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Economic and Market Outlook

June 30, 2019

The Uncertainties That Crowd

Section I. Can Slowing Economic Growth Avoid Recession?

In the first quarter of 2019, both economic and corporate earnings growth declined sharply.

Unfortunately, weakness has continued on both a broader and deeper level in the quarter just ended.

Most economists believe that Gross Domestic Product (GDP) is expected to show 1.0%-to-1.5% growth for the quarter versus the first quarter's 3.1% (second estimate). The Atlanta GDP Now indicator sits at 2% as of June 18th.

Similarly, S&P 500 Index Earnings' growth for the second quarter, just ended, is expected to be the same or lower (according to Bloomberg data) than the 1.5% of the first quarter 2019.

While the first quarter Earnings did beat late-estimates of a decline, they were a significant reduction from the fourth quarter 2018, which showed a gain of 16.8%. Additionally, Earnings in the first quarter 2019 compared very poorly to all quarters of 2018, including the same quarter a year ago of 25%.

Moreover, in Chart-1a (United States Corporate Profits), note that total U.S. Corporate Profits, which include the 500 companies of the S&P 500, fell 3.5% compared to an expected gain of 2.0%.

Chart-1b (Corporate Profits After Tax) also shows a near-zero growth trend. Corporate Profits are expected to have turned negative in the quarter just ended.

There are many reasons for the slowdown in both GDP and Corporate Earnings. Among the chief reasons, according to Corporate CEOs, is the Trade War.

Simply put, no business management can plan in an environment where the cost structure is uncertain, as well as the supply-chain for their goods.

As data presented in Section III will show, both Manufacturing and the larger Service Sector of GDP are slowing, with Manufacturing hit the hardest to date.

Normally, in decisions facing investors, Political Risk carries a small "p", not a capital "P". Said differently, Political Risk has seldom been such a dominant risk for investors, as it is today.

Before presenting the evidence of a slowing economy, we present three actions that could be taken to at least delay the expected Recession, or mitigate its severity, by reversing the growing lack of confidence among leaders of business.

Section II. What Needs to Happen to Avoid Recession

Part-A. The Fed

The Federal Reserve (Fed) is charged with a dual mandate to control Inflation and foster conditions to maximize sustainable employment.

Unfortunately, history shows too many examples when the Fed's policies have ended-up contributing to the development of a Recession by being late in stopping rate increases whose rise erodes demand. On the other hand, the Fed has occasionally failed to control inflation from developing, as it did between 1965 and 1982, by not raising Fed Fund rates soon enough.

The Inflation between 1965 and 1982 led the Fed to have to induce Recession to break-the-back of a runaway Inflation that saw both the 10-year Treasuries yield and the 30-year yield exceed 15% in September of 1981, at the peak. The Fed had finally induced the turn by raising the Fed Funds rate to 19.10% in June of 1981.

History tells us the Fed has had more than its share of problems. In the short-run (1-2 years), problems develop out of the long lag between policy changes and their effect on the economy. The lag can be longer than a year.

In our judgment, the Fed has made another error, and it is serious. The Interest Rate (Fed Funds) is too high! The effects of the increases will be felt for some time ahead, regardless of any action to lower the rate.

Simply put, the actions by the Fed to raise the Fed Funds rate to the current level of 2.5%, in order to curb potential Inflation, will prove to have been an important error.

It is our belief that the Fed has yet to understand that the rate of Inflation in today's "Digital Economy" is likely to stay low for a considerable period ahead.

In our September 2018 report entitled, **"Evidence Matters,"** we argued that the Generally Accepted Accounting Principles (GAAP) are greatly flawed because they continue to be stuck in the wrong century. Why? Because our economy has radically changed from a Manufacturing to a Service-based economy.

We argued that the change could be seen in the dramatic growth of the use of Intangible assets over Tangible assets to create growth and value.

Intangible assets used in the production of goods and services have grown from 13% of total assets utilized in production back in 1975 to 87% today.

Intangible assets—like Research and Development (R&D), patents, trademarks, royalty income, big data, analytic capabilities, customer satisfaction, stock-based compensation, franchises, leases, licenses, trade secrets, collaboration agreements, brand identification, workforce training costs, software and software development, and many more examples—if even recognized by GAAP at all, are being expensed versus depreciated each year.

Instead of treating such expenses as assets to be depreciated like the costs of Tangible assets (i.e., buildings, equipment, etc.), they are charged as they occur. The end result of mismeasurement of intangible assets has been to understate earnings, return on assets and capital, book value, etc.

This error by the Accounting Board has gradually crippled security analysis of businesses that have Intangible assets.

In the same manner, the mismeasurement of Intangible assets affects their importance to economic measurements, such as Growth, size of GDP, Productivity, and—importantly—the indexes of Inflation (PPI, CPI, PCE).

The mismeasurements affect both what constitutes GDP and what is the real value (i.e., value adjusted for the estimated price level).

The inability to determine what should be measured and how it should be measured continues to be argued by those charged with giving the best information to conduct both Monetary and Fiscal Policy.

The Boskin Commission, formerly called the Advisory Commission on Inflation, presented a White Paper on July 17, 2015, in which the title asked the question, “Are We Overstating Inflation, Again?”

Their research concludes that all price indexes overstate the Inflation rate.

In the cases of the PPI (Producer Price Index—see Chart-2), the CPI (Consumer Price Index—see Chart-3a), and the PCE (Personal Consumption Expenditures Excluding Food and Energy [Chain-Type Price Index]—see Chart-3b), the Boskin Commission estimated the overstatement has been an astonishing 0.8%-to-1.6% per year.

The Commission places the problem in the following context:

- To measure price changes, we need to compare apples with apples. But, advances in technology (especially IT and medical care) lead to the introduction of new goods and services, as well as massive improvements in

> the quality of goods and services [our emphasis]. Neither of these is likely to be accurately captured in current official price measures.
>
> - It is much easier to measure the impact of innovation on the quality of *hardware* than on the quality of *software* and new digital content (like Google, Facebook, Twitter, YouTube, etc.).
> - Medical care inflation has already collapsed, but perhaps not enough to reflect quality improvements.
> - Because of the low weight of IT goods and services and the high weight of medical care in overall consumption, the potential measurement of medical care costs matters far more for price bias.
> - Since computer hardware and software have a higher weight in investment than in consumption, the impact of their price mismeasurement on GDP and productivity growth is larger than their impact on consumer price inflation.

> When it comes to technology, the primary issue is adjusting for the change of quality and the introduction of new products. … If the quality of a good or service improves but the reported price stays the same, its true cost has fallen. For example, the graphics card in an iPhone 5s (*last* year's model! [2014]) has the *capacity* to do nearly 1,000 times the number of floating point operations per second (FLOPS) as a 1975 Cray-1 supercomputer, which (adjusting for inflation measured by the CPE basket) cost something like 100,000 times as much. That's an almost incomprehensible price *decline*.

If such a mismeasurement of Inflation is even remotely accurate, then today's CPI, PPI, and PCE (favored by the Fed) may well be considerably lower than reported. Consider how much higher the Fed Funds rate is, currently set at 2.5%, than the CPI's 1.79% (current rate) and the PCE's 1.6% (current rate), let alone how out-of-line it is if the true Indexes should be even lower.

It is clear that the difficulty as to why the Fed cannot get Inflation up to their target of 2.0% from the current PCE of 1.6% lies in the mismeasurement of Inflation. The problem is far more serious if the Commission's studies place the actual PCE, not at 1.6%, but say 0.5%-to-1.0% lower.

Such lower levels also help account for the lower-than-expected Productivity rate. The real rate of Productivity is likely higher, due to the lower Inflation found by the Commission.

Our conclusion is that Fed Policy is in error and that the Fed Funds Rate is too high; thus, Monetary Policy is too restrictive and, thus, an increasingly negative drag on the economy.

Therefore, the first of three actions that should be taken to extend the economic expansion cycle is to lower the Fed Funds Rate immediately.

Such a lowering will boost economic growth, perhaps by enough to postpone Recession, or at least to mitigate its severity when it occurs.

Since the Fed's meeting on June 18 and 19, in which Fed Policy took on an accommodative tone, the financial markets are expecting a lowering of Fed Fund rates in July, and possibly another one or two reductions before year end.

However, there may be unintended consequences for the Global economy (primarily the EU) due to the uncertainty connected to their faltering growth. The problem arises because, when the Fed lowers the Fed Funds rate, the decline in the rate will trigger a decline in the value of the dollar.

To understand how short-run help to the U.S. economy might exacerbate the Global market's economies, what follows is a brief review of the economic situation faced by the European Central Bankers in trying to cope with a recovery that has seen their nominal GDP grow just 11% over the last seven years.

The true problem for much of the Global economy, and for the EU in particular, is that it has never fully recovered from the wounds of the Great Recession (December 2007 to June 2009). Part of the Global recovery difficulty was—unlike the Fed's actions in the U.S.—first, a slow response; and, second, an errant adoption of austerity measures that made their Recessions worse. Only when they adopted lowering rates and the use of Quantitative Easing (QE) did recovery begin.

Unfortunately, despite the Central Bank's having lowered rates to near zero, and then some into negative territory, Global growth slowed again in 2018, and the Recession threat is now very high (i.e., some are near, or have recently entered, economic contraction).

Most of the EU is at the doorstep of Recession. Having used nearly every monetary tool to avoid Recession, there is now a growing fear of Deflation.

Writing for the publication, *International Investing*, releasing an article entitled, "What Negative Interest Rates Mean for Investors" (June 13, 2019), Justin Kuepper begins by saying, "Most people are familiar with the risks of *inflation*, where the value of a currency plummets and everything becomes more expensive."

Because of the significance of his analysis, we continue to quote extensively from Kuepper's article (with our emphasis throughout):

> *Deflation* is a much harder concept for people to understand—that is, when the appreciation of a currency becomes a problem. In layman's terms, deflation causes people and businesses to hoard cash rather than spending and investing it, which reduces demand for products and services and puts downward pressure

> on prices. Lower prices can lead to reduced profits and less economic growth, which in turn leads consumers to hoard even more cash.
>
> In this article, we'll take a look at one unusual way to beat deflation that's being increasingly employed by central banks around the world since the *2008 economic crisis*.
>
> **Negative Interest Rates**
>
> Interest rates are the single most important monetary policy tool used by central banks to influence inflation throughout an economy.
>
> A central bank attempts to combat deflation by reducing interest rates in order to encourage consumers and businesses to spend money and raise prices. In some cases, these conventional *monetary policies* don't work and the central bank will lower interest rates into negative territory. The move is designed to incentivize banks to lend money and businesses to spend money rather than pay a fee in order to keep it safe at a bank.

Kuepper continues:

> The impact on economy and markets of negative interest rates is difficult to quantify … but there's some evidence it might be working. …
>
> When negative interest rates are in place, investors tend to search for better returns in foreign markets, which sends a currency's valuation lower. Lower currency valuations help boost exports by making them more attractively priced around the world.

Investopedia tells us:

> Since it is not too difficult to pursue growth through currency depreciation—whether overt or covert—it should come as no surprise that if nation A devalues its currency, nation B will soon follow suit, followed by nation C, and so on. This is the essence of competitive devaluation.
>
> This phenomenon is also known as "beggar thy neighbor," which far from being the Shakespearean drama that it sounds like, actually refers to the fact that a nation which follows a policy of competitive devaluation is vigorously pursuing its own self interests to the exclusion of everything else.

There are at least two problems with the "beggar-thy-neighbor" policy:

First—as a country adopts negative interest rates because they want to devalue their currencies, other governments will eventually do the same, and in the end all are likely to experience lowered consumption and a higher savings rate.

Second—low- and negative-interest rates are supposed to reduce savings and stimulate spending, but the opposite seems to be happening. Instead of spending, consumers and investors have sought to increase their savings in the form of investments with better returns.

Among the better returns, of course, are U.S. Treasuries, Corporate Bonds, and income-oriented stocks.

In effect, the uncertainty about Global economic growth may fuel haven-demand for both safety and income.

Such foreign money flows to U.S. securities would mean that negative-interest rates no longer encourage domestic spending. Such a flight of funds would put upward pressure on the price of the U.S. dollar and on the price of U.S. Treasuries (i.e., lowering Treasuries' interest rate).

Moreover, if foreign Central Banks become unable to utilize negative-interest rates to increase demand, they might well turn to a Currency War of Devaluation ("beggar-thy-neighbor").

Perhaps none of this will happen, but the conditions for such a problem (i.e., a Currency War on top of a Trade War) are there.

There has never been a developing Recession at the time of negative-interest rates. But if negative-interest rates fail to turn around demand, fund flows would commence and a Currency War would simultaneously develop.

In almost every nation, the use of some form of Monetary policy to aid recovery from the Great Recession (2007-09) has become the only game in town.

It may well be that the use of negative-interest rates and the danger described above of the on-set of a Currency War could be the catalyst jolting politicians globally into finally making use of powerful Fiscal tools to ward off a Recession that, once started, could be prolonged.

We note, however, that Chart-3c (Foreign Bond Investment in U.S.), so far, shows little evidence of a rush by foreign buyers, which would add downward pressure on bond yields, regardless of Fed policy.

Part-B. Infrastructure Spending

We offer Infrastructure Spending as the second of three actions that could be taken to delay or mitigate a Recession (i.e., use of a Fiscal tool, rather than Monetary tools, such as interest rate changes and Quantitative Easing measures).

If Congress and the Trump Administration can agree to passing an Infrastructure Spending Bill, such action would initially be felt as a boost to Business, the Consumer, and Investor Confidence.

The economic impact would develop relatively slowly, but planning would be an immediate stimulus. One strong plus would be on the hiring of skilled labor, but the greatest help would be to those less skilled.

Chart-4 (Job Openings, Hires, and Quits) shows we are at or near full employment for the highly skilled and skilled workers.

The Labor Bureau reports, "At the end of the most recent recession in June 2009, there were 1.1 million more hires throughout the month than there were job openings on the last business day of the month. In April 2019, there were 1.5 million fewer hires than job openings."

Most economists agree that such a gap between openings and people hired suggests there are not enough skilled workers to fill the open jobs. The large number of currently still-open jobs says it all. The Unemployment rate is likely to turn up very soon without job openings for the less skilled, or without an increase in the willingness of job offerors to train the less skilled.

Opening more jobs among the less skilled would postpone the upward turn in the Unemployment rate. While the Unemployment rate is at a 50-year historic low rate of 3.6%, we must not forget that Recessions are often preceded by a low rate that turns up by 0.3% from any level, or by a negative crossing of the current rate above its 12-Month Moving Average; for when it crosses, a Recession has struck the economy within 3.45 months, on average—see Chart-5 (U.S. Unemployment Momentum) and Table-I (Recession Start).

Infrastructure spending is a win-win for the economy, but Congress remains dysfunctional. While both parties understand the need, the question of how to pay for it is the block.

Some possibilities both sides could consider are the following:

One—Give tax breaks to investors who invest in ETFs created for the purpose of funding Infrastructure projects; make dividend returns tax-free, like muni-bonds.

Two—Set-up partnerships between Business and the Federal Government to create and fund Infrastructure Banks.

Three—Encourage greater use of States' Build America Bonds; have the Fed guarantee interest payments; have the Fed and States split guarantee of principal repayment; and make bonds tax-free, like muni-bonds.

While we view Infrastructure Spending as a win to aid or prolong economic growth, we view our suggested actions as being too-little-too-late to help the short-term, but they could be part of the growth of GDP long-term, once projects commence.

Part-C. Put a Small "p" Back in Political Risk

As history has proven, in a Trade War there are no winners.

Christoph Rieger said, in a *MarketWatch* article (June 10, 2019) entitled, "All Market Forecasts Depend on Politics":

> The recent political developments may well point the way for coming years. … The U.S.-China battle appears to have moved beyond a fight over trade

> balances, revealing deeper conflict over technology policy and broader economic and political concerns.

According to economists Jeff Kearns and Reade Pickert, writing for Bloomberg (June 6, 2019), in an article entitled, "Exports, Imports Both Plummet as U.S. Trade Deficit Narrows": "Trump can claim some victory on pledges to reduce the trade gap, though it's come at a cost to American companies that have lost export business or are paying higher prices."

Of the three issues that can help the economy the most in the short-run, reducing the worry over the Trade War's disruption to planning (i.e., by solving the Trade War) carries the highest importance to possibly reversing decelerating economic growth.

Our **Part A**, above, on The Fed, required a close review of the complex problems it faces. In the end, our analysis suggests lower rates will help extend economic growth.

Here in **Part C** concerning the Trade War, there is always the possibility that any positive outcome with China may be countered on another front of the Trade War with our many trading partners.

So we wait, as all Consumers, Businesses, and Investors must do. The ebb and flow cannot clearly be measured. We assume a China deal of some substance will come into being, but whether or not it importantly lowers the anxiety enough to compensate for the many areas of uncertainty created by this Administration remains but a guess.

We will watch surveys of Business leaders, and we will wait to see any effects on the economy. We will take actions in response as we see them to be appropriate.

Section III. The Gathering Clouds of Recession

We are in the late stage of the longest economic expansion in history. The expansion can be extended for a time, but not without actions, such as outlined in Section II.

We begin this Section of our Economic Review with Chart-6 (U.S. GDP Output Gap), a Chart first presented in our December 2018 report.

Output Gap is defined by *Investopedia*:

> Just as GDP can rise or fall, the output gap can go in two directions: positive and negative. Neither is ideal. A *positive output gap* occurs when actual output is more than full-capacity output. This happens when demand is very high and, to meet that demand, factories and workers operate far above their most efficient capacity. A *negative output gap* occurs when actual output is less than what an

> economy could produce at full capacity. A negative gap means that there is spare capacity, or slack in the economy due to weak demand.
>
> An output gap suggests that an economy is running at an inefficient rate—either overworking or underworking its resources.

Chart-6 shows that the Output Gap is currently positive, which means the economy is expanding, but under stress. The lack of skilled workers is just one cause.

Chart-7 (U.S. Labor Market Capacity Utilization) looks a lot like Chart-6. Capacity Utilization has not been this high since in approximately 2000, and before that, in 1974-75. Both time periods preceded Recessions.

Simply put, the U.S. economy is running above capacity, which greatly increases the risk of Recession.

In Chart-8 (Average Weekly Hours + Overtime Hours of Production), we see a sharp decline in hours worked. This decline is an indication that our historically low Unemployment rate is about to turn up. There is a possibility that layoffs may follow.

In Chart-9 (U.S. Manufacturing Growth Slows to Decade Low), we see a Chart from *IHS Markit* presenting the Manufacturing PMI (Purchasing Managers Index). The May level is 50.6, which was a sharp drop from April 2019. As the Chart states, at 50.6, the Index is at a decade low and just above contraction.

Chart-10 (Core Capital-Goods Orders) shows that the earlier run-up in Capital spending (Jan. 2017 to September 2017) is over. Spending has been in a downtrend from a growth rate of 13% annualized to the current level of just over 1% annualized. This shows a rather negative reaction to the 21% reduction of Corporate taxes on December 22, 2017. In fact, core Capital-Goods orders had already begun falling before the cut was enacted, and the fall has continued through April of this year (latest data).

Chart-11 (ISM Manufacturing Index and Markit Manufacturing PMI) presents the two Indexes as charted together. The ISM Index is the Index of Supply Management, while the PMI is the Index of Purchasing Managers. They are both still expanding (i.e., over 50 = expanding; less than 50 = contracting). However, note that not only are they falling, but the slopes of their declines spell trouble.

Chart-12 (ISM Non-Manufacturing Index and Markit Services PMI) likewise shows a second set of data with sharp drops. The Markit Service PMI has had the greater recent drop to less than 51%. The ISM Index has had a recent turn up, but we expect it to join the Markit Index at a level near a contraction when the June data become available. Note that the Service sector is 70% of the total economy.

Chart-13 (University of Michigan Consumer Sentiment Index) shows that Consumer Confidence remains near record levels; however, Chart-14 (Consumer Confidence Jobs Survey) shows a much different story, with Confidence faltering. The Conference Board in doing this survey asks only two questions:

> First, whether respondents are finding jobs “hard to get”; and

Second, whether they expect "fewer jobs over next 6 months."

What a difference we see between the two sets of data. The Conference Board's results show a breaking of the zero line. Such a move into negative territory has historically been an indication of imminent Recession risk.

Chart-15 (NFIB Small Business Optimism Index) continues to show optimism, like the Consumer Confidence Index seen in Chart-13. However, it also shows Confidence has fallen significantly since last July (2018). This is even more evident among Corporate leaders of large businesses, as shown in Chart-16 (Moody's Analytics Survey of Business Confidence). Management expectations of large corporations in the U.S. are poor. The level shown in Moody's Survey is, in fact, at the lowest level since just prior to the Great Recession in 2007.

The conditions seen in the Charts referenced so far are important. Why? They show us what direction things are going.

Chart-17 (S&P 500 Index) reminds us that there are warnings before Recessions, and one of those warnings is the stock market itself. Note the lead-time shown by market peaks taking place before the onset of Recessions (see arrows on the Chart).

Chart-18 (Months Before/After Cycle Peak) shows that some seven (7) months prior to Recession, the stock-market peaks. Therefore, it is very important to consider not only the condition of the economy, but the direction of the economy's growth (i.e., expanding or contracting).

Morgan Stanley declared on June 16, 2019, that business conditions were at the worst level since the 2008 financial crisis.

Chart-19 (Tumbling Business Conditions) compares three of Morgan Stanley's Indexes. Their Business Conditions Index (MSBCI Headline Index [SA]) declined 32 points last month, making it the sharpest collapse on record. A separate Composite Business Index also fell to 2008 levels. Morgan Stanley said the results of the Chart show that "these indicators point to business expansion coming to a near halt in June [our emphasis]."

Chart-20 (Goldman Bull/Bear Indicator) is in warning territory, suggesting a topping of the stock market.

Chart-21 (Probability of US Recession Predicted by Treasury Spread) shows the probability of Recession is approaching the danger level of a 0.3 (30%) spread. The lines drawn at 30% and 40% indicate that a Recession may be underway at 30% and is confirmed at 40%. The key is that the Index is at 29.6229% as we write. This projection, made by the Federal Reserve Bank of New York, is nearly as close as you can get before Recession is probable.

Chart-22 (10-Year Treasury Constant Maturity Minus 3-Month Treasury Constant Maturity) shows this inversion has already happened, going into negative territory.

Such an inversion forecasts the probability of a Recession approximately twelve (12) months ahead.

The next seven (7) Charts are the basis for us to determine our decision on whether the economy is expanding or contracting.

Chart-23 (U.S. Unemployment Momentum) was earlier presented as Chart-5 in this report. It is repeated here to become part of the seven supporting our contention that the economy is still expanding, but slowing.

Chart-24 (Advance Real Retail and Food Services Sales) is clearly slowing from October of 2018, but it currently remains positive.

Chart-25 (Industrial Production Index) remains positive, as well, but nearing contraction status.

Chart-26 (All Employees: Total Nonfarm Payrolls/Civilian Labor Force) remains solidly positive.

Chart-27 (10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity) remains above inversion (i.e., the 2-Year is above the 10-Year), and thus holds on to a positive rating.

Chart-28 (Chicago Fed National Activity Index) is one of our two "Now" economic indicators that we use to confirm the start of a Recession or the start of Recovery. While the indicator is in the minus, it requires a further decline to -0.70 from the current -0.32 to confirm a Recession has begun.

Chart-29 (Aruoba-Diebold-Scotti Business Conditions Index) is the second of our "Now" indicators. While each of the "Now" Indexes measures a number of different aspects of the economy, their confirmation of Recessions has always been close to each other. Note that this Index is also negative, but needs a decline to -0.80 from the -0.35 currently to declare a Recession is underway.

These seven indicators (Charts-23 through -29) are the ones we use to make the final decision to hold stocks or to divest.

The final decision depends on four (4) of the seven (7) indicators falling into negative territory at the same time as the S&P 500 Index's current price falling below its 40-week moving average, or average price.

As reviewed above, the indicators, though significantly weakened, all remain positive. As of June 21st, The S&P 500 is 6.55% above its 40-week moving average.

Section IV. The Global Economy—Things Are Weaker

In our March report entitled, **"A Taste of Things to Come,"** we stated, "While most commentators, analysts, investors, politicians, etc., will concede that the Global economy is slowing, they steadfastly hold the view: 'We see no signs of a Recession.'"

Things have been changing.

In the quarter just ended, the Manufacturing sector of the Eurozone was in contraction. Chart-30 (Manufacturing Activity in the …) shows the Eurozone below 50, which is contraction. We also see the U.S. Manufacturing sector at 51, just above contraction. The slope of the U.S. decline has been very sharp since mid-2018, which was the beginning of Trade Talks.

Chart-31 (Germany Factory Orders) shows the persistent weakness since July of 2018. Orders are contracting.

Chart-32 (World Trade Growth Has Slumped) shows what Trade Wars can do. (Note: EM = Emerging Markets; DM = Developed Markets.)

On June 17, 2019, the New York Fed reported that its Manufacturing Index had the largest single month drop in history and that it had gone below zero, which means contraction—see Chart-33 (Empire State Manufacturing).

On June 20, 2019, the second of the twelve Fed Districts—the Philadelphia Fed—reported their Manufacturing Index came in at +0.3, down from +16.3.

On June 23, 2019, the Dallas Fed (the third Fed District, so far) reported: “Dallas’ General Business Activity Index for Manufacturing in Texas fell to -12.1 in June 2019 from -5.3 in May and compared with market forecasts of -1.”

Something seems to have been going terribly wrong in some of the key Fed Districts during the May-June period. This may help explain why the Fed seems to have turned more dovish in their June meeting, implying they may well lower the Fed Funds rate soon.

Section V. Summary

As we indicated, a Recession may yet be deferred if the Fed and the Trump Administration begin carrying-out pro-growth policies.

On June 17, 2019, the Fed kept rates the same, but indicated that, with the economy slowing, they are likely to lower rates in the near future. The market’s odds suggest July.

As we said in our review, the Fed needs to lower rates nearly immediately because of the long-lag before a change is felt by the economy. We would have preferred a cut in June, but July is reasonable.

However, whether or not a rate cut helps the economy in the short-run is debatable since, in our opinion, the increase to 2.50% was in error and is likely the partial cause of forces slowing growth currently.

The latest news of Manufacturing Indexes, mentioned above, may indicate that lowering rates in July will only mitigate the approaching Recession, rather than defer its onset.

Based on the Fed’s intentions to lower rates, maintaining current stock and bond allocations is appropriate. Addition to portfolios’ stock allocations is also appropriate where greater-than-normal bond/cash allocations were utilized to maximize protection in light of retirement-related issues, and/or where attitudes towards risk-bearing warranted added protective steps.

Essentially, we are waiting to become fully invested—

- until the downtrend of growth is arrested
- until congress can pass something! Infrastructure? …USMCA? …
- until the Trump Administration can negotiate Trade policy
- until Political Risk has a small “p” rather than a capital “P”
- until the Fed lowers rates sufficiently to assist the economy.

At present, Businesses, Consumers, and Investors must maintain a heightened awareness to the uncertainties that persist.

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