SMITH AFFILIATED CAPITAL

SECOND QUARTER 2019 INVESTMENT COMMENTARY

As Recession Bias Gains, Fed Goes to the Sidelines

In this Issue:

- **The Fed's Hot Seat**
- **Forecast Mismatch**
- **Shrinking Labor Force**
- **Slow Growth New Normal**

The headline performance of the economy in 2018 combined with the outcome of the Mueller investigation gave President Trump a double-dose of good news in the early months of the year. But while the elation over being vindicated of collusion will likely linger for a while, the president's spirits over economic developments is decelerating. Indeed, last year's robust 3.0 percent growth rate is already becoming a fading memory, as the year ended on a downbeat note and the economy is coming out of the starting gate this year on shaky legs.

After hitting 4.3 percent in the second quarter of 2018, the annual growth rate in real GDP slipped to 3.4 percent in the third quarter and to 2.2 percent in the fourth, which was revised down from a previous estimate of 2.6 percent. The final month of the year was particularly brutal, as numerous headwinds battered activity, including the start to a 35-day partial government shutdown, a deepening stock market rout that wiped out nearly $4 trillion of household wealth, and lingering anxiety over trade tensions. Both the Fed and the markets were blindsided by a disastrous plunge in retail sales in December, thwarting widespread perceptions that a festive holiday shopping season was all but certain.

With the final quarter showing considerably less strength than in previous estimates, the handoff to the new year was even weaker than thought. Hence, the economy started 2019 in a deeper hole than expected even as the uphill climb is proving to be exceptionally arduous. Figures for the first two months of the year are mostly coming in weaker than expected, tracking a first-quarter growth rate of less than 1 percent, which is perilously close to stall speed. Not surprisingly, recession fears are gaining traction and calls for the Fed to rescind its December rate hike are growing louder, particularly from the administration. The bond market is already pricing in a 70 percent chance for a rate reduction, not only because of the ever weakening economy but because deflationary forces have become more firmly entrenched.

The Fed's Hot Seat

Welcome to the new Fed 'normal'**.** In another remarkable dovish pivot, the Fed completed its sharp policy U-turn started in January by delivering an even more "patient" outlook than anticipated at the conclusion of its FOMC policy meeting held on March 19-20. The magnitude of the paradigm shift is striking. Just three months after the Fed estimated that two hikes would be appropriate in 2019, it is now forecasting no rate hike this year. Even if the Fed retains a slight tightening bias in 2020 – with one rate hike still expected –the dot plot 'capitulation' shows that policymakers believe we have reached the end of the tightening cycle. In addition, the Fed announced its plan to stop the unwinding of the balance sheet by September of this year, leaving its size around $3.5 trillion – more than $2.5 trillion above its pre-recession level.

The Fed's promise of indefinite patience along with weak manufacturing data in Germany and lingering trade policy uncertainty led to the first inversion in the 10-year/3-month yield curve since the Great Recession in late March. While the inversion partly reflects markets' pricing in the Fed's less rosy outlook, the deteriorating external backdrop is having a crucial impact. Inflation readings around the world have been drifting lower and continue to surprise on the downside, as illustrated by the decline in the Citi global inflation surprise index to its lowest level since the spring of 2016. Nor are recent European economic data offering much comfort, as the contracting German manufacturing PMIs starkly illustrates that the European industrial sector is having a hard time getting back on its feet. Although the yield curve turned positive again on April 1, its recession signal cannot be discarded. We currently do not foresee a US recession on the near-term horizon, but we note the increased risk that extreme Fed dovishness and the emerging recession bias could lead to a self-fulfilling prophecy. A look at what happened after the end of the four prior Fed tightening cycles does show that a recession typically followed within the next 18 months. The only time it did not happen was in the mid-1990s, when the economy experienced a rare soft landing.

The yield curve inversion and its recession signal raise another concern: the Fed's policy arsenal is still largely depleted. The balance sheet remains historically inflated, the fed funds rate historically low, and the credibility of the Fed's 2% inflation target has eroded. Indeed, for much of the expansion, inflation has fallen short of the Fed's 2% target and actually fell further behind in January, as the personal consumption deflator clocked in at 1.4 percent. In fact, Chairman Powell underscored in the latest post-meeting press conference that the biggest challenge facing the Fed is the persistently below-target pace of inflation since it eventually restricts the degree of easing the Fed can enact in the next downturn.

Forecast Mismatch

In its latest economic projections released with the new budget for fiscal year 2020, the administration expects the economy to at least match last year's stellar performance, pegging a growth rate of about 3.0 percent over the next five years and even stronger both this year and next. Most economists, however, scoff at that rosy outlook, noting that the economy just doesn't have the structural capacity to meet that speed limit. Both the Federal Reserve and the Congressional Budget Office expect growth this year to wind up closer to 2 percent than 3 percent and stay there over the next five years.

We concur with that more modest outlook, which would be consistent with the downshifting in the economy's growth potential. Over the ten previous postwar expansions, the economy grew on average 5.0 percent a year. But the average pace slowed over the last three upturns – to 3.6 percent in the 1990s and to 2.8 percent during 2001-2007 expansion; the current upturn, set to become the longest on record, has also been the weakest in the postwar era, averaging a 2.2 percent growth rate over its nearly 10-year span. No doubt, the Great Recession's broad and devastating impact had lingering effects that contributed to the current expansion's weak performance relative to the earlier ones. But those effects dissipated years ago, as unemployment steadily fell, the financial system returned to health, corporate profits roared ahead and the astonishing rally in stock prices and housing values restored household wealth. By the start of 2015, consumer confidence had returned to prerecession levels and has since continued to climb. Yet, after spiking to above 4 percent in the second quarter of 2018, the economy's growth rate as noted earlier receded to 3.4 percent and 2.2 percent over the succeeding two quarters and is on track to slow considerably further in the first quarter of this year.

The administration, of course, is undaunted by the slowing trend and believes that the economy can sustain the 3.0 percent growth rate established in 2018 over the foreseeable future. Unfortunately, the assumptions in the budget document provide few specifics on how that goal would be achieved. The only explanation given for the administration's above-consensus economic forecast is that it assumes the policies put in place and the proposals made in the budget will lift the long-run output potential of the economy. It goes on to say that "…other forecasters are unlikely to be operating under the same assumptions." More than likely, those policies, particularly the Tax Cut and Jobs Act enacted in late 2017 and the budget-spending bill passed in early 2018 provided a temporary sugar high that juiced the economy's growth rate in 2018. It is hard to see how the proposals in the new budget, which includes nondefense spending cuts, would sustain that improvement or increase the output potential of the U.S. economy.

Shrinking Labor Force

Keep in mind that the reasons underpinning the nation's lowered growth potential are not easily reversible. For one, the population is aging and spurring an ever-rising tide of retiring baby boomers, which is restraining labor force growth. True, older workers are staying on the job longer than in earlier decades, but that is only slowing the inevitable decline in the labor force participation rate not reversing it.

From 1949 through the 1980s, the labor force increased by an annual rate of just under 2.0 percent, a period that included seven recessions. Growth slowed to 1.2 percent in the 1990s and to 0.8 percent since the turn of the century. The Labor Department expects the labor force to continue slowing — to a 0.6 percent growth rate through 2026. Simply put, the slower growth in the labor force alone has sliced the economy's potential growth rate by more than a full percentage point compared to earlier decades.

That, in turn, largely explains why the majority of economists believe 2.0 percent growth is the "new normal" for the U.S. economy. To be sure, stronger productivity growth could offset the slowdown in the labor force. But productivity growth has declined significantly in recent decades, and it is unclear if or how it can return to its earlier pace. With the labor force growing around 0.5 percent a year and productivity at 1.5 percent, the administration would have to provide more compelling evidence than it has that the economy can sustain growth above 2.0 percent. The politically charged notion that the tax cuts of 2017 would validate the increased output potential advocated by supply-side economists is just not happening. Despite the cash flow windfall accorded corporations, a sustained boost to capital spending has yet to occur, as the bulk of the funds went to share buybacks, dividend payments and M&A activity.

But even those recipients are about to see a reduced inflow of funds going forward, as the benefits from the tax cuts are fading and rising costs are eating into bottom lines. Along with the slowing economic momentum depicted in the fourth-quarter's GDP data, corporate profits fell for the first time in a year and market analysts have been marking down first-quarter earnings prospects, which will start trickling in over the coming weeks. In addition to the profits squeeze coming from domestic supply and demand influences, the administration's protectionist measures that have kept higher tariffs on the books are taking an increasing toll on corporate earnings. Those measures may become more of a drag if ongoing negotiations with China collapse and higher tariffs on auto imports are put in place.

Slow Growth New Normal

If, as we expect, the Fed's December rate hike was the last for the current cycle, the endgame for the federal funds rate would be considerably below the peak rates seen in every other postwar expansion. Indeed, the median funds rate at 2.40 percent would pale in comparison to the 9.1 percent average peak seen over the previous eight business cycles. To be sure, the disparity over those previous Fed-tightening episodes is extremely wide, ranging from 20 percent peak funds rate in the early 1980s to 3.5 percent in the 1950s. The common variable driving the wedge between the two extremes is inflation, which hurtled towards runaway territory in the late 1970s and was relatively tame in the 1950s and early 1960s. The trend since the 1980 peak is the mirror image of the trend leading up to that peak, as deflationary forces replaced the upsurge in inflation and inflation expectations that characterized the period from the mid-60s to the early 1980s.

But the recent decline in bond yields is not just an inflation story in the U..S. Global growth concerns, which have been simmering for months, may be reaching a boiling point, as manufacturing activity in Europe plunged in March, signaling a soft end to the first quarter. That follows tepid growth over the second half of 2018, when the region's growth powerhouse, Germany, barely escaped a recession.

The global growth slowdown – together with the chaotic Brexit process – is sending yields on sovereign debt tumbling, with rates on German bunds falling into negative territory. Capital goes to where the better risk-adjusted yields are, and the U.S., even with its grimmer outlook, is still an attractive destination for foreign funds, underpinning the strong demand for U.S. Treasuries. We suspect that the global economic and inflation landscape will continue to favor the safety and liquidity provided by high quality securities in the U.S.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	3/31/2018	12/31/2018	3/31/2019	Last Quarter	Last Year
6-Mo. Bill	1.92	2.48	2.44	0.66	2.27
2-Yr. Note	2.27	2.50	2.29	0.97	2.56
5-Yr. Note	2.57	2.51	2.23	1.86	4.37
10-Yr. Note	2.74	2.69	2.41	3.08	5.60
30-Yr. Note	2.97	3.02	2.82	4.98	6.26

Municipal Bonds	Yields (%)			Total Return (%)	
	3/31/2018	12/31/2018	3/31/2019	Last Quarter	Last Year
Barclays GO Bond Index	2.59	2.54	2.19	2.78	5.41
Barclays State GO Bond Index	2.54	2.46	2.13	2.58	5.32
Barclays Local GO Bond Index	2.64	2.62	2.25	2.99	5.49
Barclays Revenue Bond Index	2.81	2.81	2.43	3.07	5.57

Equities	Levels			US $ Terms (%)	
	3/31/2018	12/31/2018	3/31/2019	Last Quarter	Last Year
S&P 500	2640.87	2506.85	2834.4	13.65	9.48
DJIA	24103.11	23327.46	25928.68	11.81	10.03
NIKKEI (Tokyo)	21454.3	20014.77	21205.81	6.46	-3.39

Commodities	US $			Percent Change (%)	
	3/31/2018	12/31/2018	3/31/2019	Last Quarter	Last Year
COMEX Gold Active Monthly	1322.8	1281.3	1293	0.91	-2.25
CRB Future Com. Pr. Index*	195.364	169.8018	183.7511	8.22	-5.94
West Texas Intermediate Crude ($ per bbl.)	64.94	45.41	60.14	32.44	-7.39

Currencies	Levels			Percent Change (%)	
	3/31/2018	12/31/2018	3/31/2019	Last Quarter	Last Year
Yen	106.28	109.69	110.86	-1.07	-4.31
Sterling	1.4015	1.2754	1.3035	2.20	-6.99
Euro	1.2324	1.1467	1.1218	-2.17	-8.97

Global Bond Markets**	Levels			US Dollar Terms (%)	
	3/31/2018	12/31/2018	3/31/2019	Last Quarter	Last Year
German 10-Yr.Bond	0.34	0.09	-0.21	2.65	5.46
Japanese 10-Yr.+ Bond	-0.01	-0.08	-0.16	0.78	1.60
UK 10-Yr.+ Bond	1.30	1.17	0.91	2.35	5.07
Emerging Market (USD)	5.02	6.05	5.32	5.43	4.38

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices