MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

Special Edition

The increase in equity market volatility and sharp decline in stock prices from all-time highs in early October have been stunning and unexpected. Stunning, in that the fourth quarter is shaping up to be the worst such period since 1931 (and the worst quarter of any kind since the financial crisis), and the market is on pace for its worst December ever. And unexpected, in that investors had virtually no historical precedent to suggest such a decline might be coming. In stock market history, a streak of six straight months of gains -- terminating at an all-time high -- had never marked the end of a bull market. There was almost no basis for predicting what subsequently occurred.

Generally, when individual stocks or stock indexes decline in advance of negative developments, we understand after the fact that investors “saw the bad news coming”. But in the current case, there is still very little “bad news” that has emerged that would explain or justify the market’s violent downdraft. It would be understandable if economic data had suddenly deteriorated, or if corporate profits had meaningfully disappointed, or if a confidence-shattering exogenous event had occurred. No such event has transpired.

The core of investor concern is not just an economic slowdown in 2019, which is widely anticipated and perfectly reasonable, but rather a collapse into recession. The distinction is extremely important. Stock market downturns not associated with subsequent recessions historically have resolved themselves with recoveries to new highs. While they may be painful, they are short-lived, and investor patience is rewarded. Such was the case during at least four “growth scares” since the financial crisis, in each of 2010, 2011, 2012 and 2015-16. Recessions are another matter, often pushing stock indexes down to levels that require years from which to recover. Thus, correctly assessing the economic outlook is vital.

The overwhelming majority of the key (and historically reliable) indicators we monitor suggest that the economic expansion remains on track despite its advancing age. In the included charts that follow, we illustrate this fact across a broad range of measures of economic health, including credit conditions, banking sector strength, consumer and corporate well-being, inflation, industrial activity, spending, and employment. Were we to give the economy a “report card”, the student would be passing all their core classes, with no hints of trouble to come.

There are some measures that suggest weakness, but they are in the minority, and they include:

- companies describing overseas problems especially in Europe and China
- some widening of credit spreads
- falling commodity prices
- more pervasive housing sector sluggishness

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There are also new non-economic factors that may have an impact on investor sentiment but that are impossible to assess other than qualitatively. They are all geopolitical in nature, and historically, concerns of this type have <u>never</u> derailed the economy from its underlying trajectory. They include:

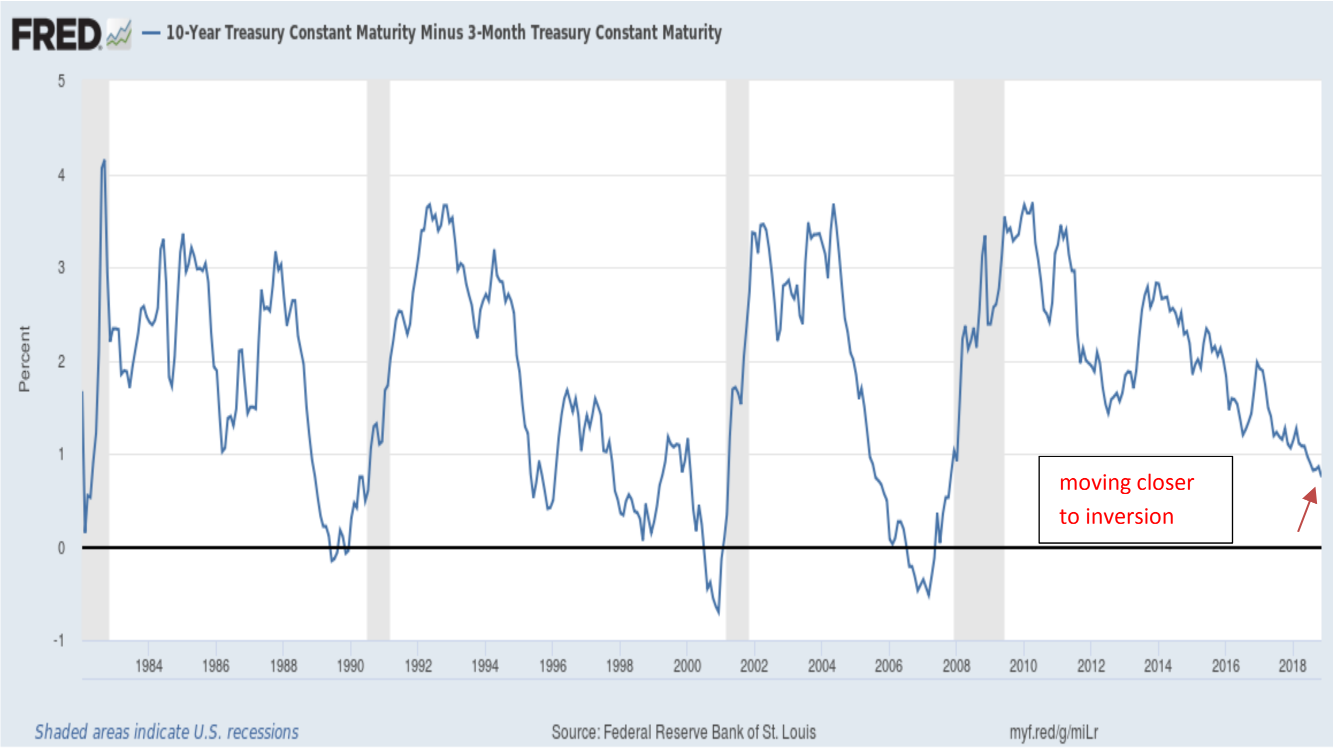
- President Trump's potential legal trouble and how he might respond, given his history of unpredictability
- Lack of policy progress from politically-divided Washington, including possible government shutdowns and difficulty raising the federal debt ceiling
- Trade conflicts potentially expanding to allies like Germany
- Uncertainty about the country's future political direction in a potential post-Trump environment
- Deteriorating national mood and growing distrust of institutions, driven by social media
- Rise of nationalist politics among our major trading and military allies
- More frequent and more damaging cyberattacks on our major companies and national infrastructure

We are flexible enough to know that this time might be different, and of course these issues should be monitored. But if they do not ultimately have measurable economic effects, their impacts on the markets will be temporary.

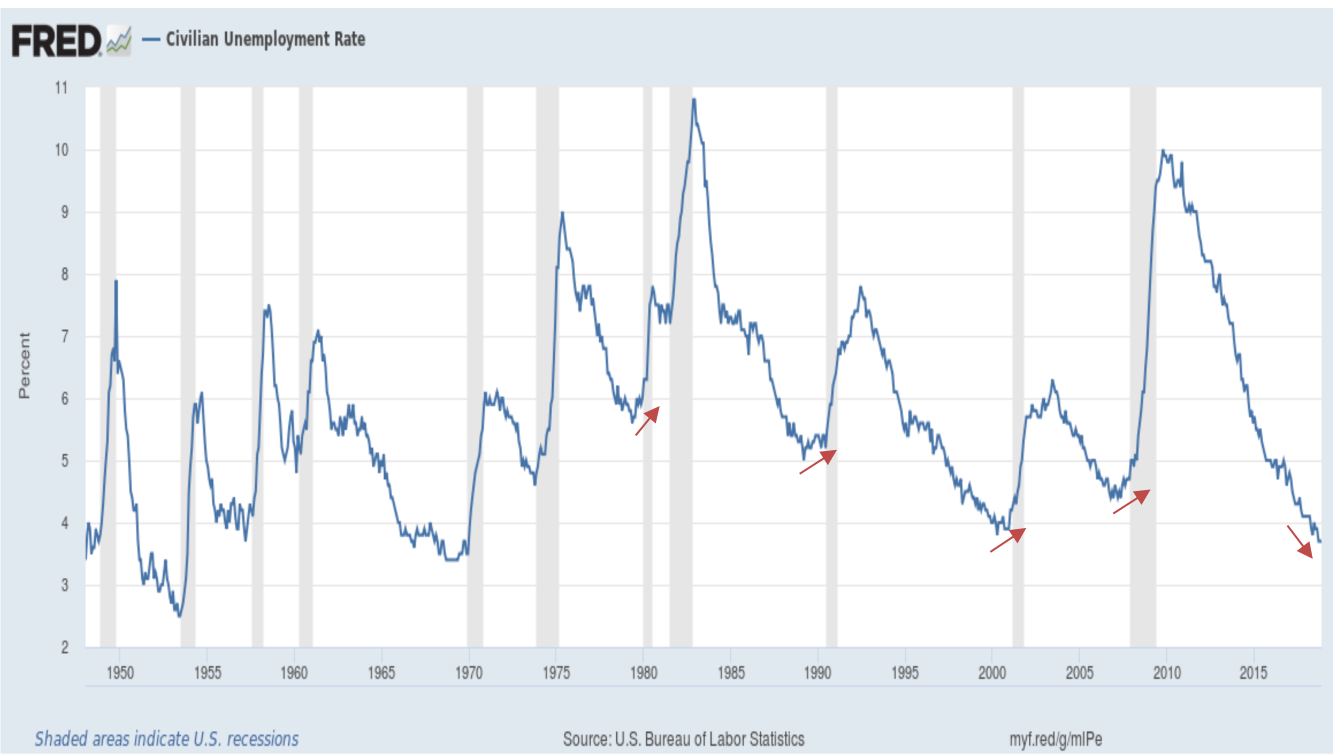
Investors are understandably skittish and do not want to give back significant portions of their hard-won gains over the last decade. At a minimum, even if we have not seen panic selling, we do see something of a "buyers' strike" in progress. We expect volatility to continue in the short term with tax-loss harvesting occurring in what is normally a low-volume trading period around the holidays. But joining in the selling, responding to hints, anecdotes, and narratives, instead of data, strikes us as "seat of the pants" investing. Which isn't really investing.

We are experiencing a growth "panic" and crisis of investor confidence, and we take it seriously. But it bears a remarkable similarity to prior such episodes, including the 15% correction in stock markets in late 2015 and early 2016. This was a very volatile and worrisome period that featured much weaker economic conditions, but no recession – and equity markets were at new highs within a matter of months.

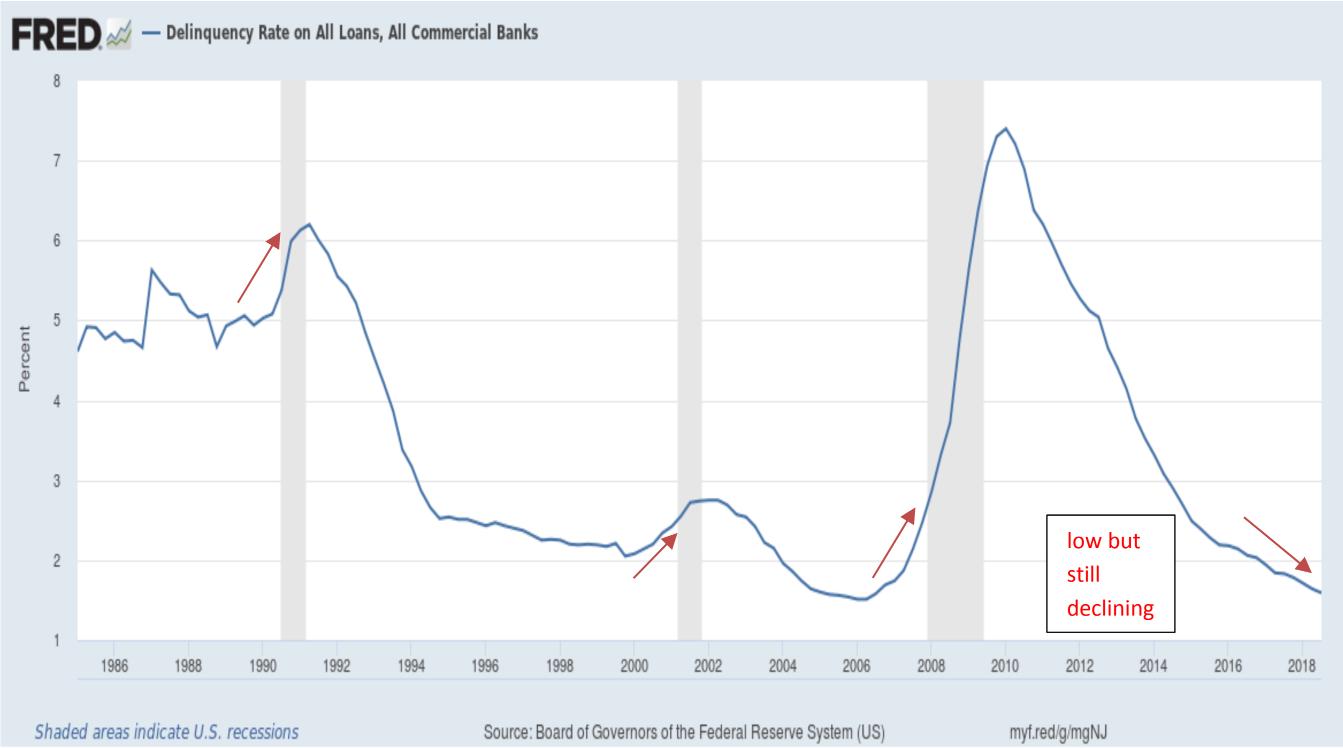
Every correction looks like the start of a bear market, but few of them actually are. We also know that every bear market in stocks started off being a correction. If the data supports a turn to cautiousness, we will do so and make appropriate adjustments in client portfolios. We are not permanently bullish, and understand that the economic cycle has not been outlawed. But with a supportive backdrop for our companies, and now with many growth leaders trading at depressed valuations, we believe the market will find its footing and demonstrate resilience in the days and weeks ahead.



The **slope of the US Treasury yield curve** (the difference between short term and long term interest rates) is one of our most reliable recession early warning signals. When the curve "inverts" – that is, the spread turns negative – it has a flawless track record that goes back decades. But, it has not paid to jump the gun and anticipate an inversion that might not occur. **The curve is close to inverting, but has not yet.**

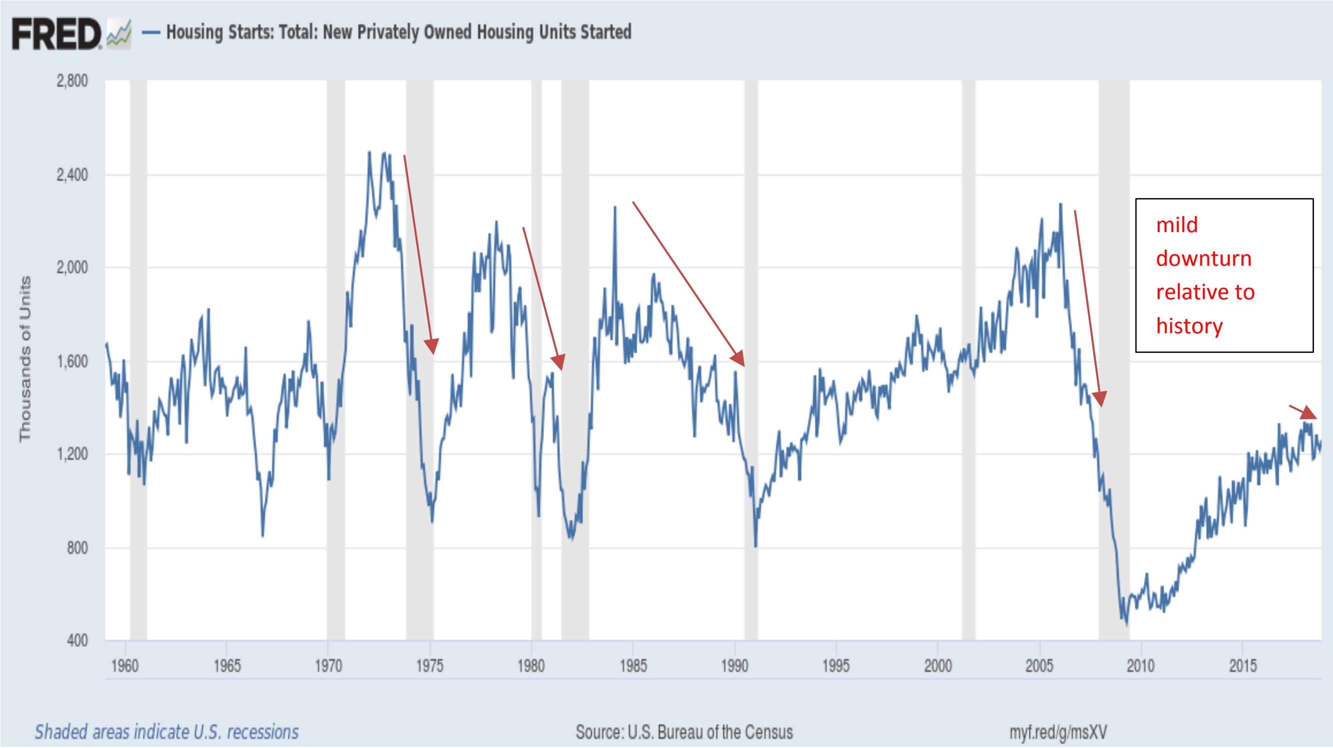


The **unemployment rate** is also a very dependable recession signal and works well with the yield curve because it tends to be a slightly lagging indicator. When the unemployment rate rises above its most recent one-year average, a recession is almost certainly at hand. **The unemployment rate remains in a downtrend.**

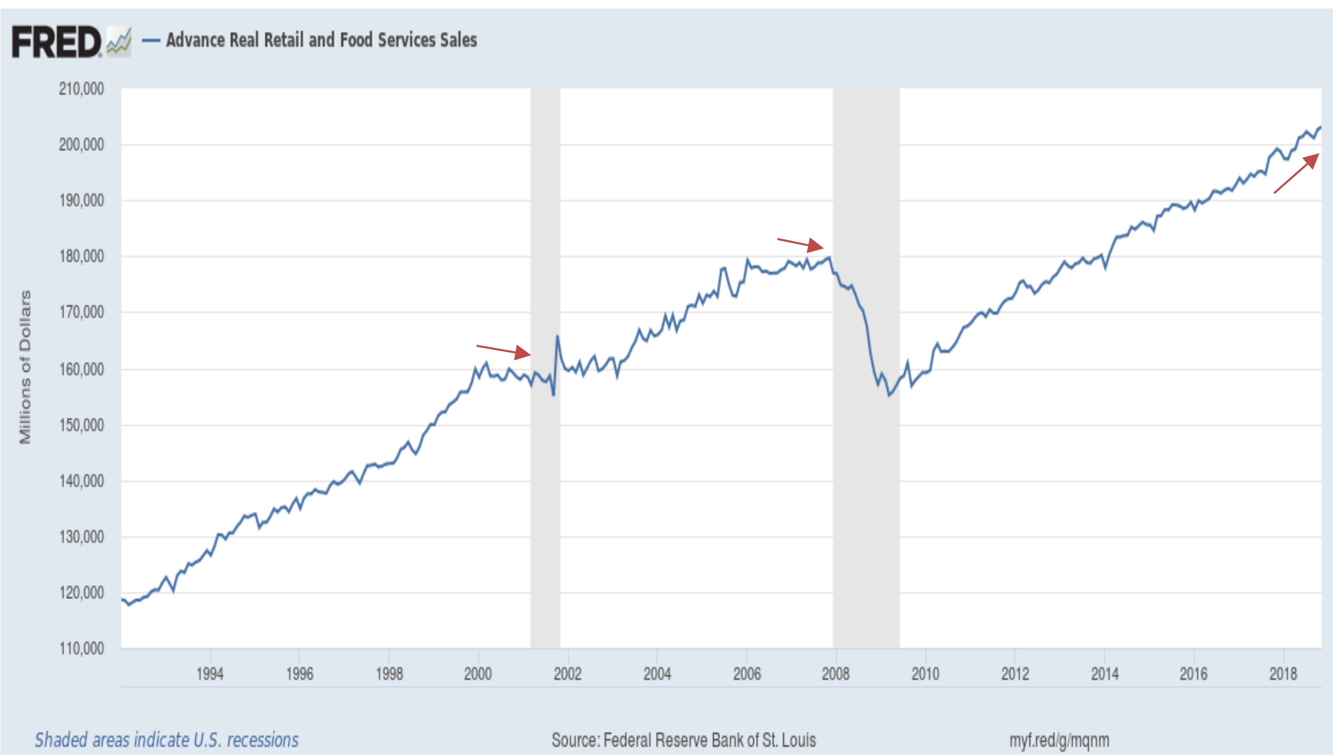


Loan delinquencies rise in advance of recessions, contributing to a tightening of lending standards by banks, and creating a negative feedback loop of stingier credit and more loans going bad. Conditions remain benign and **delinquency rates on loans are still improving.**

So-called "**credit spreads**" – the higher interest rate required of risky borrowers – usually turn up sharply as part of the process of tightening credit conditions. While spreads have moved up recently, the magnitude of the increase does not appear material compared to previous cycles. **This indicator bears watching but is not yet signaling concern.**



Not every indicator is positive; **housing** metrics in particular have been **weakening** for over a year. Housing starts and new home sales appear to have peaked last fall, and historically this sector turns down well in advance of any recession. This data also bears watching but is **insufficient to suggest an imminent downturn.**



Consumers represent 70% of all economic activity, and **retail sales** (adjusted for inflation) historically turn flat or down before a recession. Consistent with the strong labor market, consumer activity shows **no sign of recession**.

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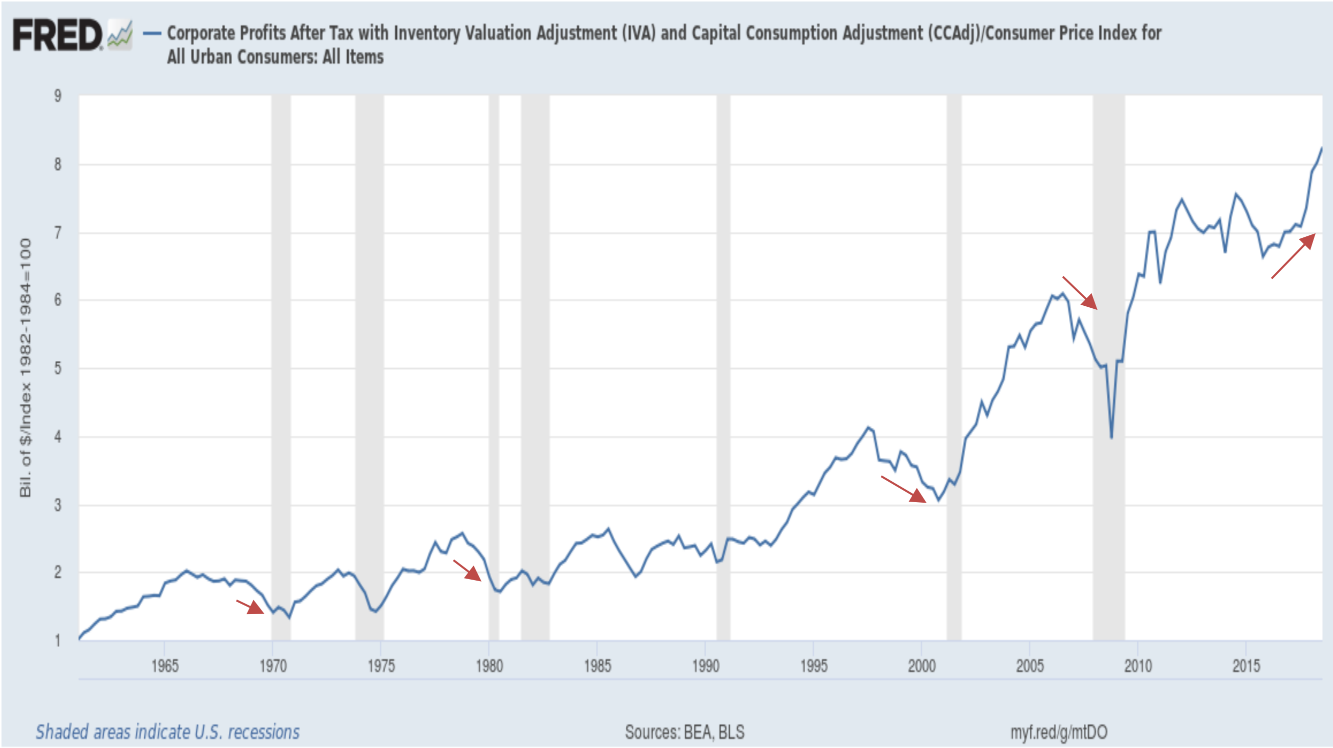
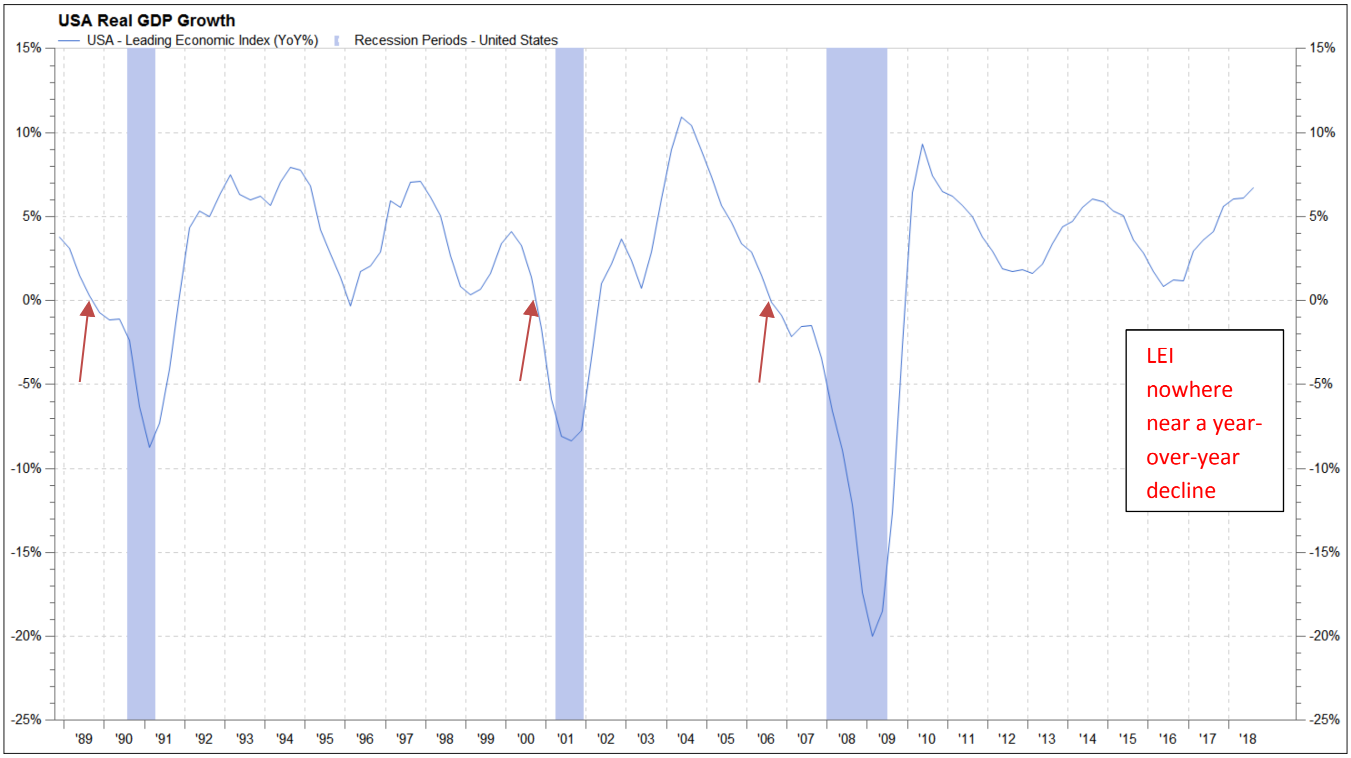


Corporate profits (adjusted for inflation) generally turn down before recessions; indeed, they contribute to the negative feedback loop because businesses cut back on hiring – and start firing – when profits weaken. **Profits are at an all-time high.**

Businesses do not buy new **heavy-duty trucks** if they expect conditions to weaken. This is a measure of confidence that always softens before a downturn, **but no such decline is occurring**.



Finally, the Conference Board's **index of leading economic indicators** – intended to capture and summarize many of the same signals discussed above (which it has done reliably for decades) – has always turned decisively negative in advance of recessions. The index recently touched an all-time high with **no hint of a downturn**.

Sources: Federal Reserve Bank of St. Louis, Factset