ECONOMIC OUTLOOK

bounty management

unique investment insight

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Battling Slowdowns Present and Future
The Fed Pivots Away From Rate Hikes

Alarmed by last year's economic slowdown and stress in the financial markets, the world's central banks are engaged in a major policy reversal, calling off interest rate increases and, in some cases, easing monetary policy. In the U.S., despite a strong labor market and rising wages, the economy faced headwinds from slowing global growth, lower consumer spending, rising labor/energy costs, Washington's trade war with China, and uncertainty over Britain's departure from the EU. Concerns about the health of the economy have been sufficient to cause one of the most abrupt course changes for global central bank policy in recent memory. The Federal Reserve's U-turn was most significant, flipping from an expected course of gradual hikes continuing in 2019, to a message that the committee would be "patient" in raising rates further and flexible in the pace of reducing the balance sheet. The European Central Bank wrapped up its asset purchase program in December, but in March announced a fresh targeted long-term lending program would begin in September. It also pushed back the possibility of rate hikes from summer 2019 to 2020. Chinese authorities cut bank reserve requirements in January, added targeted tax cuts, and made progress in their trade spat with the U.S. The only major developed market where market players are pricing in a rate hike over the next year is the United Kingdom, and even there, they see a cut as more likely over the next six months amid Brexit risks.

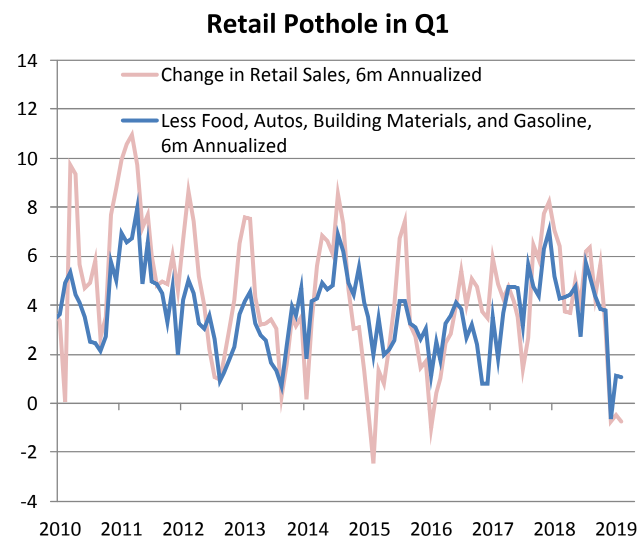
Targeted measures and policy support may be enough to allow the global economy to skirt recession and extend the expansion. The U.S. expansion will be the longest on record if it continues through mid-year. Even as good times continue, it's worth considering what recession-fighting ammunition will be available in coming years if, on the monetary policy side, space to cut interest rates remains limited in many developed markets. There is currently over $10 trillion in global debt that yields less than 0%, guaranteeing a loss for any investor who holds these bonds to maturity. Issuing negative yielding debt has become increasingly unattractive in hindsight - it's likely no coincidence that the country with the healthiest banking sector and strongest growth, the U.S., has been paying banks to park reserves, not charging them for the convenience. Beyond rates, global central bank asset purchases of about $14 trillion since 2008 have stabilized the world economy and aided the recovery, but have been more successful at boosting asset prices, particularly stocks, than in raising household income. On the fiscal side, high debt levels present a challenge to countries committed to fiscal restraint, but interest rates and inflation are generally low. The U.S. needed 192 years to amass its first $1 trillion in public debt, hitting the mark in 1981. Now we have $22 trillion in debt on the books, exceeding 2018's $20.5 trillion in gross domestic product, and $1 trillion additional debt each year. All eyes are on global central banks and interest rates since, with this amount of debt, any increase in rates will hurt corporate profits and impinge on debt holders' ability to repay loans.

U.S. Economy

The soft patch that started in the fourth quarter continued into the first. After averaging near 4% in mid-2018, weaker consumer spending and hesitation across business investment contributed to a downshift to near 2% growth. To be fair, 2% has been a good run rate for most of the expansion and represents a slowdown after the tax cut stimulus in mid-2018. Soft starts to the year have been the norm in recent years, and growth has averaged 3.6% in the second quarter over the last five years so we would not be surprised by a strong rebound. Manufacturing activity rose in March to 55.3 from 54.2 the previous month (numbers over 50 indicate expansion). The latest Federal Reserve forecast for 2019 revised growth down (again) from 2.3% in December to 2.1% in March.

Consumer and Employment

Wealth effects from the negative equity market shock in Q4 are in part to blame for a retail spending pothole since December. Consumer confidence data were surprisingly soft in March as the Conference Board's index fell 7.3 points to 124.1, due to weaker current job market and business condition components. Blips are normal, but also consistent with a modest rise in the jobless rate that started last October. Employment growth downshifted in the first months of 2019, averaging 180,000 (just 33,000 in February) after 223,000 on average in 2018. The good news is that wage growth is picking up with a post-recession high of 3.4% y/y in February. Auto sales showed a rebound in March, bouncing to 17.5 million annually, another hint the slowdown may not worsen.



Global and U.S. Manufacturing

Global slowdowns have been most evident in manufacturing, with clear downshifts toward slow growth or contraction in many regions. Conditions worsened into the first quarter, with data through March showing sub-50 readings (below 50 is contracting) prevailing across the core of Europe and most of Asia, until a bounce in March. Ripples from the China-U.S. trade spat are part of the reason, with relatively stronger conditions prevailing in the U.S., Europe's periphery, and India. The March ISM manufacturing survey rose 1.1 points to 55.3, with key rebounds in the employment and orders indexes - the top line index points to moderating growth, but still decent momentum.

Oil/Commodities

Oil prices climbed to a five month high, hitting $63 per barrel in the U.S. or $70 on the world Brent crude benchmark. This was up from $45 and $52, respectively, at year-end. Oil prices have gained because major oil exporting countries have been disciplined in curbing production in an effort to eliminate a global surplus. OPEC production fell to the lowest in more than four years in March in part due to a steep decline in Venezuela. The supply/demand characteristics of gold are favorable with lower supply and increased merger activity. On the demand side, central banks are on a buying spree with 2018 purchases of 651 metric tons – the highest in more than 50 years as geo-political uncertainty and economic worries prompted national banks to diversify their reserves.

World Economy

Europe

After strong growth in 2017, economic expansion moderated in the eurozone in 2018, marked by a clearer drop in momentum in the fourth quarter to just 1.1% y/y, the weakest since late-2013. The European Central Bank (ECB) revised downward eurozone growth projections for 2019 from 1.7%, to 1.1% y/y, between December and March. A global trade slowdown, along with country-specific factors (e.g., the auto sector in Germany, Italy's fiscal and political troubles), are among the drivers. A shift in vehicle emission standards impacted German industry more acutely than others. The European Central Bank ended its asset purchase program in December, but diminished economic prospects led to the announcement of (1) a new targeted lending program that will begin by September, and (2) a pushback of any potential rise in interest rates into 2020. Policymakers are mulling how to counteract the negative impacts of sub-zero deposit rates (-0.4%) on bank profitability and lending, costs they can't easily pass on to households.

UK Brexit Update

Instead of being dressed and ready for a smooth exit on March 29th, the U.K. is still searching the couch cushions for its keys. Parliament took over the reins in late March after rejecting the government's deal with the EU in three separate votes, but there is no clear consensus ahead of a new April 12 deadline. A "soft Brexit" remains a possibility, but won't satisfy many Conservatives or the government. Remaining in a customs union means the U.K. loses the ability to set its own rules on the movement of people, it would still make contributions to the EU budget, and the Irish border question could remain unresolved. If cross-party talks fail to yield a solution, a long extension of the Brexit process by a year or more could entail a general election or second referendum. Near-term, stumbling out of the EU in an accidental "hard Brexit" remains an uncomfortably high risk.

Japan

Posting 0.3% y/y growth in the fourth quarter after 0.1% in the third, a slowdown in external demand was the main culprit for low growth while the service sector showed resilience. The local manufacturing PMI fell below 50 in February and March. Looking ahead, the economy may slow ahead of another round of consumption tax hikes later this year. The government has softened the anticipated blow in Q4 2019 by scheduling just a two percentage point sales tax hike and paired it with more spending on health and childcare subsidies. Spring wage talks are a key event in Japan, as unions and businesses set plans, and the outcome in March was for increases of 0.6% y/y in 2019, compared to 0.5% last year. This is progress, but still well shy of sustained increases in inflation-adjusted wages.

China and Emerging Markets

Policymakers took further steps in January to smooth deceleration in economic activity, with a combination of bank reserve ratio cuts, personal income tax cuts, and value added tax (VAT) reduction in manufacturing. Stimulus may amount to about 1% of GDP in 2019 according to local sources - these estimates are particularly opaque in China - helping to ease the slowdown in GDP growth from about 6.6% in 2018 to 6-6.5% in 2019. The "old" stimulus levers of infrastructure investment are less palatable under rising corporate and local government debt burdens. Progress in the trade war with the U.S. has helped sentiment, with local equities edging higher in the first quarter. Asian equity markets pulled back in the fourth quarter with Taiwan and South Korea leading regional losses. Latin America was the only emerging market region with a slight gain due to strong performance in Brazil.

Investment Perspective

The U.S. expansion will be ten years old this summer and become the longest on record. The recovery has also been one of the mildest with 2.2% annual growth. Economists believe it will reach this milestone since employers continue to hire and households – buoyed by bigger paychecks – continue to spend although at a slower rate in the first quarter. GDP for all of 2018 was 2.9%, but growth peaked in the second quarter of 2018 at 4.2% and has been declining since. The revised 4th quarter GDP fell from 2.6% to 2.2% with the consumer looking softer at each revision. Even with tax cuts and increased government spending, GDP growth could not break 3% last year and this year's forecast is for 2% growth although we suspect it could be higher. Citing increasing trade tensions and tariff hikes, tightening financial conditions, and lower world trade, the International Monetary Fund (IMF) cut the outlook for 2019 global growth from 3.7% in October to 3.3% in April.

The rally in the stock market, after the dismal final quarter of 2018, started when the Fed indicated in January that it was done raising rates for the year. This was the opposite of what occurred after the Fed's December meeting as stocks were tumbling and then fell further after the Fed raised rates and signaled even higher rates in 2019. As he reversed course, Chairman Powell cited growing risks of a sharp U.S. slowdown due to cooling growth in Europe and Asia, trade disputes, Brexit, and the potential for more U.S. government shutdowns. Economists believe a large slowdown in China's economy and slower growth in Europe are holding back the U.S., reducing demand for American exports and making companies more reluctant to begin long-term projects. As we have mentioned before, debt and aging demographics are also restraining growth.

The average investor has had a difficult time sticking with equities over the past ten years and who can blame them after the collapse in 2008? Since 2008, there have been a series of events to unsettle investors: the near collapse of the financial system in 2008-2009, the crisis in Greece in 2010 and fears of recession in the U.S., the U.S. downgrade in Treasury debt in 2011, the eurozone on the brink of break up in 2012, Brexit in 2016, global tariffs/trade issues in 2017-present, and multiple Fed rate increases or talk of increases leading to declines of 10-20%. Earnings estimates for the first quarter are at -4.1% lower than a year ago and the first decline since 2016. As we have seen over many quarters, analysts are likely guessing too low, so expect earnings slightly ahead of estimates. Although we still favor equities, valuations have been a concern for years: the current market capitalization of U.S. equities is $40 trillion, twice the level of total GDP, and the highest multiple in history. On the fixed income side, we still like the shorter-end of the yield curve. In equities, we favor areas such industrials, energy, healthcare, and technology. Dividends remain a key component of total return. Although market fluctuations are uncomfortable, we continue to focus on the long-term, investing in businesses with strong fundamentals, attractive valuations, and sustainable business advantages. For now, the markets have reacted positively to the global central bank's pivot to lower rates and this continued monetary support should act as a counterweight to the slowing global economy. As always, we remain vigilant and patient.

March 31, 2019
DJIA: 25,928.68
S&P 500: 2,834.40

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.