# Winslow, Evans & Crocker, Inc.[SM]

**JUNE/JULY 2019** GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY


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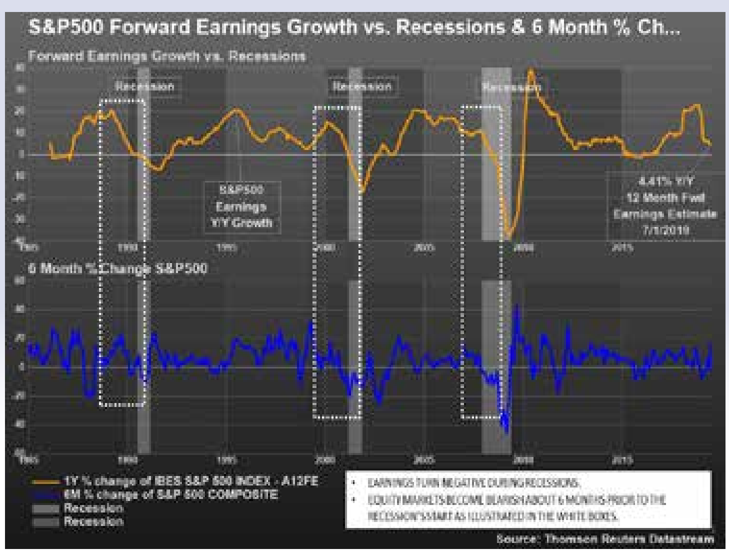
## U.S. Equity Markets & The Longest Economic Cycle On Record

As of July 1st the United States economic cycle is, in its tenth year, the longest on record for the US economy. These cycles do not die of old age but are terminated by one of three fundamental forces: 1) Restrictive monetary Policy implemented by the central bank to battle inflation; 2) Event driven Issues such as war, oil price shocks, etc.; and, 3) Structural issues triggered by imbalances and asset bubbles such as the 2008 recession. Of these three forces, monetary policy is the most common catalyst for recessions. From the perspective of an investor, it is important to be cognizant of the warning signs of an impending recession because corporate earnings go negative and equity markets fall. Chart #1 provides a good illustration of this phenomenon. The top half of the chart shows the forward twelve month earnings projections for the S&P500 index. This chart clearly shows that earnings contract, or go negative, during recessions. The bottom half of the chart shows the six-month percent change in the S&P500. It is clear that, as an investor, it as is important to reduce risk exposure if there are signs that a recession is imminent.

1

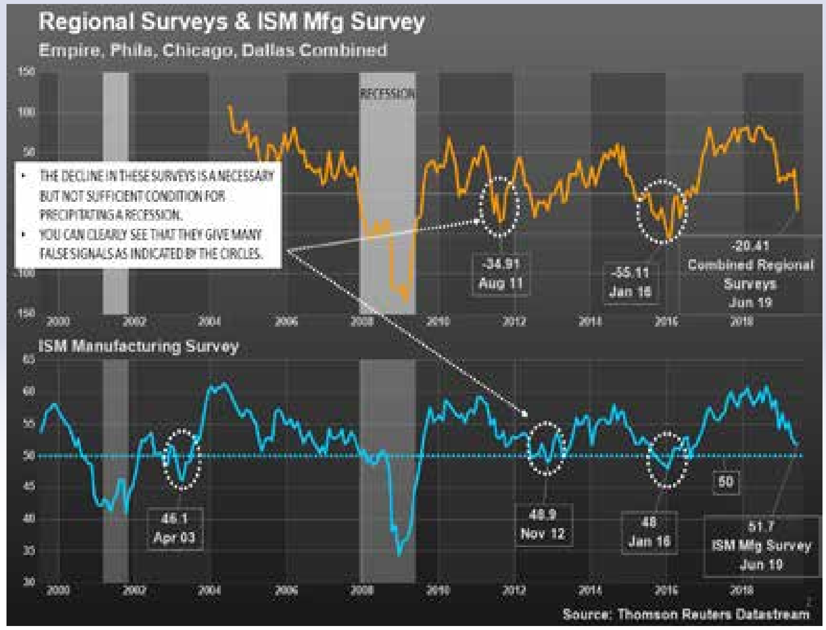


## CHARTS 2-3

Now that we have established the importance recognizing the early warning signs of an impending recession let us examine some of the recent, disappointing economic data and surveys that may provide just such a warning.  A good place to start is with the regional and national economic activity surveys shown in Chart #2. You will clearly see in this chart that the combined regional surveys in the top half of the chart are in negative territory while the national Institute for Supply Management Manufacturing (ISM) survey has fallen sharply over the past year.  So long as the ISM survey remains above 50 it implies that the economy is still expanding, but given the decline in this and the regional surveys, the expansion has clearly slowed down.  This, however, does not imply that a recession is imminent.  You can see in the circled areas that both of these time series have a sine wave-like pattern and have been lower during this cycle without triggering a recession.

Chart #3 illustrates a similar pattern.  US industrial production and durable goods orders have also fallen over the past year and, like the surveys in Chart #2, have performed even more poorly earlier in this cycle without triggering a recession.

2

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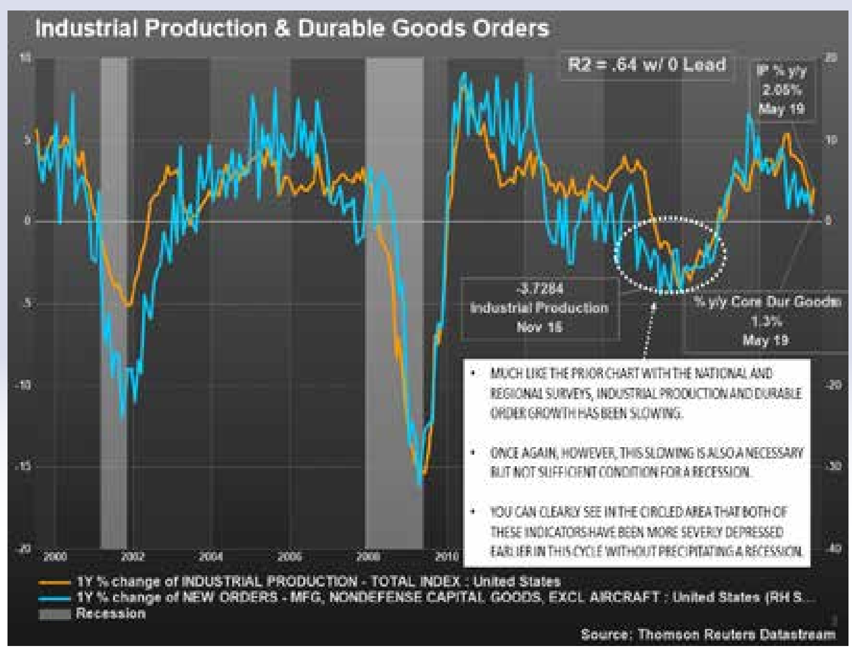

## CHART 4

Another indicator often cited as a warning sign for an impending recession is the Leading Economic Indicators as published by the Conference Board as shown in Chart #4. Once again, this provides further evidence that the economy is slowing but, like the prior data with their false signals, does not provide sufficient information to condemn this economic cycle to a recession.

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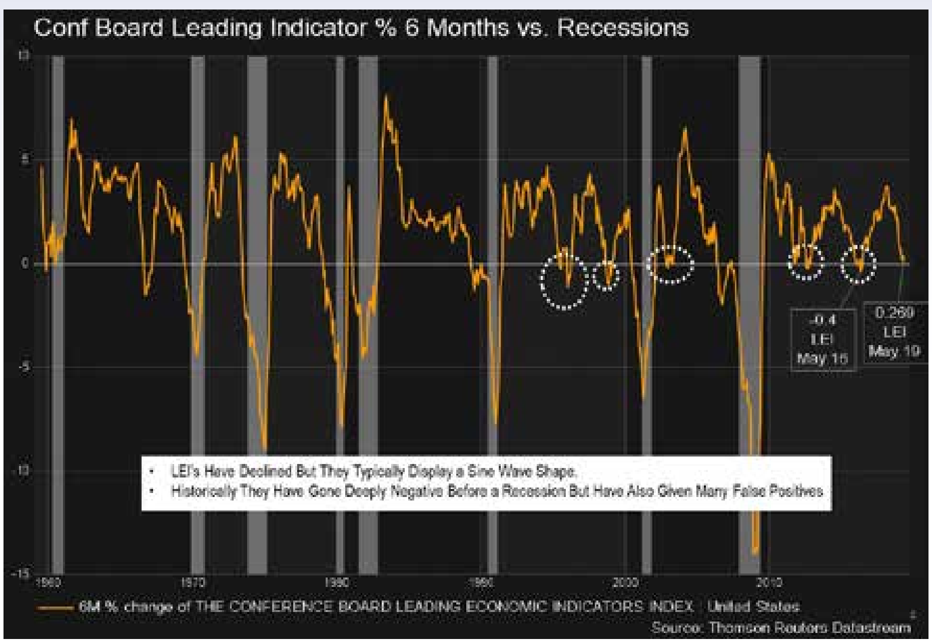

## CHARTS 5-6

The one key indicator that does cause concern is the shape of the yield curve as shown in Chart #5. In the past, a negative yield curve has been a very reliable indicator of an impending recession. As can be seen on the chart it is currently -0.14% which means that the three-month Treasury Bill is 0.14 percentage points higher than the ten year Treasury Bond. The reason that this inversion has been such an accurate barometer of recessions is because, in the past, the Federal Reserve has rapidly elevated short-term interest rates to fight off inflation. Additionally, investors, fearing a slowing of the economy, have invested in long dated bonds thus driving down their yields. Although the yield curve still warrants close watching, we think that its signaling ability, during this economic cycle, has diminished. First, you will see on the bottom of this chart the Chicago Financial Conditions index. During past curve inversions this index has been rising which indicated increased financial stress in the economy. This time, however, you will notice that this index is declining which tells us that financial conditions remain easy. Secondly, something called the Term Premium, displayed in Chart #6, is at its lowest level in 50 years. The Term Premium is the extra amount of yield that an investor expects for assuming the added risk of investing in longer dated bonds. As you can see in the chart, it is currently negative and at its lowest level in nearly 50 years. Amongst the many reason given for such a low term premium is the Fed's quantitative easing program, the consistently low levels of domestic and global inflation, and the desire of an aging population to invest in low risk fixed income.

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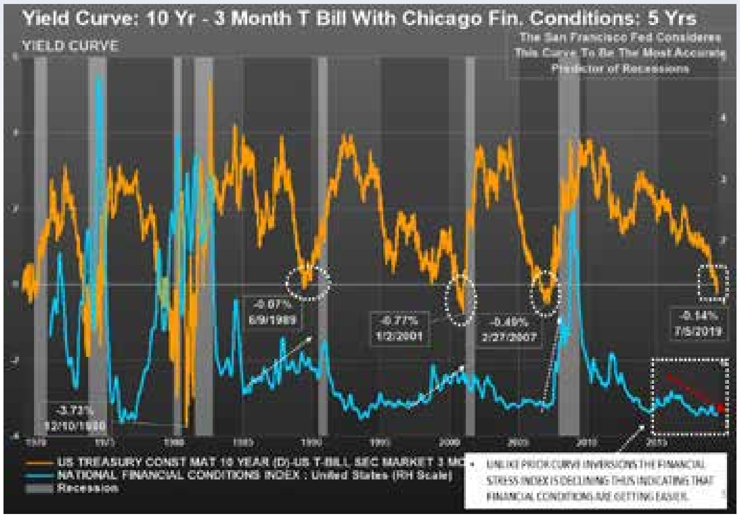


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## CHARTS 7-8

As shown in Chart #7, when the term premium is subtracted from the yield curve it gives us a completely different perspective of how to interpret the curve's inversion. As can be seen by the white circles the curve still provided a very good indicator during past cycles of impending recessions but, because the term premium today is so low, the yield curve is presently positive and no longer signaling a recession!

The softening economic data and declining surveys are an indication of a mid-cycle slowdown rather than a precursor to an imminent recession. We come to this conclusion because the Federal Reserve is still pursuing a relatively easy monetary policy and because the various financial stress indicators are at their easiest levels on record, Chart #8. The top half of this chart shows the real, after inflation Fed Funds Interest rate. Note that, at 1.13%, it is well below the levels that triggered a recession during past cycles. On the bottom half of the chart is the Chicago National Financial Conditions Index that we referenced in Chart #5 and, once again, it is showing that in contrast to prior cycles current financial conditions are getting easier.

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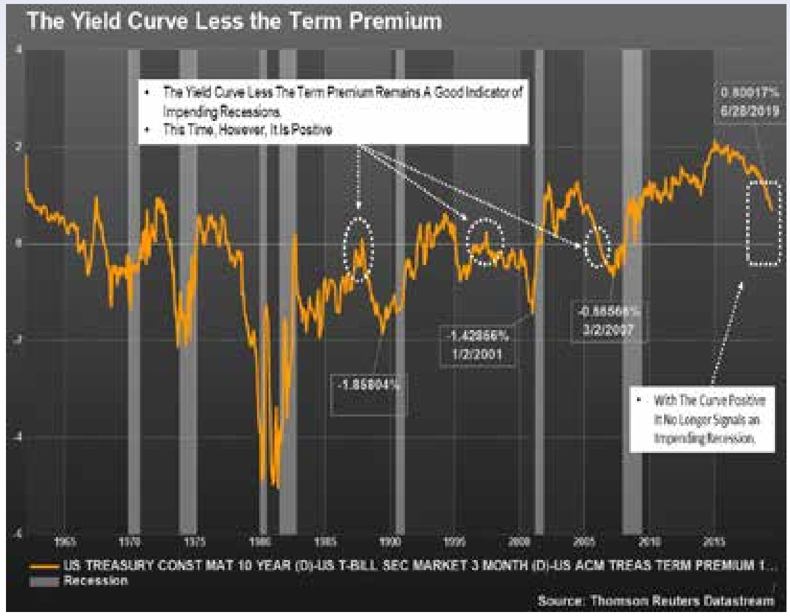


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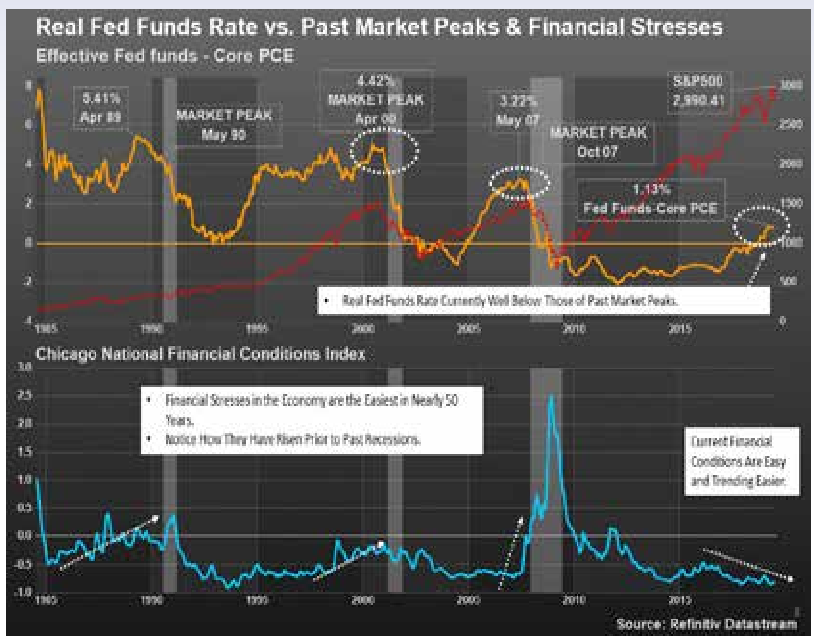

## CHARTS 9-10

In this current environment of low inflation and nearly full employment the Federal Reserve faces an asymmetric risk.  If they maintain or raise interest rates they risk sending the economy into a deflationary spiral which will be difficult for them to counteract since rates are already very low.  This leaves them with the option of allowing the economy to overheat and for letting inflation rise above their target.  It is easier for the Fed to combat excessive inflation by raising interest rates and tightening the supply of money. Because the Fed has now taken a more dovish monetary stance, it means that this economic cycle is likely to continue well into 2021, which is very bullish for equities.
Given that we view an extended economic cycle as bullish for equities the next logical question is to examine valuations.  In Charts #9 and #10 we have taken two different approaches.  In Chart #9 we show the market's historical forward price to earnings ratio as being just above its twenty-five year average. This indicates that the market is only slightly expensive.  In Chart #10 we take a different approach by comparing the total market value of the S&P500 to the capitalized value of the National Income Profits Account (NIPA).  NIPA represents the total profits of all US public and private corporations.  By dividing this figure by the interest rate on the 10-year US Treasury Bond we achieve a market value of those profits.  The chart shows that this ratio is well below past levels of market bubbles.

Our conclusion is that the economy is going through a mid-cycle slowdown that does not presage an imminent recession.  The Fed's recent change to a more dovish stance on monetary policy will prolong this economic cycle.  This is bullish for risk assets and the equity markets.  We view equity valuations to be reasonable.  Please contact your financial advisor if you would like to discuss this report in more detail

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