VERITY
Asset Management

Commentary

May 2019

**And The Beat Goes On … ?**

Having closely observed financial markets since the early 1980s, including the circumstances that preceded two truly severe market events, we are inclined to be skeptical of dire predictions in the face of underwhelming evidence – and for a large percentage of dire predictions, the evidence, closely examined, proves underwhelming.

Through the last two quarters of 2015, our commentaries rather dispassionately observed that the wave of "impending recession" predictions were – despite a material weakening in the economy - not nearly supported by the *full* body of economic data.

In July 2017, as we read article after article suggesting that the "aging" bull market had to be near its end, we responded that market expansions simply do not expire of old age. While one can peruse plenty of data regarding the historical durations of bull markets, that information is in some ways worse than irrelevant, because it can divert focus from the economic, monetary, and market factors that are legitimately pertinent.

In August 2018, though we have long recognized the U.S. Treasury yield curve as a critical economic indicator, we asserted that alarmed predictions of recession based on the flattening yield curve were at the very least premature for a whole combination of reasons.

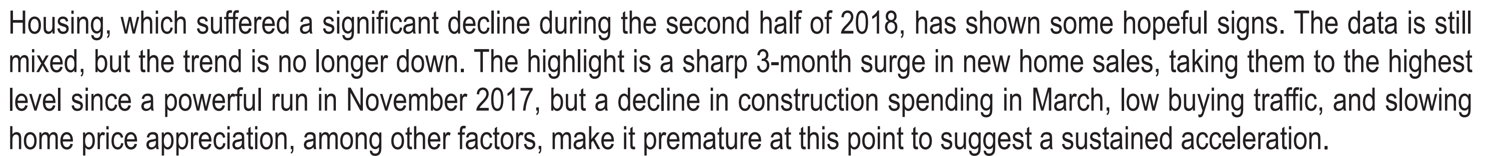
And in January of this year, we figuratively rolled our eyes at renewed forecasts of an impending recession – forecasts based on factors that included the weakening of economic activity, the assumption that the Federal Reserve would relentlessly continue to raise rates, and the observation that the expansion was now ***very*** old. We argued that the full body of economic evidence did not provide support for such a definitive conclusion, and that Fed governors can change their minds. [In fairness, the jury remains out on these latest forecasts – they certainly remain possible, though not, in our view, reliable.]

And the beat goes on - at least for now. Tomorrow, that could change. As always, we squint into a very hazy future, using the available data in an effort to soundly assess our opportunities, our risks, and our apparent trajectory.

While the economy continues to solidly grow, the pace of economic activity year-to-date has clearly slowed relative to much of 2018. The initial report on 1st Quarter GDP growth was very encouraging at 3.2%, but that likely overstates the pace of core economic activity. Net exports were a positive outlier in this report, and a sharp build in inventories that was positive for 1st Quarter may prove to be a drag on future quarters if sluggish consumer demand does not pick up sufficiently to absorb them.

The Services sector of the economy, given its magnitude, is probably the most critical. It continues to grow solidly, but, according to national survey results, at a slowing pace over the first four months of 2019 relative to the levels sustained during most of the past two years.

Manufacturing growth more sharply faltered at year-end after a strong 2018 and has been struggling to find a floor. An acceleration in new orders reported by some regional surveys has been cause for optimism, and the official government data in the March Factory Orders report seemed to support this view. But with headwinds from what the PMI Manufacturing Survey describes as continuing "trade tensions and slowing foreign demand" along with a lack of skilled labor, the rate of growth reported by the two national surveys continues to erode; the ISM Manufacturing Index reported the weakest growth in nearly two years.



Housing, which suffered a significant decline during the second half of 2018, has shown some hopeful signs. The data is still mixed, but the trend is no longer down. The highlight is a sharp 3-month surge in new home sales, taking them to the highest level since a powerful run in November 2017, but a decline in construction spending in March, low buying traffic, and slowing home price appreciation, among other factors, make it premature at this point to suggest a sustained acceleration.

Employment remains very strong, with the unemployment rate down to an expansion low at 3.6% and jobless claims in the week of April 13 falling to 193,000, the lowest total since 1969, when the labor force was half the current size. But even here there are hints that the strength of 2018 may be ebbing a bit:

- Jobless claims rebounded to around 230,000 for three consecutive weeks after that April 13 low.
- Job cuts have been fluctuating in a higher range over the past 6 months, and corporate announcements of cuts planned for the coming months are higher still.
- Consumer surveys show the perception of "jobs-hard-to-get" is rising.

However, with the labor market still quite strong and wages now progressively climbing, the consumer is in pretty good shape. Consumer credit conditions appear relatively strong: revolving credit demand is low, credit scores have reportedly surged, and despite alarmist headlines of "household debt at all-time highs", household debt service payments as a percentage of disposable income are at a 40-year low.

Despite all this, the consumer appears cautious. Spending remains solid but is not accelerating. Retail is doing better coming into the spring after a very weak December which was likely due in part to the government shutdown, but consumer confidence fell sharply during the shutdown and is still working its way back. Buying plans are down in April for everything from vehicles to major appliances and even new homes.

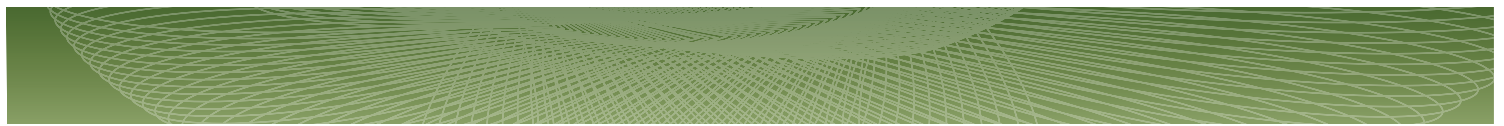
To summarize, the current data is mixed, with not much looking particularly bad but also not much looking particularly exciting. Some segments of the economy seem to be swapping hopeful signs for concerning signs, and then the reverse, almost from month to month.

While the lack of acceleration can be frustrating, there may be silver linings …

- The slowdown in the economy and renewed softness in inflation have led the Federal Reserve to halt for now its progression of rate increases, and market rates have dropped, with positive effects on the mortgage market and other elements of the economy.
- With the consumer spending solidly, but not exuberantly – saving some money and taking a measured approach to revolving debt – there is on the one hand less danger of a sharp decline in consumer spending, and on the other, room for acceleration.
- The moderation in home price appreciation reflects tempered speculative activity and less danger of overheating in certain markets, and less aggressive pricing may create more opportunity for some of the large base of millennials who have postponed entry into home ownership.

… just to name a few.

A very strong argument can be made that this economic expansion has continued for so long at least in part because it has proceeded at a generally slow to modest pace, never accelerating to the point of overheating into the excesses that invariably end in a severe decline. For those who would prefer to push more aggressively on the gas – we all want more, and we want it now – perhaps we should be careful what we wish for.



We have currently entered a period in which corporate earnings growth is down dramatically. Year over year comparisons with the powerful earnings growth of 2018 are tough, and U.S. and global economic conditions are less supportive of growth. With 80% of S&P 500 companies having already reported, it's clear that 1st Quarter earnings will finish somewhere close to break-even. The market, of course, has known for months that something along these lines was coming, and with the Fed backing off its rate increases, has digested it surprisingly well. The question, as always, is where it will go from here. Despite the huge run in the market off the December lows, valuations haven't significantly ballooned, but they will if the market renews its run without renewed growth in earnings.

Given the mixed data and current conditions, meaningfully predicting any sustained near-term change in the current course, up or down, seems at present particularly difficult – not the news desired by those who want to know whether to specifically position for either a strongly rising or falling market. As we write, markets have been falling on news of at least a partial breakdown in the anticipated trade deal between the U.S. and China, but as we have seen, that could all reverse very abruptly.

As always, we seek to differentiate between what seems reasonably knowable and what does not, an approach intended to be more prudent than chasing headline-grabbing forecasts which often reflect more boldness than supportable analysis. Given the scope of what we can currently ascertain, we do not at present see a compelling rationale for material allocation changes.

This material contains forward looking statements; there is no guarantee these outcomes will be achieved. All investing involves risk of loss, and there is no guarantee that strategies which may have been successful in the past will be similarly successful in the future.