Stuck in the Middle?

Little has changed since we last wrote, at the beginning of May. The stock market has moved higher, but not yet beyond the late January peak. The U.S. economy remains strong – unemployment is near record lows, new orders for both services and manufactured goods are robust, and consumer sentiment continues to linger near 14-year highs. Corporate earnings are booming for the second consecutive quarter, reflecting economic strength with an added boost from the corporate tax cut. The one modest shift in overall conditions is a slowing in the pace of growth in both Europe and China, but the impact on the U.S. economy has been of limited significance to date.

Areas of potential concern are also largely the same:

- We're slowly pressing up against a labor ceiling – It has helped that an uncommon number of individuals have decided to re-enter the labor force, expanding the number of available bodies, but the ability of companies to find qualified labor is becoming increasing difficult. If unresolved, this condition presents a significant constraint to the pace of growth moving forward.
- The Federal Reserve is raising rates – This is not necessarily a bad thing, up to a point, but higher rates do inevitably apply economic pressure in a variety of ways, so the impact bears watching.
- Tariff effects are a wild card – The scope of the tariffs actually implemented to date is small, but some industries have begun to experience materials shortages and pricing pressures. With the ultimate magnitude yet to be known, the mere uncertainty appears to be having its own impact on certain business activities, though many companies appear reticent to speak openly of their concerns.

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A snapshot of two important market sectors may help illustrate the potential economic impact:

Home construction has been in a long, relentlessly positive uptrend since the financial crisis, providing one of the foundational underpinnings of the economic advance. But housing has softened recently – housing ***starts*** essentially plateaued the first five months of the year before dropping rather sharply in June (along with new home ***permits***, suggesting that starts may not immediately rebound as is often the case in this somewhat volatile piece of data). New home ***sales*** also dropped in June, despite builder price concessions, and the pace of home ***price appreciation*** – which has been running very solidly at a 6-7% annualized pace - fell to a significantly slower rate for the months of March, April, and May.

- The issues are complex and multi-faceted, but two of the primary factors are (1) a limited supply of new homes – attributed in part to shortages of both labor and materials (including lumber and aluminum), and (2) affordability – with rising mortgage rates exacerbating the existing problem.

Manufacturing, which supplies roughly 10% of GDP, has over the past two years become a renewed source of solid economic growth. Business is accelerating, new orders are rolling in at a strong pace, and inventories will need to move higher to keep up with current demand, suggesting a continuation of near-term production growth.

- But some of the same constraints slowing the pace of new home construction are creating headwinds for manufacturing as well. Survey data reports a growing shortage of qualified manufacturing labor, a severe shortage of delivery drivers, and supply shortages along with rising prices for steel and aluminum.

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These are oversimplified illustrations of a much more complex set of dynamics, but the constraints bear watching. At the same time, it is important to maintain a clear perspective. Headline writers have been known to dramatize the insignificant, and commentators sometimes get ahead of themselves in their eagerness to develop an idea.

As one example related to the issue of rising rates, the flattening of the yield curve has been a popular topic of late, with some implying we could be on the verge of slipping into a recession. [If you are unfamiliar with the yield curve, congratulations, you're not an economics geek. If you would like to skip to the last couple sentences of this paragraph, you will save yourself a dose of boredom.] For those following the yield curve conversation, I would suggest two things: (1) given the economic distortions that were created by the Fed's quantitative easing program, the yield curve may not prove as clear a recession indicator as it has been in the past; and (2) be aware that there are many loose interpretations floating around out there. Cameron Harvey, the finance professor at Duke's Fuqua School of Business who first identified the relationship between an inverted yield curve and economic recessions in his 1986 University of Chicago doctoral dissertation, recently wrote the following: "The media focuses on the 10-year yield minus the 2-year yield. I did not use that in my model. Instead, I used the 5-year yield minus a 90-day Treasury bill yield. This spread is not nearly as small [currently] as between the 10-year and 2-year. Also, there is no evidence a relatively flat yield curve predicts recessions … There is only a prediction of recession when the T-bill yield is greater than the 5-year yield for a full quarter. We are not near that situation."

As always, we're keeping an eye on quite a number of important indicators and potential sources of trouble. Equity markets go down for lots of reasons, but it is recessions that typically hit them hardest. And markets are good at sniffing out impending recessions and reacting well in advance, so we work particularly hard to be attentive to the pertinent conditions. Things sometimes change quickly, but we can at present see no discernable indications of an impending recession.

As for the tariff issue, it is a potentially significant concern, but not one that is easily actionable. Since the tone of the conversation can shift quickly and without warning, investment decisions based on the latest twists must be approached with considerable caution. From a general perspective, some investors may be inclined to take a more conservative stance for the duration of the uncertainty, but the decision should be made with the awareness that, along with the risks, there is potential for sudden and significant market advancement should perceived breakthroughs emerge.

August and September can be periods of considerable market volatility, so the road may become bumpy, whether the general trend turns higher or lower. For now, we continue to maintain a balanced outlook, with recognition of the risks but also clear awareness of the potential for the market to sustain its path higher.

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