Verity
Asset Management

Commentary

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As is common when economic data goes through a period of erosion, there are plenty of individuals and organizations currently jockeying for attention with their forecasts – and with both the U.S. and major international economies having clearly slowed relative to the past year, the percentage of those predicting a recession at various points between late 2019 and the end of 2020 has predictably mushroomed. Some of these forecasts may hit their target – but for perspective, how much of your money would you commit to the accuracy of long-term weather forecasts – and would you consider that an investment or a simple wager?

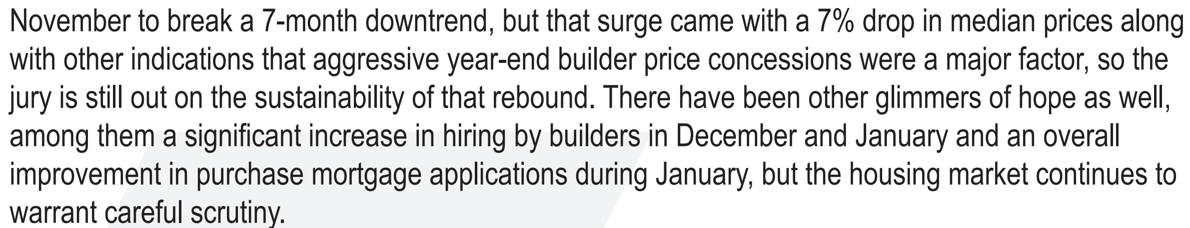
Weather forecasting is actually applied science, yet even so is subject to the effects of even small variations in initial conditions, producing a mathematical level of uncertainty that begins low but increases exponentially over time. Economic forecasting, on the other hand, is not a science, regardless of the quality of the data. The variables used in economic forecasting are not built of particles and forces subject to the "laws" of physics – the pertinent variables include useful economic data, but they also include human emotions and subjective decision making processes, so the very fact that circumstances are evolving will cause players to change their actions, in the process altering the otherwise expected course of events.

The point is that economic conditions are quite dynamic. The bewildering array of variables, a great many of them subjectively changing in reaction to changing conditions, makes ***time-specific*** longer-term forecasts in the economic arena questionable if not comical.

Despite this, in every period a few prognosticators may find themselves having correctly nailed the actual timing with their predictions a couple of times in a row and will be anointed for their "genius". In reality, while some individuals are indeed more insightful than others, even the best are unlikely to reliably forecast with any degree of precision very far in advance.

Rather than speculating about the timing of events somewhere out on the horizon, let's examine some of the current data in an effort to better assess where we are now:

- **Manufacturing** overall slowed significantly through 4th quarter after an otherwise strong year, with new orders falling in December to the lowest levels in many months. But manufacturing production surprisingly strengthened in December, and both the PMI and ISM national manufacturing surveys showed renewed strength in January, including a rebound in new orders. Notably, while export orders continue to slow, they are being offset by an expansion in domestic demand.
- **Services**, which comprise the bulk of the U.S. economy, softened modestly late in the year, but the data across both national surveys for January was steady and solid.
- **Payroll** numbers continue to surge, moving dramatically higher in January, supported by a continuing and significant influx of individuals back into the labor force, pushing the labor participation rate up by a not insignificant ½% over the past 6 months.
- **Housing** was a major weakness in the second half of the year. Sales growth continued to slow, and buyer traffic has been in outright contraction. Existing home sales fell in December to the lowest level in 3 years, and pending sales data for existing homes provide no sign of a lift heading into January. In data delayed by the government shutdown, **new** home sales did stage a sharp 17% rebound in



November to break a 7-month downtrend, but that surge came with a 7% drop in median prices along with other indications that aggressive year-end builder price concessions were a major factor, so the jury is still out on the sustainability of that rebound. There have been other glimmers of hope as well, among them a significant increase in hiring by builders in December and January and an overall improvement in purchase mortgage applications during January, but the housing market continues to warrant careful scrutiny.

Looking across the entire spectrum, the data at present, as was the case in late 2015, can easily be interpreted as an economy downshifting to a lower pace of growth rather than one heading for outright contraction. Both are potential intermediate-term outcomes; only time will tell. Had this been written a couple of weeks earlier, the perception may have tilted a little further toward the contraction argument, but January data has been generally solid, all of which is reflective of how dynamic the data and resulting outlook can be in the present environment. It is simply not productive in this environment to deal in predictions.

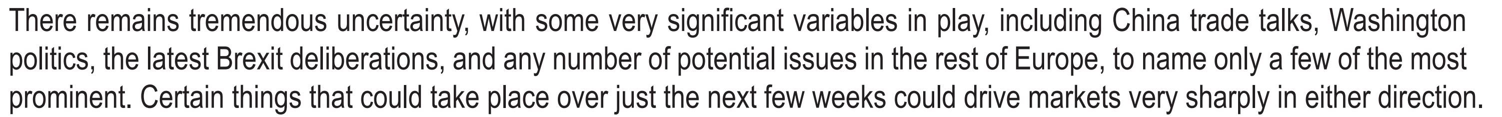
Digging just a bit deeper, it is not a surprise given the slower pace of growth worldwide to observe that the modest inflation pressure appears to be slowing as well. Import and export prices were actually dropping when reported in November, and in December, the Producer Price Index turned negative while the Core Consumer Price Index came in steady, with no acceleration. The national manufacturing surveys by PMI and ISM both show cost inflation easing into January, with similar data from the non-manufacturing surveys mixed. The all-important wage and salary data is still showing some pressure at 3.1% over the past twelve months, but average hourly earnings managed only an anemic 0.1% rise in January.

We raise this point because one of the major factors, if not ***the*** major factor, in the market's sharp 4th quarter decline was fear that the Federal Reserve would continue to raise rates for an indefinite period in its efforts to dampen the inflationary effects of an accelerating economy, potentially squeezing the life out of the economic expansion. But with the economic data having slowed and inflation pressure easing, the Fed has tempered its outlook, reconsidering the pace of rate increases and even the rate at which it may reduce its bloated balance sheet. This pause by the Fed, along with a significant drop in market interest rates since early November, could materially lessen the likelihood of a more precipitous economic slowdown.

From a market perspective, we should bear in mind that we are coming off a year in which the equity markets declined meaningfully despite extraordinary strength in corporate earnings. As a consequence, equity valuations have moderated – for the S&P 500, the forward 12-month price/earnings ratio of 15.7 in early February is materially below the 17.5 to 18.0 range sustained through most of 2017 (data from FactSet).

The larger question at present is how much earnings may weaken moving forward, and, relative to the recent past, there's a lot of pessimism among market participants. Analysts have been progressively downgrading their estimates for 1st quarter earnings and are now projecting an actual decline in earnings for the quarter. Comparisons to the torrid pace of 2018, which factored in the added boost from the corporate tax cut, will be tough.

Of course, the market knows this very well and has been anticipating it for months, so it is legitimate to suggest that the market may have now priced in the slower pace of the economy and corporate earnings. In fact, expectations have moderated to the point that the market is digesting the relative weakness of 4th quarter earnings surprisingly well – as the reports are released, many companies are being rewarded for relatively modest results despite often cautious forward outlooks, a big change from the 3rd quarter earnings season, when even companies beating earnings expectations frequently saw their stock prices punished, and any hint of weakness in a company's forward outlook could deliver devastating market losses.



There remains tremendous uncertainty, with some very significant variables in play, including China trade talks, Washington politics, the latest Brexit deliberations, and any number of potential issues in the rest of Europe, to name only a few of the most prominent. Certain things that could take place over just the next few weeks could drive markets very sharply in either direction.

This is not a time for big, out-of-character directional bets, not for most investors anyway. On the other hand, for those who simply enjoy the thrill of gambling – and can afford the potential consequences – there are a variety of narratives out there one could choose to handicap. One thing is for certain, life in the financial markets is far from boring.

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