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Weekly Market Insights

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A global slowdown – perhaps?

Although U.S. equity markets lost a bit of ground last week, they closed the week on a very strong note. The Dow Industrials fell 0.13 %, the S&P 500 was up 0.16% and the NASDAQ lost 0.10%. The rally of the week's gains were not just due to good news on the trade front, but by solid economic reports.

Few economic forecasters are looking for a recession in the next 18 months, but many are forecasting a global slowdown. Although there is plenty of evidence that an economic slowdown is occurring, there is evidence that the slowdown may not be global. The National Association of Business Economics, of which I am a member, feels a slowdown of economic activity is in progress. The International Monetary Fund's (IMF) latest Global Financial Stability Report argues for a significant global economic slowdown. Although neither suggests a recession is imminent, they do expect a slowdown.

We will first argue the points for a generalized global slowdown and then present the argument that casts doubt on the accuracy of the forecast.

First and foremost is the spector of trade war. The United States vs. China is by far the most obvious, but there is still no real trade agreement between the United States, Canada and Mexico, nor are the lingering trade disputes between the U.S. and the E.U. settled.

The E.U. has not made the same strong recovery that the United States has from the Great Recession of 2008. This weakness in the European Union has led to extraordinarily sharp declines in market yields. The IMF estimates the amount of bonds with negative yields has risen to about $15 trillion. This easy money policy has kept the economy going for some time, but has encouraged risk taking to an unhealthy level.

The low level of interest rates in the developed economies has encouraged investors to take on riskier and relatively illiquid investments. Many of these investments are going to emerging markets. To make matters more worrisome, most of these are loans made in U.S. dollar terms. The danger here is any adverse move by the dollar or home currency makes it very difficult for the borrower to pay the debts. Simply put, many emerging market countries attempt a common arbitrage, borrow an expensive currency and convert to their cheaper currency, which they can then spend. This arbitrage has occurred for ages and has seldom worked.

There are at least three financial risks to the system:

1. Rising corporate debt levels
2. Increasing levels of riskier and more illiquid securities
3. Increased reliance on external borrowing by emerging and frontier market economies.

No amount of Central Bank easing will cure these problems.

Germany

We single out Germany because of its importance to the European Union. Any economic slowdown in Germany is significant due to the size of its economy.

Germany has been the engine of the E.U. If the German economy continues to slow, it spells the advent of a new problem for the E.U.

What can be done?

The E.U. needs a healthy dose of fiscal stimulus. The system is loaded with liquidity and more won't help. Governments must put money directly into the system if they expect to jump-start their economies. Even with Christine Lagarde's impassioned plea to the European Banking Congress, we don't expect any movement toward fiscal stimulus.

Weekly Market Insights (cont'd)

China

We, along with almost everyone else, have written about the slowdown in China. China has serious debt problems, along with an increasing capital flight. Both of these, along with the infamous tariff war, are heavily weighting on China's vaunted economic growth. It seems highly unlikely China will be in a position to pull the world out of an economic slowdown.

Why might the slowdown not be global?

The answer is simple - the United States. Until recently U.S. economic statistics have been signaling a slowdown. To be sure there were positive signs, but it did appear the tariff war was taking its toll. But, as we have written many times, the United States is far less dependent on trade than most countries. Tariffs have certainly taken their toll. Agriculture and manufacturing have suffered badly. Although, the rest of the economy appears to be doing well - very powerful job increases, reasonable wage growth, the lowest unemployment rate in fifty years and an expanding labor force. These are not statistics that lead to an economic slowdown. Are there still questions about the U.S. economy? Sure. As we constantly warn readers, don't be fooled by one or two releases. We don't put great odds on the United States escaping a slowdown, but it is certainly possible. In either case, reacceleration or slowdown, the United States should continue to outperform.

A long term solution

Although we will devote an entire paper to this topic at a later date, it deserves a mention. One of the most important and beneficial steps that should be taken is to modernize the various world organizations. They have served the world very well, but they are hopelessly outdated. A simple example is the World Trade Organization.

They still list China, Hong Kong, South Korea, Russia, Taiwan and Thailand as Emerging Markets. Clearly, these are not Emerging Markets.

Why are these designations important? They are important because they give certain privileges to Emerging Market countries that others don't have. This is but one example, but any one reading the newspapers can name others that need modernizing, such as NATO.

What is needed is a new Bretton Woods convention dedicated to modernizing global organizations.

In our continuing effort to add substance to economic releases, this week we discuss Personal Consumption Expenditures and the Consumer Price Index.

Inflation Measures: Personal Consumption Expenditures Index and the Consumer Price Index

The two central measures of inflation in the United States are the Personal Consumption Expenditures (PCE) Index, released by the Bureau of Economic Analysis (BEA), and the Consumer Price Index (CPI), released by the Bureau of Labor Statistics (BLS). The Consumer Price Index seems to capture the most media attention because of its relation to federal income tax and social security payment adjustments, as well as its use as a reference rate for some financial contracts. One could argue, however, that the PCE Index is more central in the economic policy landscape given its designation as the Federal Reserve's primary inflation gauge. While both indices capture similar measures for the periodic change in prices, differences in data collection and calculation methods have resulted in slight differences between the two over time.

The PCE Index reading is published monthly as part of the BEA's Personal Income and Outlays report. The report uses data acquired from a sample of business surveys; and, as the name suggests, it shows how much income consumers are bringing in and how much they are spending on goods and services. The expenditures portion of this report is based on the prices of goods and services offered by businesses and is used for the calculation of the PCE Index. The BLS also releases its CPI report monthly, but uses data collected from thousands of consumer surveys on the prices paid for a basket of goods and services. Changes in the amount paid for this extensive basket is used to determine changes in the cost of living.

Weekly Market Insights (cont'd)

In general, CPI has stated a higher rate of inflation than that of the PCE Index, reporting an average annual inflation rate 50 basis points greater than that of the PCE over the past century.[1] So, what accounts for this divergence? While both the CPI and PCE use a basket of goods and services to value the cost of living, differences in basket composition result in conflicting inflation measurements. One reason for the basket differences lies in the formula used for each—specifically, CPI is calculated using a Laspeyres formula while PCE uses a Fisher-Ideal formula. We will not delve into the specifics of these methods, but the key takeaway is that the PCE Index more accurately adjusts for changes in consumer preferences. As a result, CPI tends to overstate inflation because it fails to adjust its basket for the substitution effect that occurs when consumers decide to buy more of one good and less of another based on price changes.[2] Another notable reason for the differences in basket composition results from data collection processes for each. While CPI uses survey data based on what consumers are buying, PCE uses data on what businesses are selling. So, CPI excludes some expenditures that are not paid for directly, but are instead paid for by employers or governments.

Both inflation measures are important in their own right, and equal attention should be given to both. Recognize that a reported CPI above expectations may result in higher adjustments to social security payments and wages, while a persistently high PCE reading may influence the Fed to implement more restrictive monetary policy. Rather than concentrate on one inflation measure over the other, pay attention to both while understanding the primary reasons for their differences and their respective impacts on the U.S. economy.

Paul Volcker

Sadly, we report the passing of Paul Volcker. Mr. Volcker represented all that can be great in a public servant. Mr. Volcker will be most admired for taking over as Chairman of the Federal Reserve when inflation and monetary policy were out of control. He was appointed by President Carter to try to stop runaway inflation. This he did. He courageously raised rates to the 20% level. This was not going to make him popular, but he had to do it for the sake of the country. Mr. Volcker spent most of his life as a public servant, mostly at the Federal Reserve. He most certainly had many opportunities to cash in on his brilliance and sterling reputation. He didn't. He remained a true patriot.

He should be held up as an example of what is good in government. He will be sorely missed.

[1]Federal Reserve Bank of Cleveland, "PCE and CPI Inflation: What's the Difference?"
[2]U.S. Bureau of Labor Statistics. "Focus on Prices and Spending."

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