STRATEGAS

insight

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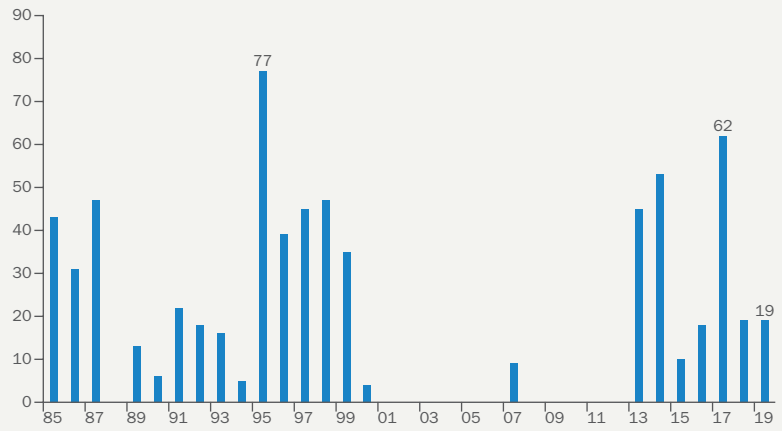
Over the Slump

A little more than a year ago, the market was racing through Q32018, seemingly without a care in the world. In fact, the S&P 500 Index closed the quarter a few notches off its September 20 all-time high (the 19th of 2018). Then it all fell apart. Very quickly, the prospects of policy overreach became an acute concern. Remember? Persistently hawkish comments from Jay Powell, Chair of the Federal Reserve (the Fed), President Trump's increasingly antagonistic cadence of rhetoric on trade relations with China, and a complete lack of agreement between the Administration and Congressional Democrats on border security and the debt ceiling sucked the oxygen out of the room. Not surprisingly, business operators pulled in the reigns and investors hit the 'sell' button. A year ago, as the bottom fell out of the market, investors would have been hard-pressed to find many market participants standing firm in the pocket with a positive outlook for 2019. Yet, here we are. Ten plus months in, it is not the most robust of years when seen through the lens of the various and sundry economic aggregates—but far from the worst. Frankly, it has shaken out as a typical period of late : a late-cycle transition from an accelerating expansion to a slowing expansion phase. Against this backdrop, however, the equity market has been relatively robust. The Dow Jones Industrial Average (DJIA), the laggard among the "big three," is up 18.7% on the year, the S&P 500 Index is up 23.3%, and the Nasdaq is up nearly 28%. Classic wall of worry. In fact, as of November 12, 2019, the S&P 500 Index has just scored a new all-time high (coincidently, the 19th of 2019). So, what of the year ahead? Can the market climb higher still?

Number of New S&P 500 Closing Highs Per Year



Source: Strategas

At a high level, we do not see recession as the base case. Strategas's chief economist, Don Rissmiller, lamps the odds of a contraction in the US economy at 30% over the next eighteen months. He and his team are keeping an eye on six business cycle markers to gauge whether the recent fatigue (Q22019-Q32019) in the US economy slides into a soft landing or accelerates into a hard-landing scenario. These are : 1) the pace of US non-farm payroll growth; 2) labor's increased share of GDP; 3) rising average hourly earnings; 4) the re-steepening of the yield curve; 5) sluggish consumer confidence; and 6) the recent peak (August 2019) in the Purchasing Managers Index. Despite investors' increased attention to these and other sluggish data, in Q32019, none appear to be flashing more than an early cautionary signal. Although the current quarter and early months of next year already appear to be on firmer footing than the quarters just past, it is always worth staying close to the data. Stay alert.

More granularly, although the list of things for business operators and investors to worry about is not short, an improved outlook for the two primary headwinds has undoubtedly helped. The Fed's midcycle "adjustment," coupled with deescalating tensions and (ostensibly) progress toward resolving our trade dispute with China, has buttressed investors' confidence in the outlook for next year. (We have noticed even the Fed's own model for predicting recession over "the next twelve months" has fallen to 29% from a recent high of 34%.) The US cannot continue to rely solely on the consumer, however. Business spending must increase for the economy to accelerate through calendar year 2020 . For that to happen, it will be critical for the US and China to reach an accord. It seems that now is the time to get a "phase one" deal done, if investors are to remain bullish on the prospects for next year .

As our policy research guru Dan Clifton reminds us, one of the best predictors of presidential election outcomes is the state of the economy in the second quarter of an election year. Another—going nine for nine since 1984, and with 87% accuracy since 1928—is the S&P 500 Index's performance in the three months preceding election day . If the Index is up, the incumbent returns for another term; down, and the opposition candidate comes to office. From the President's perspective, the best way to get the market up in the three months prior to election day is to ensure the economy is strong in Q22020. Previous administrations knew, and appreciated, this dynamic. Rest assured, the current Administration knows it too. Love him or hate him (and few seem to be in between), the President is going for growth ahead of his reelection bid next year. Despite the President's public statements, which suggest China is paying the tariffs directly, the Administration is aware of the toll they are taking on US business confidence and the bottom line. Although the Administration can be applauded for dealing with the long-term misalignment of incentives in our economic relationship with China (and other countries), a scaled-back approach could support renewed business investment stateside. We remain optimistic that a phase one deal gets done in the intermediate term.

The bond market appears to be signaling a near 100% probability of (at least) a watered-down trade deal getting done by year end, and an improved growth outlook would likely result in an uptick in yields. That said, we do not expect a sharp reversal higher. Longer-dated notes and bonds (five-plus years) looked capped in the 2.10% to 2.25% range, given the structural damage that has been done to the US economy. Until the tenets of a trade deal are revealed, it is difficult to forecast how quickly this damage can be repaired. We expect the curve to remain flat, with the term premium stuck near zero for more convex parts of the yield curve. We are not being paid for duration. It is worth noting that just once since 1979—during the Fed's midcycle "adjustments" in the mid-1990s—have 10-year Treasury yields breached the peak in the federal funds rate from the prior cycle. Today, that peak is 2.50% after the Fed's tightening earlier this year. Before the economy shows evidence of structural improvement, however manifest, it is difficult to see the long end of the curve trade beyond 2.25% to 2.50%.

Looking abroad, the global economy appears to be putting in a bottom to its recent weak patch, and the US is making progress toward this end. As we wrote last month, greater clarity on both the trade and monetary policy fronts would compel us to shift our size, style, and geographic bias over the coming months. Against classic late-cycle, slowing expansion dynamics, we would begin to shade our equity exposure down cap, in favor of small and mid cap operators, and give preference to value over growth and international over domestic.

About Strategas

Strategas is a global institutional brokerage and advisory firm. The Firm provides macro research, capital market and corporate advisory services, and investment management solutions to institutional investors and corporate executives in more than twenty countries around the world.

Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **Gross Domestic Product (GDP)** rate is a measurement of the output of goods and services produced by labor and property located in the United States. **Real Gross Domestic Product (GDP)** is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. **Nominal Gross Domestic Product** is gross domestic product (GDP) evaluated at current market prices. The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The **Russell 1000 Index** is a market capitalization weighted benchmark index made up of the 1000 largest U.S. companies in the Russell 3000 Index. The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **PCE (Personal Consumption Expenditure) Index** of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The **Producer Price Index (PPI)** program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. **FAANG** is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The **North American Free Trade Agreement (NAFTA)** is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The **Seasonally Adjusted Annual Rate (SAAR)** is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The **Atlanta Fed GDPNow** forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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