ECONOMIC OUTLOOK

bounty management
unique investment insight

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Global Slowdown Spillover
As U.S. Growth Decelerates

In the past, the global economy, for better or worse, would follow the U.S. economy. Whether high interest rates in the 1980’s, the internet bubble/bust in the 1990s to 2000s, or the mortgage crisis in 2008, a weak U.S. economy would drag the rest of the world lower or into recession. Today, the script is somewhat flipped – it is the global economy that is affecting the U.S. While the U.S. is not in recession, the manufacturing sector is close, and the broader economy has certainly slowed. Drops in business investment and trade both subtracted from GDP growth in the second and third quarter. The overall economy is still growing in the 2% range helped by strong consumer spending, but signs are pointing to flagging growth there too. Since exiting the 2008-2009 recession, growth has averaged 2.3% compared with 3% for the ten years prior to the recession and 3.3% in the 1990’s. In the future, baring a population boom, a wave of skilled immigration or technological breakthroughs, the economy’s potential growth is not what it was in prior decades.

During the third quarter, instability in equity markets increased due to global trade tensions, the approaching Brexit deadline, Hong Kong protests, the impeachment inquiry, and drone attacks on oil fields in Saudi Arabia. The U.S. has been pushing to raise tariffs on almost all imports from China. The U.S. increased tariffs on selected goods from the European Union (EU) such as Scotch whisky, Parmesan cheese, and French wine, after the World Trade Organization (WTO) ruled EU nations had failed to comply with a ruling regarding government subsidies. Despite U.K. politicians’ best efforts to exit from the European Union, Parliament is pushing back on Prime Minister Johnson and his hard-line approach. In the U.S., the House of Representatives has begun a complex impeachment process that will likely be in the headlines for the next year dampening investor confidence and adding to market unpredictability.

Against the backdrop of geo-political conflict and a decelerating global economy, the Federal Reserve reversed course from last year’s rate hikes and cut interest rates to ease monetary conditions. The Fed also stopped reducing the size of its balance sheet and started to buy $60 billion a month in shorter-term securities – effectively starting a new round of quantitative easing. Since interest rates were still fairly low before the rate cuts even began, technocrats at global central banks are likely to find little ability to maneuver monetary policy to provide adequate economic stimulus if conditions further sour. The global slowdown and low interest rates will likely require additional fiscal stimulus; a number of countries are already engaging in this very necessary behavior to encourage confidence among business leaders to stimulate capital spending and hiring. Consumers in the U.S. remain supportive with robust spending, but a contraction in manufacturing appears to be spilling over into the service sector.

U.S. Economy

Supported by household spending, GDP grew a moderate 2.0% in the second quarter, following an impressive 3.1% growth in the first quarter. Economic expansions don't die of old age, and the current one seems less likely to end soon considering that the central bank is cutting interest rates to insure against rising risks. Private consumption is driving the sustained expansion, while more than offsetting real net exports weakness and soft business sector spending. However, worries of a recession are brewing as the Federal Reserve becomes more divided on the path forward after two consecutive rate reductions in the third quarter.

In addition to trade policy worries amid a global slowdown, political turmoil joins the pack. Elevated uncertainty is weighing on U.S. business investment in the third quarter. The House of Representatives started an official impeachment inquiry, sparked by a report on his call with the President of Ukraine in which he asked for political favors. Amid the many risks that the economy faces, businesses may continue to cut spending and reduce hiring; the consumer is holding the economy up, but it is unclear how long that will continue. A number of indicators are showing deceleration of growth in the non-manufacturing sector as well as the manufacturing sector. Risks of a global slowdown reaching the U.S. are rising as we see manufacturing enter its second month of contraction based on the ISM purchasing managers index. While a number of other indicators appear to be strong, the leading indicators are becoming more mixed. Financial markets forecast two more interest rate cuts through year-end 2019. Analysts expect GDP to moderate from a strong 3% at the start of the year to 1.5% to 2.0% through 2020.

Consumer and Employment

Consumers bolstered second quarter GDP with 4.6% annualized growth, offsetting the 6.3% shrinkage of private investment. Personal income growth continues to be robust, up 0.3% m/m in July and 0.5% m/m in August, as wages grew 3.3% y/y in July and 3.2% y/y in August. Personal spending has slowed to 0.1% m/m in August, compared to 1.0% m/m in March. The recent drop in consumer confidence may also indicate lower spending in the next few months. The labor market is strong despite a deceleration in jobs growth with 161k added jobs in first nine months of 2019 vs. 220k in the first nine months of 2018. Jobless claims hover at low levels around 210k and the U.S. is approaching full employment. The slowdown in manufacturing is alarming, but the non-manufacturing sector, with a significantly higher proportion of jobs, is still holding up despite slowing growth.

Real Estate

Low mortgage interest rates since the end of 2018 are continuing to support the housing market. However, Mortgage Bankers Association data began to show a slowdown in home purchases in late September possibly due to additional rate cuts as well as the heightened uncertainty surrounding economic outlook. With a declining stock of homes, housing starts surged 12.3% m/m in August and building permits jumped 7.7% m/m. Existing home sales were above 5.4 million in both July and August. Year-over-year changes in the Case-Shiller 20-City home price index have been decelerating for the past 16 months. Consumer sentiment on housing fell in September from its August high, according to a monthly survey from Fannie Mae. Lower mortgage rates are making buying a home slightly more affordable, but financial concerns are outweighing that benefit and lowering overall confidence in housing.

World Economy

Europe

Growth slowed in the Euro Area during the second quarter to 0.2% q/q from 0.4% q/q in Q1 due to a contraction in net exports. Domestic demand shows resilience, however deterioration in manufacturing and persistent geopolitical risks have taken a toll on sentiment across the board. Manufacturing PMI tanked to 45.6 in September, the lowest since 2012, with the services gauge moderating to 52.0. Germany teetered toward recession as manufacturing stalled and business expectations plunged to 90.8 in September, the worst reading in 10 years. The sustained weakness in manufacturing may spill over to other sectors of the economy, requiring more fiscal support. Outgoing ECB President Mario Draghi delivered a package of easing measures: a rate cut, the restart of asset purchase programs, and a new loan program. However, he urged the European Commission to coordinate fiscal stimulus saying that, "it's high time for fiscal policy to take charge."

Japan

The economy continues to depend heavily on the service sector as trade tensions are taking a toll on manufacturing. Inflation remains well below the central bank's 2% target and exhibited a downward trend in the third quarter. National CPI decelerated to 0.3% y/y in August while PPI plunged to -0.9% y/y. Excluding the effects of the sales-tax increase from 8% to 10% on Oct. 1st, inflation remains perpetually low. Although the Bank of Japan is more likely to ease policy levers as it is disturbed by low inflation and global headwinds, it has a very limited toolbox to further stimulate the economy. The trade deal with the U.S. is likely the biggest potential upside for economy, which may relieve anxiety regarding its export-heavy auto industry.

China and Emerging Markets

Activity fell more quickly than expected in China amid escalation of trade tensions and domestic demand deterioration. Official GDP growth decelerated to 6.2% y/y in the second quarter. Auto sales fell 6.6% in September despite efforts by Beijing to prop up the market. As private investment continues to shrink over a downturn in sentiment, policymakers have started to ratchet up another round of fiscal stimulus. In emerging markets, Turkey posted -1.5% y/y GDP in the second quarter versus -2.4% y/y in the first as the lira plunged due to high inflation the past two years. India's GDP growth rate tumbled in the second quarter to 5.0% y/y from 5.8% y/y in the first quarter. In addition to monetary stimulus, the government answered the urge for fiscal stimulus in September with a 1.45 trillion rupee ($20.4 billion) corporate tax cut to support business investment and increase employment. The OECD reduced their world growth forecast from 3.4% in May to 3.0% in October citing subdued growth and contracting global trade.

Oil and Commodities

Brent crude oil averaged $63 per barrel in September, up $4/b from August and down $16/b from the September 2018 average. Brent prices began September at $61/b and increased to $68/b after attacks on major Saudi Arabian oil infrastructure disrupted the country's crude oil production. However, Brent prices have subsequently fallen as Saudi Arabia restored production and concerns about oil demand based on the condition of the global economy. The third quarter of 2019 was an eventful period for the gold sector, with two Fed interest rate cuts, a price rally and subsequent pull back, and lots of speculation. Ongoing geopolitical concerns between the US and China, and the US and the Middle East brought investors flocking to the safe haven metal. The yellow metal started the quarter trading at US$1,384 per ounce and trended higher for the majority of July. The September story was slightly different, as gold started at $1,529, then slipped to $1,482 to end the three-month period up +7.4% and over +14% for the year.

Investment Perspective

In the past, the global economy, for better or worse, would follow the U.S. economy. Forecasts for slower economic growth are due to low population growth, labor force participation, and low productivity (how much workers produce per hour). Add a forecast of low inflation and it looks even more daunting for companies to generate the same profits they have become accustomed to. Yet investors are counting on companies to deliver stellar growth – pension funds assume a 7.25% return with a mix of stocks, bonds, and alternative investments while individual investors polled by Natixis are the most bullish, expecting 10.9% returns excluding inflation (add an additional 2-3% for nominal returns). These types of returns suggest a long continuation of a rising stock market that is already one of the longest on record. Although the stock market has generated returns over inflation in the long-term, these types of expectations are a recipe for disappointment, particularly since long-term U.S. growth forecasts and interest rates are in the 1.5% to 2.0% range. And, as all investors have experienced with equities, there is certainly high volatility along the way.

Analysts predict third quarter company estimates will fall -4.1% from a year ago although companies tend to beat estimates so earnings will likely be flat year/year. Wall Street's estimates for next year are +10%, but as in past years will be revised down in the coming months. This is a comedown from last year when, buoyed by a strengthening economy and tax cuts, earnings grew by 20%. Trade tensions and slower economic growth are weighing down sales while rising costs are cutting into bottom lines. Net profit margin for the S&P 500 fell from 12% in the third quarter of 2018 to 11.3% last quarter. Margin pressure can be more than just a shareholder problem because it can lead businesses to cut costs and staff and cause trouble for the economy.

In spite of all the geo-political uncertainty, the markets are up year-to-date through the third quarter. Many indicators are positive including slow but steady GDP growth, low unemployment, wage growth, and consumer spending. Equity markets remain over-valued on many measures, but with continued central bank manipulation in the form of low interest rates and government bond purchases, stocks are a better value than fixed income. From many years of experience, we have learned not to time the market, but to indentify areas that are over-bought or over-sold. With inflation of around 2%, investing in fixed income yields zero. After 40 years of falling interest rates, bonds are the most over-valued asset class. Globally, there are over $16 trillion in negative yielding bonds with 70% of European bonds yielding below 0%. However, short-term bonds can play a valuable role in investment portfolios by providing a hedge against volatile markets. Precious metals yield nothing, but are a store of value in a world where fiat currencies are in question and even Greece is borrowing at sub-zero rates. For equities, we favor industrials, technology, healthcare, and materials. Dividends are still an important component of investment returns. Financials remain at risk with pressure from low rates and flat net interest margins. As investors, we try to identify stocks selling at a reasonable price in growing businesses/markets with strong management teams, financial disciple, and a competitive advantage. As global growth decelerates and affects the U.S. economy, we strive to be even more stringent in our disciple and overall portfolio selections. As always, we remain vigilant.

September 30, 2019
DJIA: 26,916.83
S&P 500: 2,976.74

About Bounty Management

Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.