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Economic and Market Outlook

December 31, 2019

On Firmer Ground

Section I. Introduction

Spend each day trying
to be a little wiser
than when you woke up.
--Charlie Munger,
Partner of Warren Buffet

In our June 2019 report entitled, *The Uncertainties That Crowd*, we argued for what needed to happen to avoid Recession.

We said, "In our judgment, the Fed has made another error, and it is serious. The Interest Rate (Fed Funds) is too high!" We went on to say that, to help extend the economic cycle, "the Fed Funds rate must be lowered immediately."

Since our June Report, the Federal Reserve has, indeed, lowered rates three times.

In our September 2019 report entitled, *Putting Time Together*, we acknowledged that the Fed had reversed its tightening policy—a step we believe vital to extending economic expansion. As a result of Fed actions, we indicated that we had become guardedly optimistic that economic expansion would continue, barring the actual breakdown of business and/or consumer confidence, or the failure to agree on the first phase of the U.S./China Trade Agreement.

Since the beginning of the fourth quarter, Recession fears have importantly eased, and the on-again-off-again Phase I of the Trade Agreement has apparently passed President Trump's requirements.

In fact, according to the median forecast of the seven available "NOWcasting" models concerning whether or not the economy is expanding or contracting, their

conclusion is that there is no Recession currently, and it is unlikely in the immediate future.

The expected GDP (Gross Domestic Product) growth for the fourth quarter 2019 is 2.0%--only slightly below the third quarter's 2.1%.

Chart-1a (US Real GDP Change: Actual vs. Expectations for Q4:2019) presents the current consensus calling for 1.8% fourth-quarter results.

The sharper "NOW" forecast improvement during the quarter can be seen in Chart-1-b (Evolution of Atlanta Fed GDPNow real GDP estimate for 2019: Q4). GDPNow's forecast back in November was that the fourth quarter could be only 0.3%--in other words, very near the point of contraction. Note the dramatic rise of the fourth-quarter estimate as late-November and early-December data emerged, (i.e., from 0.3% to 2.3%--as of December 17, 2019).

In addition, the Philadelphia and Chicago Fed's "NOWcasting" Indexes, which are both "coincident" models (i.e., showing the current state of economic activity), remain above their respective points where they report that the economic expansion has changed to contraction. They can be seen in Chart-17 (Aruoba-Diebold-Scotti Business Conditions Index) and Chart-18 (Chicago Fed National Activity Index). They are both confirming economic expansion continues.

Here, at year-end 2019, economic data remain mixed between positive and negative reports.

Despite the mix, there is a clear sense of stability returning.

And while the new GDP growth rate appears to have returned to the decade-long 2% rate, we are grateful the Federal Reserve acted.

Section II. The Uncomfortable Mix of Data

Part-A. On the Plus Side

First—Consumer confidence remains near its highest levels in twenty-three years—see Chart-2a (University of Michigan Consumer Sentiment Index).

Second—Small Business confidence, seen in Chart-2b (Small Business Optimism Index), while down from its peak after tax reduction, has held above 100 during the Trade War. As the year 2019 closes, trade tensions have finally eased, which could give a new boost to small as well as large business leadership.

Third—Chart-3 (Unemployment Rate) is at the lowest level in approximately fifty years. The only problem is the growing shortage of skilled labor.

Fourth—Chart-4 (All Employees, Total Nonfarm/Civilian Labor Force Level) also remains healthy by indicating that the employment growth is at a rate greater than the growth in the labor force.

Fifth—Consumer spending is supported by a solid Saving Rate of 7.8%, as seen in Chart-5 (Personal Saving Rate). The Rate has been rising sine 2005, when it was only about 2%. The Rate increased sharply during the Recession as Consumers cut-back spending. While such a cut-back added to the Financial Recession of 2008-09 (i.e., a Housing-led Recession), the build-up to the present day has been both a blessing and a bane in that, while Consumers' financial health has returned, the slowdown in their spending has been a major contributor to the below-average 2% GDP growth rate of the last decade.

Beyond the healthy Saving Rate, year-ahead spending is supported by growth of 4% year-over-year in wages and salaries.

Sixth—Housing Starts are near more-than-a-decade high—see Chart-6 (Housing Starts: Total: New Privately Owned Housing Units Started). Also note: Home-Builders' confidence ended 2019 at a twenty-year high.

In addition, the second big-ticket item, Vehicle Sales—seen in Chart-7 (Total Vehicle Sales)—remains in the high-end of its range.

Seventh—Retail Sales overall is holding well. Estimates for November-December suggest about a 4% gain over the same period in 2018—see Chart-8 (Advance Real Retail and Feed Services Sales).

Part-B. On the Negative Side

First—The Federal Reserve has returned to a neutral Monetary Policy. This change, we believe, is still another error. Inflation is so low that Interest Rates need further contraction. The Fed risks a resumption of the longer-term slide seen in the Charts that are positive, but well off their highs.

Second—Chart-9 (Personal Consumption Expenditures Excluding Food and Energy [Chain-Type Price Index]) clearly shows that the Fed's favorite Index to measure Inflation at the Consumer level is not only non-threatening (i.e., the Fed has been unable to get to 2% and keep it there), but, if a Recession were to begin with Interest Rates at these levels, we could be dealing with Deflation, not Inflation.

Chart-10 (Producer Price Index for All Commodities) is actually falling on a year-over-year basis.

The Fed should be concerned!

Third—The results of the Trade War can be seen in Chart-11 (Net Exports of Goods and Services). When President Trump took office in January of 2016, our Trade Deficit was about $500 billion. As of the latest data (Q-3, 2019), the Deficit was 30% greater, at $651.67.

The increasing Trade Deficit is a reduction to GDP.

Fourth—While we cannot ignore the pending Impeachment trial of President Trump, we believe it is unlikely to have much effect on the stock market, unless there is a resignation or an actual removal from office—either seeming very unlikely at present.

However, should the trial lead to a removal or resignation, we note that the market did respond quite negatively before. From August 8, 1974 (i.e., Nixon leaves office), to December 4, 1974, the Dow Jones Average fell from 797 to 577—a decline of 27.6%.

Of course, some part, perhaps all, of that decline might have happened even if President Nixon had not resigned. Why? Because a deep Recession and the accompanying Bear Market had been underway since November of 1973, and did not end until May of 1975.

The problem for the economy at that time was the Oil Crisis, when OPEC (Organization of Petroleum Exporting Countries) increased the cost of our imported oil from $2.90 per barrel to $11.65. The nearly four-fold increase, and a later Embargo, buried our 1973-75 economy. The full Bear Market decline exceeded 48%.

Fifth—The British battle of Brexit has not ended with Johnson's election victory—the battle is just about to start. New trade agreements with the EU await both form and substance.

Sixth----The main uncertainty still remains—China/U.S. relations. The Phase-I agreement means little long-term. We believe a new Cold War has just begun. Political uncertainty will remain a prime risk to the markets for years to come, but until our economy is in some way damaged to the point of Recession (i.e., until the NOWcasting Indexes show economic contraction), the markets will rise due to the wave of technological changes impacting the economy.

Part-C. Weighing the Data

Michael Wilson, Morgan Stanley's equity strategist, said to their clients in late November, "We could see growth surprising to the upside or the downside, depending on a number of uncertain outcomes on trade and rates." He went on to say that, in his opinion, "Removing the trade war would result in renewed global growth."

We believe the outlook for any such removal of tensions is likely to be short-lived. As we said, expect uncertainty concerning trade to remain a dominant issue, and perhaps the dominant economic issue, for years ahead.

While the U.S. remains economically better-off to deal with trade issues, since exports only represent 15% of our economy (i.e., GDP), if tariffs continue to be used as a weapon of policy, the disruption to supply chains may bring-on a global Recession.

We expect 2020 to avoid a Recession unless either the Fed returns to a tightening Monetary Policy, or unless the Trade War is reignited between China/U.S. and the EU (European Union)/U.S.

We expect Corporate Earnings to grow in 2020. FactSet finds that the consensus forecast is a gain of 9.7%, which would be a good improvement compared to the current 0.3% gain expected for 2019.

Concerning the stock market, we will have more to say later than just to expect a rise in 2020. Our projection will be part of the closing remarks.

What follows here are a few comments concerning the record Cash on the sidelines of the market.

In an article, dated September 23, 2019, entitled "More Room to Run in 2020," Andrew Slimmon (the Head of Applied Equity Advisors, Morgan Stanley) said (with our emphases):

> In actuality, stocks are sitting under a pall of pessimism, with the market little higher than it was in September, 2018. What upside we've seen has been fueled by corporations buying back their own stock and investors bidding up so-called "safety" stocks.
>
> Individual investors, for their part, largely haven't benefited. Between early December, 2018, and mid-August, 2019, equity mutual funds and exchange-traded funds saw $230 billion in net redemptions. As a percentage of total assets, the 52-week outflow is the most we've seen since the bottom of the market in 2002. Meanwhile, investors have poured more than $476 billion into money market funds so far this year.
>
> This is a classic case of recency bias, where investors' decisions are based on what's behind them, rather than what's ahead. Although this bearish sentiment has taken hold for many investors—and has even been the topic of some debate here at Morgan Stanley—my team and I believe that this outlook misses some significant positive factors for 2020: potential for improving earnings against relatively weak year-over-year comparisons and an incumbent president intent on boosting the economy, as election day 2020 approaches.

Finally, we close **Part-C** with the status of both sets of our five Forecasting tools and the two NOWcasting Indexes, which indicate the economy remains in an expansion. The Table below presents the status of each Forecasting and NOWcasting indicator. Three of the Charts were shown connected to the body of this report, but they are repeated here to view as part of the group.

Summary Table of Forecasting Tools and NOWcasting Indexes

Indicator No.	Chart No.	Indicator Name	Status
(1)	12	Civilian Unemployment Rate (current vs. 12 Months Moving Average	Positive
(2)	13	Advanced Real Retail and Food Services Sales (percentage change from year ago)	Positive
(3)	14	Industrial Production: Manufacturing (percentage change from year ago)	Negative
(4)	15	All Employees, Total Nonfarm Payments/Civilian Labor Force (percentage change from year ago)	Positive
(5)	16	Average Weekly Hours of Production and Nonsupervisory Employees, Manufacturing (percentage change from year ago)	Positive
(6)	17	Aruoba-Diebold-Scotti Business Conditions Index (91-day Moving Average)	Positive
(7)	18	Chicago Fed National Activity Index (3-month Moving Average)	Positive

Section III. Conclusion

It has been said that the stock market climbs a "Wall of Worry." There are enough concerns about prospects for 2020 that we can agree there is plenty worry to climb.

The good feeling about the Phase-I Trade Agreement with China will dominate the next several weeks, but China relations have been an important part of the key reasons that we have held back on our 2020 percentage-gain expectation for the S&P 500.

The U.S.-China Trade dispute and the wider geopolitical challenges posed by China's growing economic, technological, and military power may well stall or reverse as China's leaders weigh the political turmoil in the U.S. election process in 2020.

Our concerns arise from the simple fact that trade-policy headline news nearly dominates the weekly direction of our markets.

There is a second, and more important, reason why for 2020 our expected 7-8% S&P price gain is less than our expected S&P earnings gain of 9-11%.

Patrick J. O’Hare, Chief Market Analyst for *Briefing.com*, explains the stock market’s problem this way:

> Entering 2019, the S&P 500 was trading at 14.2x forward twelve-month earnings or a slight discount to its 10-year average of 14.9x, according to FactSet. Currently the S&P 500 trades at 17.9x forward twelve-month earnings, which is remarkable considering there hasn’t been any earnings growth in 2019. It’s also a 20% premium to the historical average.

Chart-19 (S&P 500 Forward 12-Mo P/E) shows the multiple expansion during 2019 over the low levels of December 2018.

O’Hare continues:

> The multiple expansion has been a function of falling interest rates, which were catalyzed by weak growth abroad, even lower (and negative) interest rates abroad, and a Federal Reserve that abandoned its tightening ways in favor of a return to adding policy accommodation.

Again, an underlying problem of a market at nearly full value, based on forward earnings estimates from FactSet, suggests caution.

That said, the Economy is key!

First—The Consumer is 70% of the economy. As long as they continue to spend—supported by increased jobs, increased income, and healthy savings—the Economy will rise and, with it, the stock market.

Second—What happens to Interest Rates remains key to supporting both Business and the Consumer. Although the Fed has returned to a neutral status, they indicate a willingness to lower Rates should data suggest slowing has returned.

Third—It is clear that investors are feeling much better about the Economy heading into 2020.

Until our five leading indicators or either of the two “NOW Indicators” indicate the Economy has begun contracting (i.e., has entered a Recession), we maintain an investment policy of caution, but stay alert to respond—as the Fed says—to incoming data.

We wish all a Happy and Prosperous New Year!

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