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Economic and Market Outlook

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Light at the End of the Tunnel?

May you live in an interesting age.
- Sir Austin Chamberlin (British Foreign Secretary, 1936)

Section I. Misinformation

Many attribute the above quote to an ancient Chinese curse. The truth is that no such curse existed from Confucius. It was changed in 1966 by Robert Kennedy in a speech in Cape Town to “May he live in interesting times” also claiming that is was an ancient Chinese curse.

Today, misinformation runs rampant in our society. From the Right or the Left, and with the media editorializing instead of just reporting the facts, it is becoming very difficult to discern the truth. We will attempt to do just that in discussing our proprietary in house indicators and the issues facing the economy.

Section II. The Recession Model

As we have discussed in past reports, earnings and the economy are the true long term influences on the stock market. Recessions are the major reason you see corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and can happen multiple times each year.

But how can we attempt to predict which is happening in real time?

We have developed what we view as a recession indicator which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative and the S&P 500 is below the 40 week moving average, this is a very strong indicator that a recession is near or maybe already underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of November, the unemployment rate was 6.7% and the 12 month moving average was 7.85%. Therefore this indicator is positive. It is also important to note that for the next four months the monthly rates coming out of the 12 month moving average are 3.5%, 3.6%, 3.5% and 4.4% respectfully, so this indicator is likely to remain positive.

Indicator number two is represented in Chart #1. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. As you can see, the Covid-19 shut down had a major effect on this index in early 2020. This indicator bottomed in April 2020 at -20.2% and had recent high of 4.6% in September 2020. Currently the reading is 2.9% for November, so this indicator is positive.

Indicator number three is represented in Chart #2. This shows the year over year change in Industrial Production. This indicator bottomed in April 2020 at -16.3%. Even though the reading has steadily improved, it was still -5.5% in November 2020. This indicator remains negative.

For indicator number four (Chart #3), we look at total nonfarm payrolls divided by the unemployment level on a year over year percentage change basis. This indicator has dropped in the last couple of months and stands at -0.526%. A zero reading represents neutral therefore this indicator is also negative.

Indicator number five (Chart 4) represents Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Once again, this indicator bottomed back in April 2020 at -7.69%. Currently the reading is -0.483%, so while improving, this indicator also remains negative.

Currently three of the five indicators remain negative but the S&P 500 Index is 15.69% above its forty week moving average. As long as the S&P 500 is above the forty week moving average this model is not giving any warning signs.

These indicators are only updated on a monthly basis. To offset this situation we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile so we use three month moving averages as our indicators.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average sits at 0.497, and the divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average sits at 0.56.

Therefore the two “early warning signs” are not predicting recession at this time, but they are not very strong either. In addition, historically the gap between the S&P 500 and its forty week moving average is a bit extreme. Some might consider this as a contrary indicator signaling a pullback is possible.

Section III. Market Psychology

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently most of the price/volume indicators remain positive except for the indicator where we weight negative volume greater than positive volume. We track this indicator because historically markets correct faster than they rise.

Our advance/decline line remains positive as well as our model that measures the first and second derivative on price and volume. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years and years of historical data.

Section IV. Covid-19

It is truly a miracle that the medical community has created vaccines for the Coronavirus that have received approval from the Food and Drug Administration in less than a year. Over the long term it should prove to be a great positive for our economy and the human race.

The problem is determining how long it will take for the general population to be vaccinated as well as how many will get sick before that moment it time. In addition, how long will government imposed economic shut downs last and what effect will they have on the economy? Also, how long will supply chain disruptions due to infections persist. We have seen meat processors, distribution hubs and manufacturing plants affected by this phenomenon?

So while we continue to focus on a long term investment strategy, the possibility of a better buying point in the short term is a real possibility due to the Coronavirus.

Section IV. The X-Factor

The other real concerns to portfolio management are the Georgia Senate races to be held on January 5th, 2021. **Let us be clear** – professionally we have no opinion on which way the election should go.

Our point is that the types of investments we will be recommending for our clients for the next two to four years depend on which party gets control of the Senate. Both lists are being developed at this writing.

We are also concerned about the scope and size of any stimulus package that is finally agreed upon in Washington, D.C. At any rate, it is only a short term solution but may hold ramifications for evictions, job growth and the economy in general.

Section V. <u>Moving Forward</u>

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So what does all this mean? We remain optimistic for the long term but cautious in the short term. As conditions develop, we will look for opportunities to increase investments in portfolios.

Section VI. <u>On a Personal Note</u>

As some of you already know, one of our founders and mentor for many years, Thomas H. Clutinger, is entering retirement. We want to personally thank Tom for his 50 years of service. We also want our clients to know that the firm's commitment to excellent customer service and quality investment guidance will continue.

We wish you all health, happiness and prosperity in the New Year!

Scott B. Williams, CFA, CFP
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