March 4th, 2019

Soft or hard landing, that's the question…

During times of heightened uncertainty and diverging indicators, I always attempt to ground my thoughts by trying to simplify the complex. The complex in this equation is the capital markets and global economy, where each are sending two very different messages. Take for example the latest J.P. Morgan Global Manufacturing PMI which fell to its lowest level in 32 months at 50.6 in February. Now to be fair, a reading above 50 still indicates that global manufacturing activity is expanding (albeit modestly), but when you look at the subcomponents – only output prices showed an increase from January to February.

Global Manufacturing PMI™ Summary

50 = no change on prior month.

Index	Jan.	Feb.	+/–	Summary
Global PMI	50.8	50.6	–	Rising, slower rate
Output	50.8	50.7	–	Rising, slower rate
New Orders	50.1	50.1	=	Rising, same rate
New Exports	49.4	49.1	–	Falling, faster rate
Employment	51.1	51.1	=	Rising, same rate
Input Prices	54.1	53.6	–	Rising, slower rate
Output Prices	51.5	52.1	+	Rising, faster rate
Future Output	60.7	59.2	–	Positive, lesser extent

And no one should be surprised by a decelerating growth backdrop out of Europe or Asia as the capital markets have been front-running this outcome since this time last year. China's economy has been weak as a result of a self-imposed objective to de-lever its over indebted shadow banking system, and it wasn't until just recently they decided to abandon that policy and inject massive levels of stimulus to re-inflate their economy. So far, investors have taken the bait and the incoming data has been showing subtle signs of some stability percolating, but given the debt imbalances that have been built up over the last decade, it's still too early to tell whether these actions will have a shelf life beyond a quarter or two. Likewise in Europe, it looks as though Italy may already be in a recession and Germany just managed to skirt its second consecutive quarter of contracting growth in Q4. But even in this region there are faint signs that the data, while still falling, is doing so at a decelerating rate.

Which brings me to the U.S., where it's no longer debatable that the economy is slowing. I know, everyone was pleasantly surprised to see the Q4 GDP print come out last week at

+2.6%, but it wasn't too long ago when a number like this was considered sluggish. Therefore, it's the rate of change over the last several quarters that is relevant and necessary to contextualize the extent of the current slowdown in the U.S. economy:

- Q2 2018 GDP growth: 4.2%
- Q3 2018 GDP growth: 3.4%
- Q4 2018 GDP growth: 2.6%
- Estimates for Q1 2019 GDP growth are +0.3% from the Atlanta Fed and +0.9% from the NY Fed

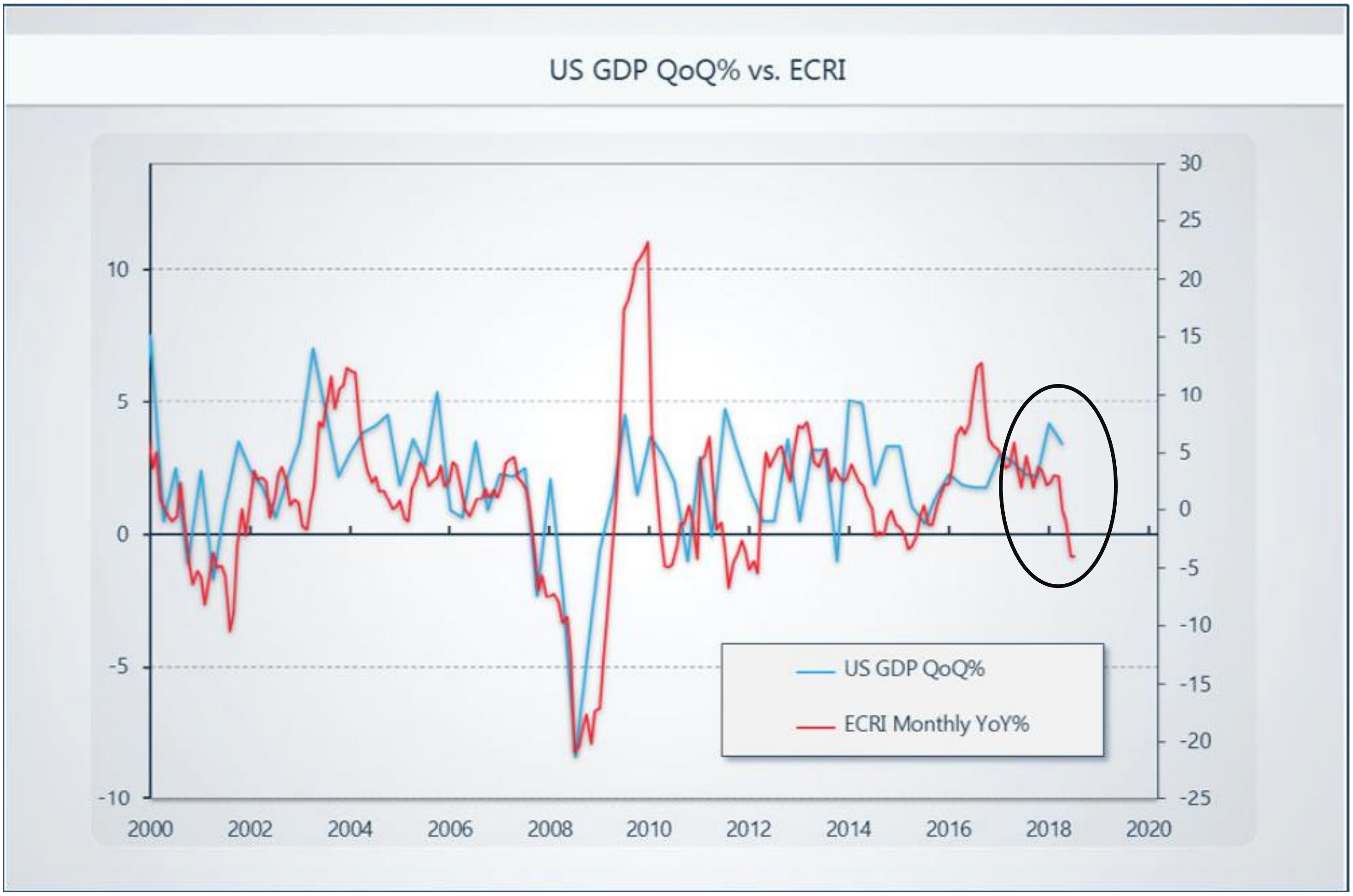
Is that all we're really going to get from the much-ballyhooed deregulation, tax cuts, and elevated government spending, is two quarters of above trend growth and then a reversion back to the 2% muddle-through environment that has persisted for the last eight years? It's still too early to derive a definitive determination, but one thing that is for sure is that we have the increased debt and deficits that need to be financed going forward, and that is going to continue to crowd out private sector uses of capital indefinitely or until growth picks up in a sustained fashion to pay for this fiscal largesse.

Over the last seven weeks, investors have been all too confident to dismiss any negative data point that has come in with the view that this is just another economic soft patch, akin to the ones experienced in late 2015/2016 and before that in 2011. I'll concede the relevance of this view, and it's not an unrealistic expectation given prior experiences in this cycle where anytime one of these episodes has occurred, central banks around the world came to the rescue with some form of monetary easing – be it interest rate cuts, another episode of QE/asset purchases, or some esoteric way to provide additional lending facilities to a troubled segment of the credit market. And that is exactly what Chairman Powell and the Fed have done since the start of the year, where on almost a daily basis there is a Fed official reiterating the patience they will be employing with any future policy moves.

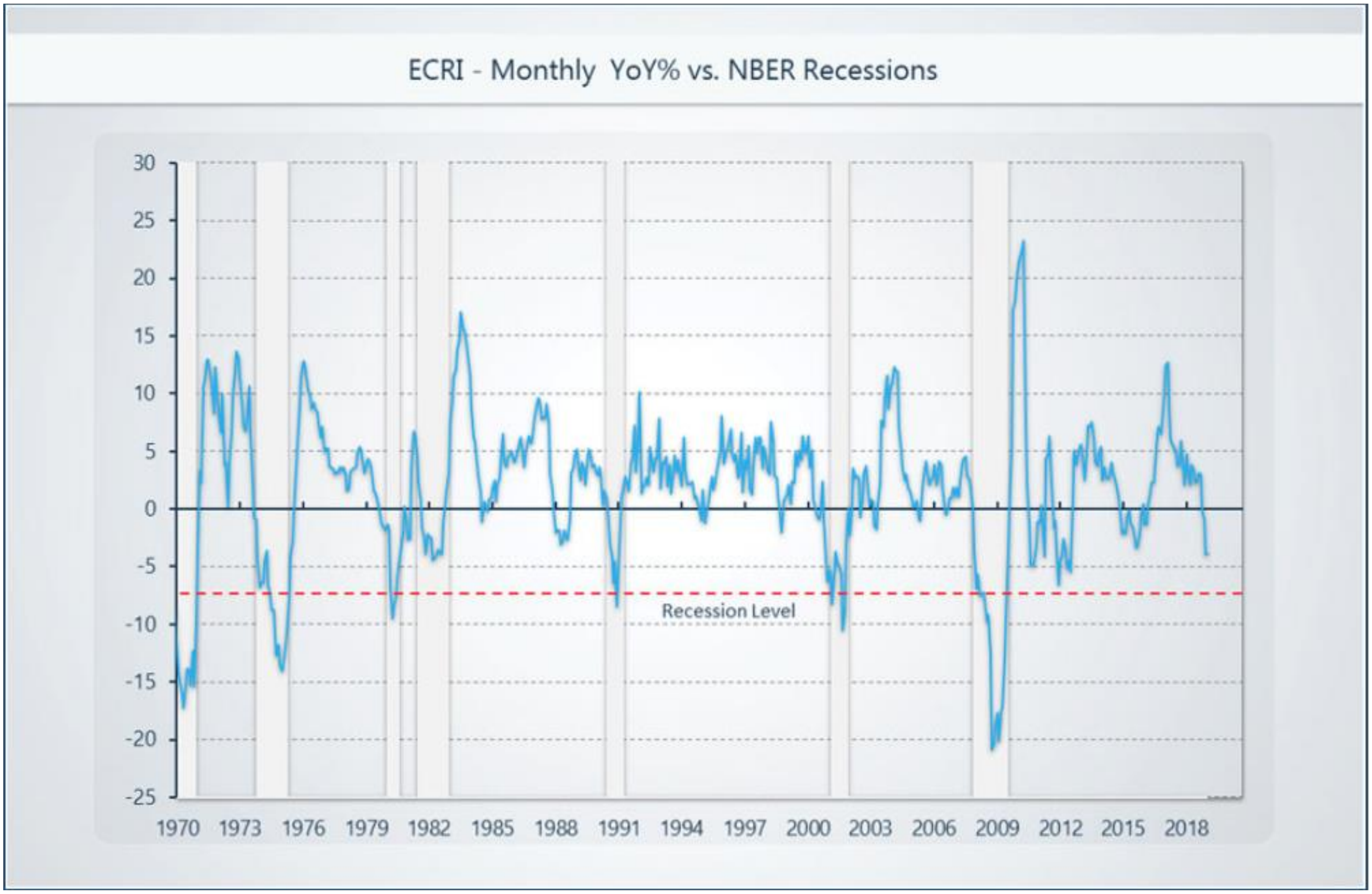
But here is the thing – and this is really why I want to keep this week's missive short and sweet so as to not drown out where we are and where we go from here (I might add it's much easier to pontificate on where we are than on what lies ahead, but I'll give it a go…) – simply stated, we're at a point where the data needs to find its footing in the next several months or I think we'll be talking about an actual recession starting before year-end. Right now, the stock market is looking through the present-day weakness with the view that things will start recovering some time in the second quarter, and once we get into the back-half of the year we'll all be able to look back at this period as being nothing more than another soft landing in this Teflon expansion.

I'll leave you with a couple charts I lifted from Raoul Pal's Macro Insiders piece, overlaying the Economic Cycle Research Institute (ECRI) Index versus other economic variables to see what this index (which has a historically good track record at leading the business cycle) suggests about where we may be heading:

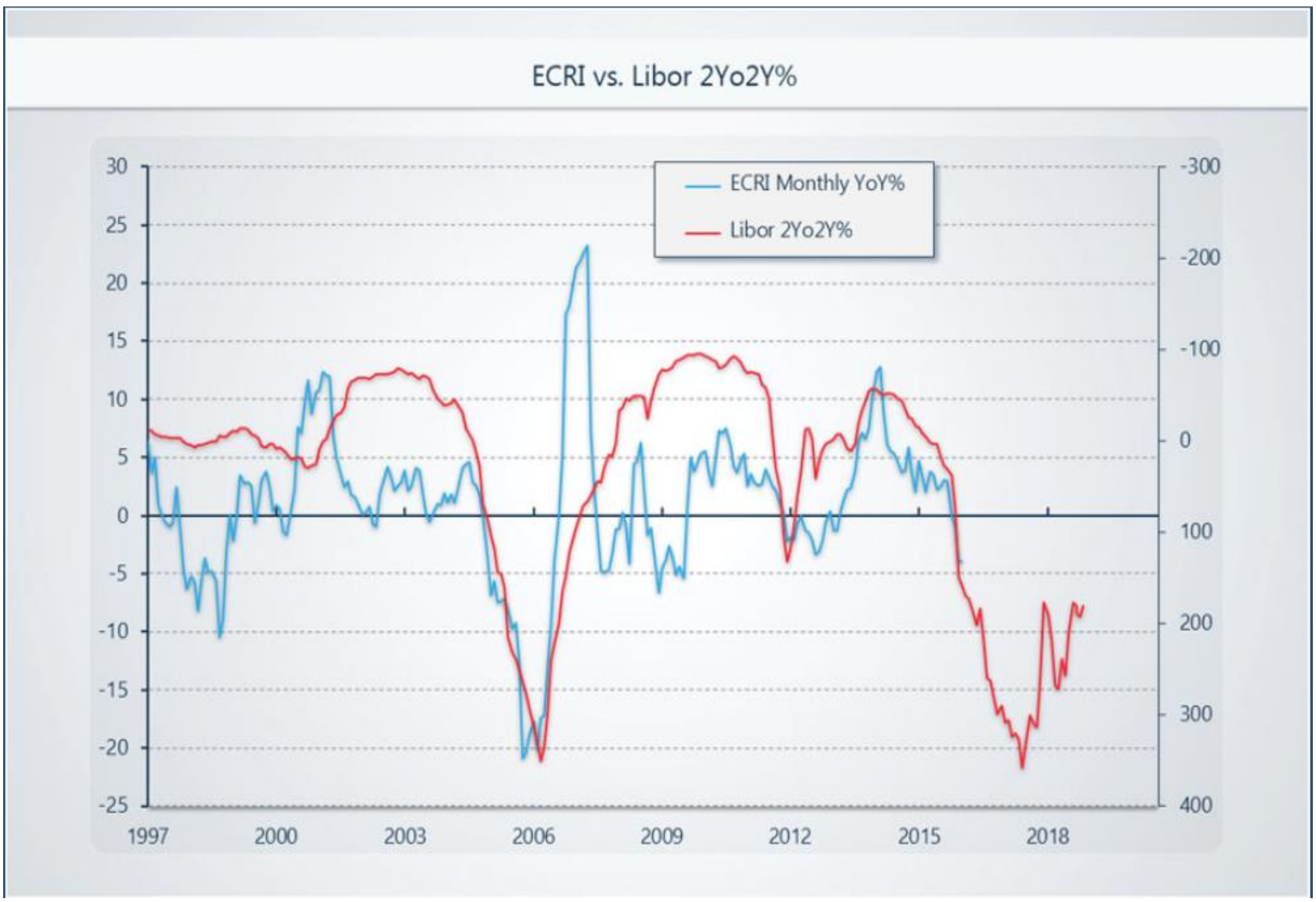
> First up is the ECRI (red line - right axis) vs. the Quarter-over-Quarter % change in GDP (blue line - left axis) which suggests that unless the ECRI inflects higher and in short-order, then it's likely that GDP will slow materially in the quarters ahead.



The next chart is the monthly Year-over-Year % change in the ECRI vs. the National Bureau of Economic Research (NBER) Recession dates. The NBER is the actual committee that dates the start and end dates of a recession – ironically (as they are notoriously late in calling the start of a recession) when they come out and call the start of a recession is usually the time when investors would want to start the process of aggressively accumulating risk assets, as this typically marks close to the point when much of the bad news is priced in and an inflection higher is typically 3-4 months away. Back to the chart, which indicates that the ECRI is now within a few points of signaling a recession. It's not there yet, but in the nearly 50 years of data on this chart there has been only one occurrence where the ECRI was lower than it is at present that did not lead to a recession. Like I said above, it's imperative that incoming economic data over the next several months starts to move higher or recession odds become probable versus 3/2 odds today (40% probability).



This last chart is the one that I think is most insightful in that it incorporates the lagged impacts of the Fed's tightening from last year. The red line is the 2-year Libor rate versus the 2-year percentage change (inverted scale on right axis) – it's a way of measuring the increased cost of lending in the banking system and is an indication of how tight or loose lending conditions are. Once again, this Libor metric is plotted against the ECRI monthly YoY percentage change (left axis) and what it suggests is that lending markets still have a lot of catching up to do with the impact of the last two Fed rate hikes as well as the ongoing roll-off of the Fed's balance sheet.



What I'm trying to get at is the economic data from around the world (and even the corporate earnings data which has been revised lower) is indicative of U.S. economic growth that is tracking between 0 – 1%. For sure, that is not a contraction, but I'll say it again: it increases the risk that the U.S. could experience one should the data not take a turn for the better in the not too distant future. But we also have the stock market and the risky parts of the debt markets that have raced to price out a material slowing in the economy before it's even materialized. It's kind of like when you fail to acknowledge something that is obvious in the hopes that the lack of recognition will make it go away. Sometimes that works, but often times it only makes the issue worse.

One final comment on this soft landing versus hard landing debate, and that is that we were at a similar juncture back in 2011 – 2012 when ECB Chair Mario Draghi came to the rescue with his "whatever it takes" proclamation. Furthermore, none of the central banks were tightening or had tightened policy at that point and the majority of them were in some form of implementing QE. Then again in late-2015/early-2016 we were in another window of vulnerability, where the global economy was rescued by massive stimulus from the Chinese, the ECB increased its QE policy, the BoJ took rates into negative territory, and the Fed went on a prolonged pause in regards to any further interest rate hikes (after having hiked for the first time in December 2015). That period closely parallels what we are seeing today and the response by various central banks is very reminiscent of what occurred back then. So it makes sense that so many investors are making similar inferences this time that it will play out the same way and an extension of the bull market can continue on. It's too early to tell whether this line of thinking will be right or wrong, but one of the most obvious distinctions between today and 2015/2016 is that there has already been a material degree of tightening by the Fed with eight additional rate hikes, the ECB is no longer implementing QE, the BoJ indicated last week that it was going to moderate its QE policies even further, and it's highly improbable the Chinese can even come close to the level of stimulus today that they implemented back in 2015/2016. Lastly, at the end of 2016 we had the surprising result of a GOP sweep in the U.S. election cycle which was then followed by a pro-business agenda (deregulation, tax cuts, and increased fiscal spending). This fiscal impulse is what gave the U.S. economy that nice spurt in the second and third quarter last year, but we are already starting to see the economic benefits fade.

So, while the verdict is still out on whether this will be a soft landing (a pause that refreshes) or a hard landing (recession), one thing I do think is interesting is that despite all the excitement and euphoria of late, the S&P 500 is little changed from where it was 14-months ago. And based on today's action, this marks the fourth time the S&P 500 has been unable to push above and hold the 2800 – 2820 level, and the index is potentially setting up a definitive right shoulder to what might end up being a very prolonged topping process. With the near-term setup riddled with a high level of uncertainty and the stock market priced at levels indicative of an abundance of certainty, I find it difficult to get excited about stocks at present. However, I have been and remain of the view that 2018 began a topping process for the market and should we fail to make new highs before this rally off of the December lows is over, then I think this thesis will be vindicated. The question becomes how much of an opportunity will be afforded to patient investors throughout the balance of 2019 and perhaps even 2020. Me thinks it may be considerable, and as such I expect to be redeploying capital into the equity market in a disciplined, systematic, and also opportunistic fashion over the next 12 – 18 months, not trying to time a bottom, but with the expectation that the grounds will be fertile to snatch up solid long-term investment positions at price levels more favorable than what presently exist.

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