0903c02a820bc602

J.P.Morgan
Asset Management