Weekly Market Insights

May 6, 2019

Continued Economic Strength, Fed Remains on Hold and Democrats Add More Candidates

Equity markets took a bit of a roller coaster ride this past week. After being spooked by Fed Chairman Powell's characterization of the Fed's stand on interest rates relative to GDP, excellent employment and wage growth, and a pickup in productivity, the Dow closed down -0.14%, the S&P 500 +0.30% and the NASDAQ +0.22%.

Although the U.S. economy continues to show remarkable strength, every time an economic release shows a softening of the economy, many investors fear that it signals the end of the current economic expansion. That is understandable. After all, the expansion is near ten years old, one of the longest in history. We hear and read reports that the expansion is getting older and closer to the end. That of course is true; no one can deny it. But economic expansions are not living organisms. They don't just die from old age, so perhaps there is a better way to look for the end.

Economic expansions most often end because imbalances develop, which throws the system off balance and the economy's self-correcting mechanisms can't adjust. The second most common cause is a mistake, most often an aggressive effort on the part of the Federal Reserve, by excessive tightening for fear of runaway inflation. The Fed has been quite cautious with monetary policy. Most analysts argue that the Fed is right on target, not aggressively easing nor tightening. So, at least for the moment, the Fed does not appear to be a danger to economic growth. The other factor, that is powerful enough to make a mistake big enough to throw the economy off base, is the government. An example is, if China and the U.S. actually did have an all-out trade war. One way this may happen is one side thinks it has the upper hand to such a degree that it can dictate the terms or demand last minute changes, and any trust dissolves. This might be enough to start a recession, although it is doubtful that would cause a recession in the U.S. Which leaves us with imbalances.

Imbalances can occur quickly, so vigilance is important. Last week, we wrote about the four factors that make up GDP. They are Consumption + Investment + Government + (Exports – Imports). They are a good place to start. The most important is consumption and there are two good ways to look for imbalances. Two of the best are buried in household balance sheets. The first is household debt to disposable income. It is at the lowest level since at least 2005. The second, related but equally important, is household debt service to disposable income. Again, we see very strong numbers, and it is the lowest since at least 2001. Although these two statistics seem highly related, they send separate signals. The first tells us the Absolute level. The second has grown in importance, because of the popularity of floating rate loans. It indicates the margin of safety if rates escalate. Investment problems most often start with lower quality loans. The St. Louis Fed keeps close tabs on these statistics and although they are approaching levels that concern us, they remain in a reasonable range. Government imbalances are interesting cases. The reason is we have a greater ability to see out into the future than with the other three. Here is where we have real concerns. Government debt is rapidly expanding with no real end in sight. There comes a point where the government is taking so much capital out of the market that it infringes on investment, and either severe tax increases or much higher interest rates are necessary to attract investors. Both lead to a downturn in the economy.

Weekly Market Insights (cont'd)

The last is the international sector, which is the cause of much concern and confusion at the moment. We and most economists do not believe the current trade deficit imperils the U.S. economy. The size of the international sector for the United States is just not big enough to push the country into recession.

We don't think the evidence points to a recession or serious economic slowdown in 2019, nor the first half of 2020.

Excitement is building about the 2020 Democratic primary. It is indeed interesting. The Democrats appear to be taking a page out of the 2016 Republican playbook. The only thing we would address at the moment is the argument that many of the candidates are too *whatever* to win. Don't believe it. The same was said about Reagan, Clinton and many others.

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