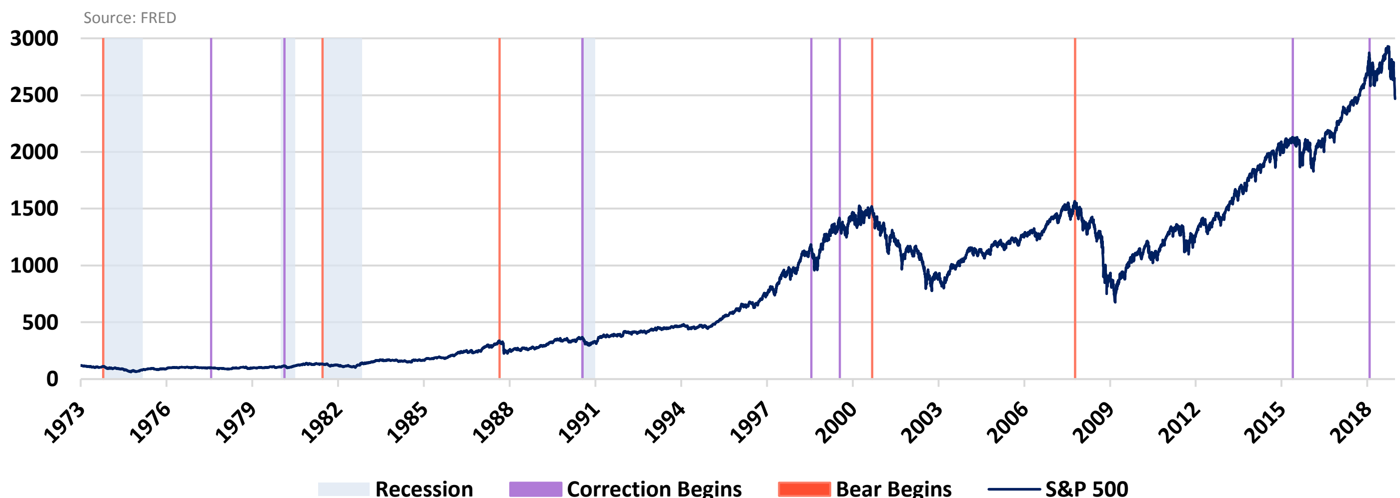
The Right-Half-the-Time Barometer

Market Viewpoint: December 22, 2018

Summary: Many equity markets around the globe have slipped into correction, or even bearish territory, and the widespread declines have re-ignited fears of an oncoming recession in the new year. However, equity markets do not appear to be the most accurate predictors of economic turmoil. Major stock market downturns without a recession appear to be just as common as those followed by a recession.

As nearly all asset classes have fallen over the past few months, equities being among the hardest hit, some market pundits have begun predicting a 2019 recession. The financial media has whipped up such a big storm of worry that Google searches for the term "recession" have reached their highest level in over seven years. Reasons include the fourth 2018 Fed rate hike, trade wars, the GOP's losing its grip on the House of Representatives, slightly inverted yield curve and the simple fact that it has been almost a decade since the US emerged from its last recession. According to a recent Reuters poll, the odds of a recession have jumped to 40%. Some have even dusted off the old adage that stock prices are a barometer of the economy and therefore the decline must be signaling a 2019 recession.

But, that ain't necessarily so. As the economist Paul Samuelson once quipped, the stock market has predicted nine out of the last five recessions. Samuelson's joke was made back in the 1960's. Interestingly, a half century later, the data shows the same pattern. Since 1973, there have been a total of 12 bear markets or corrections prior to the current pullback, but only half were followed by official recessions. So, the likelihood of a bear market indicating an oncoming recession is equivalent to the flip of a coin.



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However, many more variables are at play here including the outlook on employment, wages, and other macroeconomic indicators that continue to point in a positive direction.

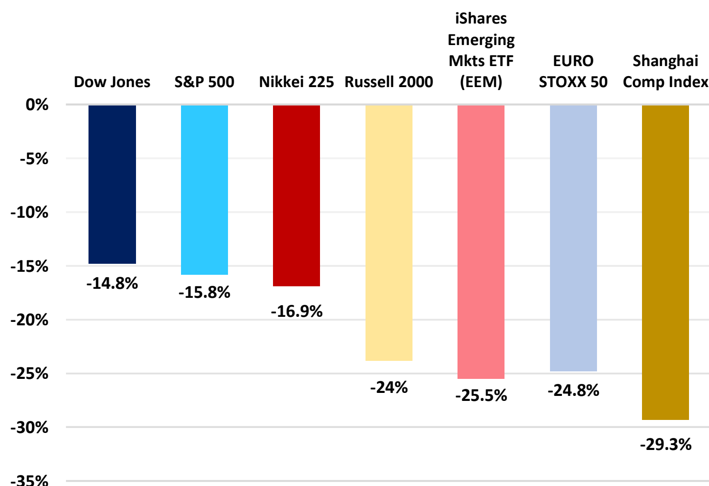
Some had begun to sound the alarm bells over the last month as weekly jobless claims began to surge, but the second week of December saw initial claims tumble back to near a 49-year low, before ticking up a bit in the week ended December 15. This has been a continual trend throughout the year, one which has helped propel average hourly earnings to consecutive months of 3%+ gains; October marked the first-time wages have reached that milestone since 2009.

Buttressed by the strong wage growth, consumer spending is expected to retain its strength going into the new year. Consumer sentiment beat economists' estimates in December, holding steady at 97.5; the current conditions index rose to 115.2 from 112.3 in November. Bolstering the confidence consumers feel, November's retail sales excluding automobiles, gasoline, building materials and food services surged 0.9% after an upwardly revised 0.7% increase in October. The figures for November blew past consensus expectations and could be an encouraging sign for December where shoppers will flock to stores and punch in online orders in masses for the Holidays.

Additionally, according to the Institute for Supply Management (ISM), 56.7% of manufacturing supply executives reported to have raised wages in the past six months to recruit new hires, up from 45.4% in the year-ago survey. The ISM also reported that economic activity in the manufacturing sector expanded in November, and the overall economy grew for the 115th consecutive month. Increases in new orders and production indices contributed to a 1.6% rebound in the headline Purchasing Managers' Index.

MRP has been negative on the equity market (see September 2017, The Gathering Storm; the S&P 500 went on to peak about a year later, but is now down 4.1% versus when we issued that report). MRP believes a further downturn in equity prices is likely in 2019; but we also think it will fail to produce a recession. Economic growth is likely to continue, albeit at a somewhat slower pace than the above-average numbers of the second and third quarters.

The past year has been a rollercoaster ride for stocks, with huge bouts of volatility in both directions. The Dow Jones Industrial Average closed at an all-time high 14 separate times this year, but that same index also logged 10 of the 20 largest daily point losses of all time, including each spot in the top 4. All in all, US indexes including the Dow and S&P 500 are on track to close slightly down on the year, but from their peaks, each have recently dived deep into correction territory, down 14.8% and 15.8%, respectively. An even more drastic sell off has occurred in the NASDAQ and small caps, as well as Europe, China, and Emerging markets, all of which are already in bear markets.



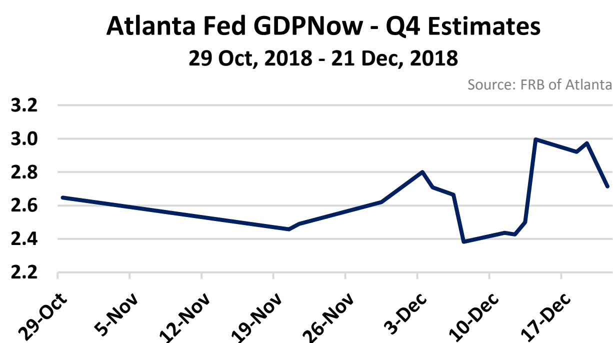
In fairness, when the stock market barometer gets it right, it usually signals a recession 6 to 9 months in advance. So we won't know for sure until the first and second quarters of 2019 if this episode is one of the 50% that correctly signals a recession or one of the 50% that does not. Economic growth is easing slightly in the U.S. and slowing more significantly abroad. The IMF's most recent World Economic Outlook, published in October, downgraded US growth for 2019 to 2.5% from a previous estimate of 2.7%, reflecting its belief that the

continuation of US tariffs will further weaken the US economy, pulling back from the robust activity the US has enjoyed since mid-year. However, even with that downward revision, it still beats 2017's growth rate of 2.2% and 2016's 1.6%.

Some have cited the housing market, a large contributor to GDP, as a tipping point for a recession as homebuilder confidence, starts, and permits have begun to decline in the latter half of the year. MRP added Short Housing to our list of themes on October 1st, and while homebuilder stocks have been battered, the industry does not appear to be on the verge of a meltdown like the one experienced during the Great Recession. This time around, the issue is a growing shortage of housing, rising mortgage rates, and a boom in the price of materials and labor. Average monthly housing starts between 2004 and the end of 2006 were 37% higher than the average between 2016 and today. It is not that demand is lacking or supply is outstripping demand, it is that prices have ballooned and must come down to meet demand. While it will take some time for homebuilders to adjust, it is unlikely that we are looking at a 2007 situation.

As mentioned earlier, a Reuters survey of 500 economists estimated the risk of recession within the next 2 years at 40%, their highest recorded figure since January 2008. However ominous, two years is a quite a long horizon. A different survey, this one from the 32nd Economic Outlook Symposium, hosted by the Federal Reserve Bank of Chicago last month, showed out of 150 invited economists, only two believed that a recession will occur in 2019. Further, IMF Chief Christine Lagarde has also said herself that she and her colleagues "don't see signs of recession in the near term based on the information we have at the moment". So, when narrowing down a more precise time for a recession to appear, our feeling is that the most substantial risk of recession is closer to the back end of a 2-year period, or further, as opposed to within 2019.

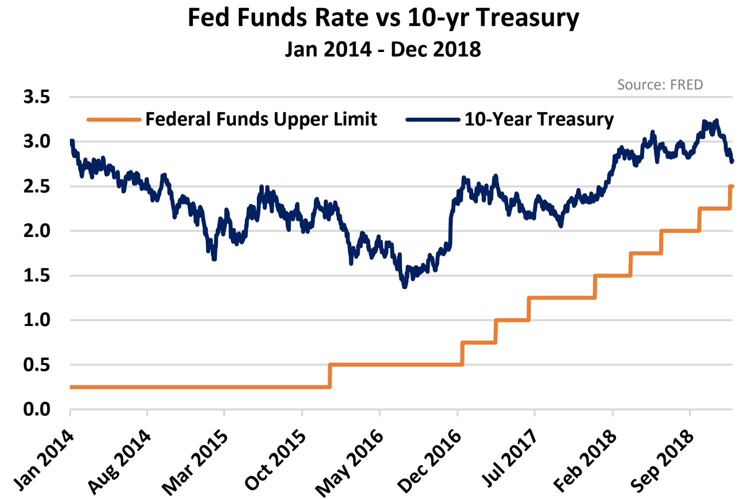
Total global output faced an identical decline as the US in the IMF's expectations but emerging and developing markets saw the largest declines in expectations for next year. Some markets like Emerging and Developing Europe saw projections pulled back by as much as 1.6%. While the US success improving growth prospects is unique, compared to other markets set to grow at a slower pace, nobody is projected fall into negative territory.



But a slower pace of US and global growth does not constitute a recession. Indeed, the Atlanta Fed's GDPNow forecast for the 4th quarter is showing 2.7%. Nonetheless, that would be slower than the most recent 2 quarters, but still Above the long-term trend. And the FOMC, as of this week, is still looking for annual GDP growth of 2.3% next year; down from their previous estimate of 2.5%, but far off from a recession. Further, the latest US Leading Economic Index (LEI) leapt back to 1.4 for the month of October, just off the average pace of 1.5 since 2010.

As we wrote in the December viewpoint, slower economic growth will mean slower earnings growth. Earnings growth in 2018 had been boosted by the way above average GDP growth numbers, the effects of the tax cut on the bottom line, and week year to year comparisons for the dollar particularly in the first and second quarters. All three of these will be absent in 2019 and earnings growth is likely to slow back towards its long-term average of 8.1%, when outliers are accounted for. Rising interest-rate's and slowing earnings growth is not a recipe for continuation of the bull market. Indeed, we believe the tumult is likely to continue in the year ahead.

A large part of what's driving the current market sell-off is indeed more hawkish monetary policy than we've seen over the last decade. Some have begun implying that the Fed may have gotten ahead of itself and is raising rates too quickly, choking off the strong stream of growth we had seen in 2018. However, as MRP highlighted in The Next Handle, the current Federal Funds upper limit of 2.5% is still nowhere near the 50-year average level of 5.30%. Even if the Fed continues on its latest stated path toward 2 rate hikes (presumably 25bps each) in 2019, monetary policy would be far from restrictive on a historical basis.



Looking at the wider spectrum of data, there seems to be a lot of bluster about recessions, but not a whole lot of substance. Such a swift correction in equities markets understandably brings back memories of a decade ago and has (unsurprisingly) set the financial media ablaze with hyperbolic articles detailing doom ahead, but according to most macroeconomic indicators, that could be all it amounts to.

As the new year unfolds and the economy continues to expand rather than plunge into recession, we think intermediate and long-term rates will rise again, resulting in a steeper yield curve. So, even with the Fed pulling back from three to two hikes for 2019, equities will be challenged by the negative combination of higher rates and slower earnings growth.

Joe Mac

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