1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

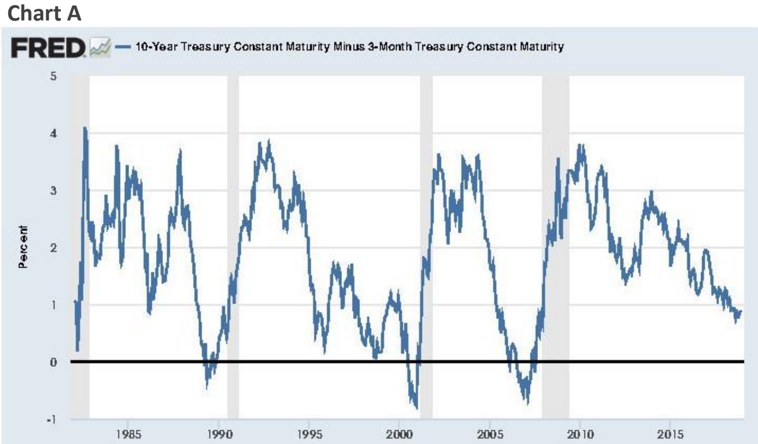
November 19, 2018

Weak Markets, Confusing Economic Signals, and General Political Confusion!

Last week the equity markets continued to show weakness. The Dow Jones lost 2.22%, while the S&P and NASDAQ lost 1.61% and 2.15%, respectively. Economic reports are not dismal by any standards and we think some may be misleading.

There is a lot of concern about the flattening of the yield curve.[1] Market wisdom has it that when the yield curve turns negative (i.e. short rates exceed long rates), it either produces or signals a recession. We agree, but we don't feel we are at that point yet. A quick glance at chart A makes our views clear.

Chart A

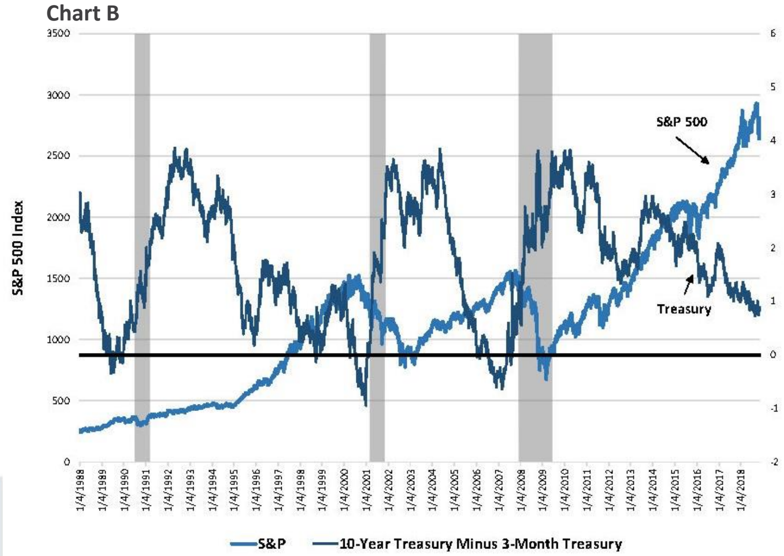


Shaded areas indicate U.S. recessions Source: Federal Reserve Bank of St. Louis myf.red/g/m2E3

Although the number of observations is not huge, it is pretty compelling. Our argument is that even if we are moving toward an inverted yield curve, we are certainly not there yet and it is not out of the question that the spread widens. The stronger case is the spread continues to compress, but that does not signal a bear market is imminent.

There is also the question of timing. We have added chart B that superimposes the S&P over the movement of the yield curve.

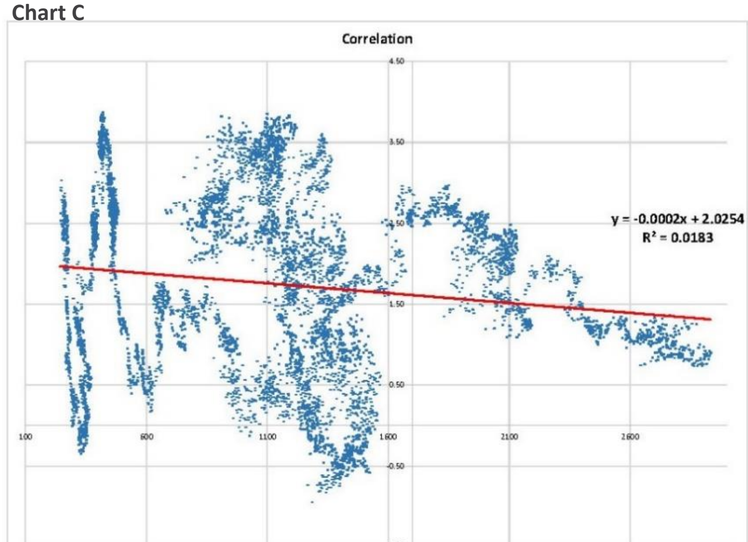
Chart B



Shaded areas indicate U.S. recession Sources: http://www.nber.org; https://fred.stlouisfed.org; FactSet

It seems to us there is a danger in trying to be too cute at this point in timing a market downturn because of a narrowing of the yield curve. We have included Chart C for those familiar with statistics. It is interesting but not necessary for our case

Chart C



Source: 1919 Investment Counsel

[1]The yield curve flattens when short interest rates rise faster than long rates, so the difference between them narrows and eventually inverts.

Weekly Market Insights (cont'd)

Much of the concern revolved around the Federal Reserve continuing to increase short rates. We have long argued that the Fed will continue to raise rates but almost no Fed Chair, with the possible exception of Paul Volcker,[2] wants to force a recession. They may create an inverted yield curve, but they will try to avoid it.

The Wall Street Journal ran a story this weekend about household debt rising dramatically. This is certainly true. But, that statistic must be taken in context. Consumers taking on debt is a sign of consumer confidence. All measures of consumer confidence, such as the Michigan Survey, reinforce this. Having confidence, of course, doesn't mean borrowers can service the debt they acquire. Fortunately, there are statistics that help us make that judgement. One that readily comes to mind is household debt service as a percent of disposable income. That statistic is at a very low level, which argues that consumers are well within their ability to service their debt.

There are three more important points that rightly concern investors and analysts alike: the falling price of oil, trade, and the deficit.

The price of oil has been falling rapidly and the question is why? The easy answer is supply has outstripped demand - welcome to economics 101. Demand change has not been dramatic. Certainly, there has been a movement away from oil to natural gas and renewables. We don't feel, although important, it is significant enough to make a dramatic effect on the price of oil. It is a supply problem, much of which is created by confusion. It began with the Trump administration negating the Iranian agreement. Oil producers and users believed this would create shortages which, of course, did happen. Prices rose and swing producers pumped more oil to fill the gap created by the missing Iranian oil. Then, in a somewhat secretive manner, the Trump administration began to make exceptions to their sanctions. These exceptions took place in a somewhat covert fashion and the exceptions turned out to be large indeed. This put the oil market out of balance with too much supply. Too much supply leads to lower prices. Over time, the market, if left alone, should solve this problem.

Market participants have worried about global trade for quite a while. We have written quite a bit about the issue and we have not changed our view. There is far too much to gain and far too much to lose by allowing this to accelerate. Of course, governments can misjudge their adversaries and this can happen here. That is not the most likely outcome.

The ballooning deficit. That is a problem that will be with us for a long time, no matter what happens. We wrote about the personal tax break and how it will spark a boost in the economy, but in the face of low unemployment and moribund productivity growth, there is no way that economic growth will cover the massive deficits. There is no current plan that is feasible. The prospect is daunting, but there are solutions: increase the labor force by getting older workers back and allowing foreign workers into the workforce, in conjunction with massive investment in both infrastructure and education. There are more, of course. The country must be careful not to fall into the trap of cutting back social services and nondiscretionary spending.

We will spend far more time on this important topic in the future.

[2]Paul Volcker was a special case. He had to subdue high double digit inflation which, in the long run, would be far more damaging than a recession.

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