A Slowdown in a Record Expansion: The Verdence View Forward

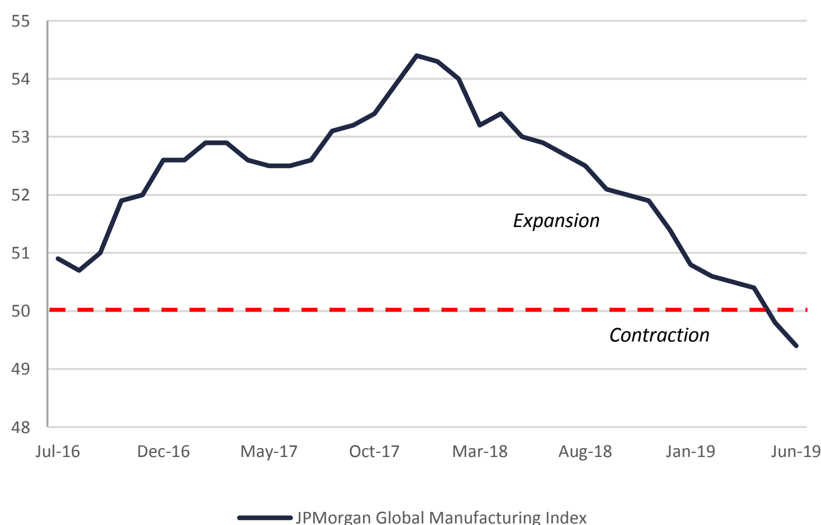
*It's official! July marks the 121st month of the current U.S. expansion. The current economic expansion officially has surpassed the previous longest economic expansion that spanned from 1991-2001. Instead of celebrating, there are many skeptics that are focusing on the time table for the end. Let's be clear, a recession **IS** going to happen. It is just the timing of when it occurs that is difficult to predict. In fact, most of the time you do not know you are in a recession until you are in the depths of it. What we do know is that the economy is amid a slowdown, but to be fair we have seen several slowdowns in this unique economic expansion. This unparalleled expansion has seen a complete restructuring of our banking system, a near collapse of the European Union, a record amount of debt, negative interest rates, massive government led bailouts and most recently an unprecedented attempt to overhaul global trade between the two largest economies in the world.*

Is anyone surprised that Economists are expecting the economy to take a breather after absorbing so much? We are not. However, in these uncertain times, it is important to look at the facts and underlying fundamentals and separate perception from reality. Below we will focus on what we see for the second half of 2019 regarding the current economic expansion and our view on asset allocation. Particularly, the value we see in a world where risk assets have climbed to fresh record highs and when patience is a virtue!

Perception vs. Reality: A Slowdown, Not Yet a Contraction

After 1Q19 GDP positively surprised even some of the most optimistic Economists, the expectation is that 2Q GDP will slow to the lowest growth rate seen in nine quarters. The ongoing trade "squabble" between the U.S. and China is weighing on confidence, business spending and manufacturing. Global manufacturing has fallen to a level that is typically characterized as "contraction" territory **(Chart 1)** as several of the major global economies (e.g. China, Germany, Spain, Italy) are seeing manufacturing activity weaken. Certain areas of the U.S. yield curve (10YR minus the Fed Funds rate) have inverted which has stirred the argument that the Federal Reserve tightened too much, and there is a misperception that a recession **must** be on the horizon. We acknowledge that some of these exogenous factors are likely going to result in a slowdown in U.S. economic growth. However, misperception may be overshadowing the reality of how our economy operates and disregarding some of the positive underlying fundamentals.

Chart 1: Global Manufacturing in Contraction Territory
Footnotes: Data is as of June 2019.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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- **Reality: A 10 year Treasury yield lower than the Fed funds rate does not always mean a recession is imminent.** There have been 10 instances since 1971 when the 10 year yield has fallen below the Fed funds rate. Six of the instances resulted in a recession. **(Chart 2)** This is not an insignificant amount but shows that this portion of the curve inverting is not the most reliable recession predictor. A Fed funds rate cut and/or series of cuts should resolve this abnormality.

- **Reality: Trade is a small portion of the U.S. economy:** The U.S. economy is more insulated (but not immune) to a contraction in global manufacturing because we are a net importer not a net exporter. In contrast to countries like China or Germany, our economic growth is less reliant on making and exporting goods. We can feel the negative impact of slowing in some of the major exporting countries but the actual impact on U.S. GDP should be limited.

- **Reality: Consumer is the heart and it is beating strong:** Roughly 70% of U.S. GDP is derived from consumer spending. While consumer spending may be slowing, it is important to remember it is slowing from some of the strongest levels seen during this economic expansion. Confidence is still near cyclical highs (and well above levels that precede a recession **Chart 3**), net worth is at a record high (and more than five times the size of the U.S. economy!), the labor market remains strong (there are more job openings than people looking for jobs) and wages are slowly rising.

- **Reality: U.S. recessions rarely start outside of the U.S.:** Since our economy is more domestically focused, it is rare to see a slowdown or crisis outside of the U.S. push our economy into a recession. For example, the Asia currency crisis in 1997-1998 or the European peripheral debt crisis 2010-2012 hit our equity markets and challenged our economic growth but did not result in an imminent recession.

Chart 2: Inverted Yield Curve Does Not Always Mean Recession is Imminent

Footnotes: Data is as of July 17, 2019. Red circles are time periods when 10YR yield – Fed funds rate inverted and no recession materialized.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors

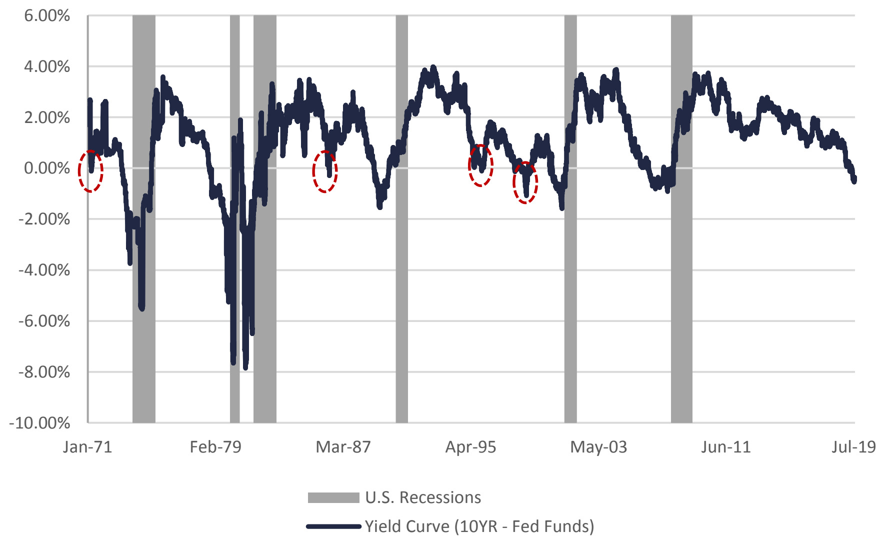
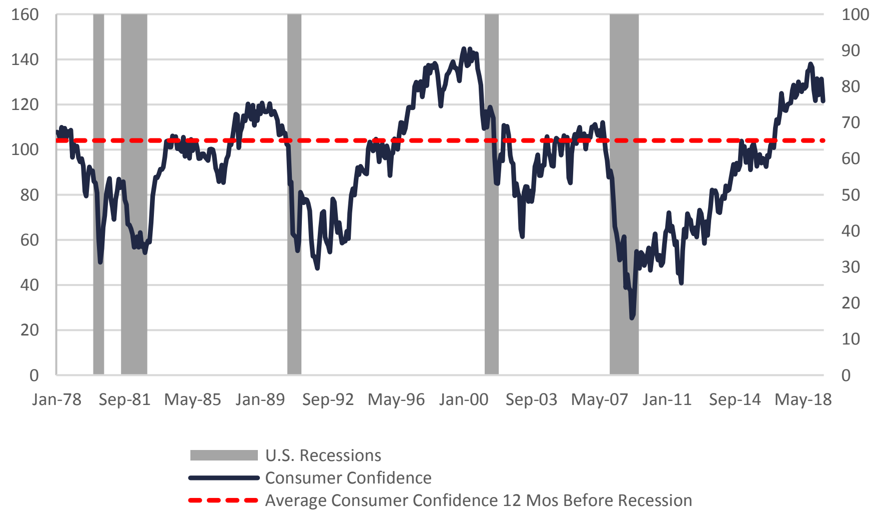


Chart 3: Consumer Confidence Slowing but Still Near Cyclical High

Footnotes: Time period reflects 1980-June 2019.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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- **Reality: The Fed offering support:** We do not agree with the sentiment that the Fed tightened monetary policy too much and that is what is slowing growth. When looking at the real Fed funds rate it has not been above 1% since prior to the Great Recession **(Chart 4)**. Therefore, monetary policy does not look restrictive. However, Federal Reserve flexibility seems warranted given the stubbornly low inflation environment.

We are not surprised by the recent slowdown in growth, especially given the current global challenges. We also warn that economic data may be noisy as distortions from the most recent round of China tariffs (from May) filter through the numbers in the coming months. We are monitoring closely any negative impacts from the economic policy uncertainty especially on consumer confidence. However, at this time supportive monetary policy, a historically strong labor market and rising wages are factors that should support a continuation of the economic expansion.

Fixed Income – Bear Market in Bonds Take a Break…For Now

The fixed income market has benefitted from the slowdown in global growth, uncertain economic policy, low inflation and negative interest rate policy around the world. **(Chart 5)** We do not think the recent move lower in long term yields is signaling another bull market in bonds, however there are outside factors that are likely to keep the rise in yields limited in the near term.

- There is nearly $14 trillion of negative yielding debt around the world **(Chart 6)** so global bond investors have limited sovereign debt options aside from buying U.S. Treasuries.
- Inflation remains stubbornly low and future inflation expectations continue to be under pressure.
- Uncertainty is evident in so many areas which will likely keep demand for the safety of Treasuries supported. Monetary policy (especially the effectiveness of zero interest rate policy), growth fears, political concerns and geopolitical tensions have limited the unwind of the flight to safety that has driven yields artificially low.

Chart 4: Federal Reserve Policy Supportive

Footnotes: Time period reflects 1980-June 2019.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

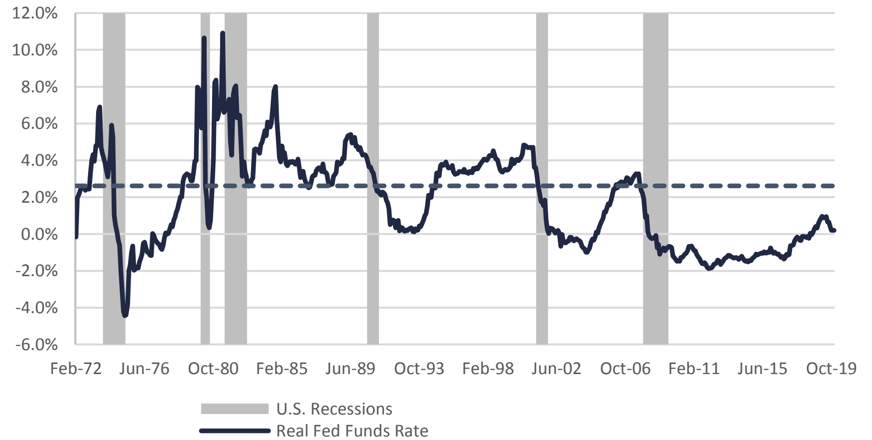


Chart 5: Slowing Economic Activity Drags Down Yields

Footnotes: Data is monthly and as of June 2019.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

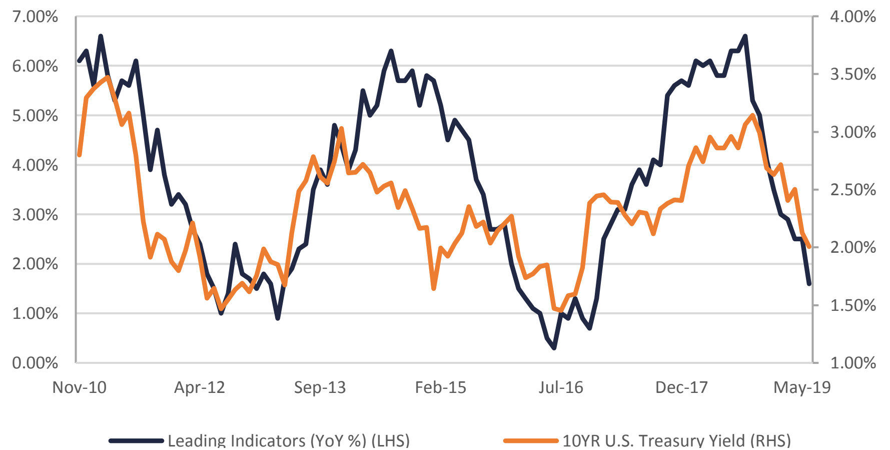


Chart 6: There are Few Other Global Sovereign Alternatives

Footnotes: Data is as of July 5, 2019.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

While long term U.S. Treasury yields may remain lower than fundamentals would suggest they should be, chasing an expensive investment would be unwise as yields at current levels carry substantial interest rate risk. While the upside to floating rate notes is likely exhausted given the change in monetary policy, investing in long term maturities is also not recommended. Instead we would be cautious with fixed income and remain in short to intermediate investments to mitigate interest rate risk. While lower interest rates may have stemmed fears of defaults in high yield, the yield investors earn for taking on the extra credit risk is not worth the return over the next 12-18 months. Credit quality in high yield is weakening as seen by the rise in the downgrade to upgrade ratio and investors are not being rewarded for the extra risk associated with the historically low level of spreads. **(Chart 7)** Instead we would focus on emerging market bonds and income producing private equity as attractive alternatives to high yield and sovereign bonds.

Global Equities – What Bear Market? Finding Value in a Fully Valued World

What a difference a half of a year makes! While investors were basically writing off equities and declaring the end of the bull market at the turn of the year, the MSCI AC World Index ended 2Q19 less than 5% from its record high (reached January 2018). The S&P 500 made six fresh new record highs during the quarter and the NASDAQ Composite made four. At the same time, some of those momentum driven stocks (e.g. FAANGs) that pushed the market higher in recent years and took the bulk of the beating in the 4Q18 correction are closing in on fresh new record highs. **(Chart 8)** As a result, broad valuations have returned to levels that look stretched, primarily in the US. However, given our base case scenario that the economic expansion has room to run and the Federal Reserve is entering an easing phase, we continue to look for attractive buying opportunities and recommend a modest overweight to global equities for our risk tolerant investors. **(Chart 9)**

Chart 7: Do Not Sacrifice Quality for Yield

Footnotes: Data is as of June 27, 2019. 2Q19 is consensus estimate.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

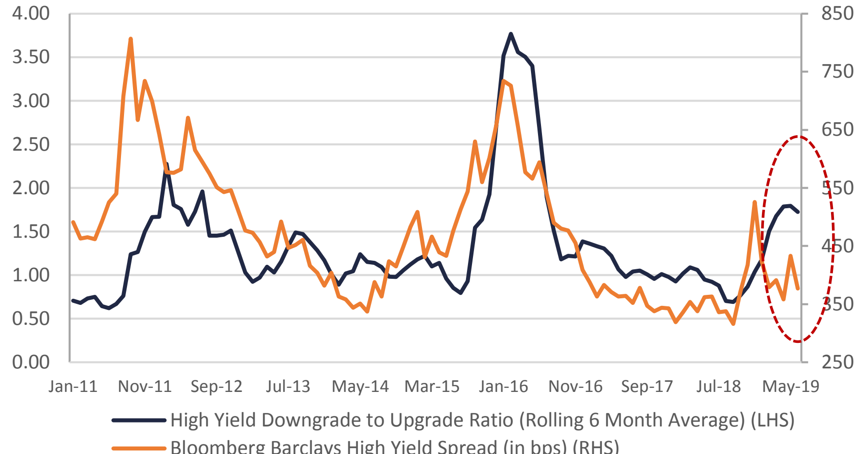


Chart 8: Momentum Overriding Reason

Footnotes: Data is indexed year to date as of June 28, 2019. Price return only.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

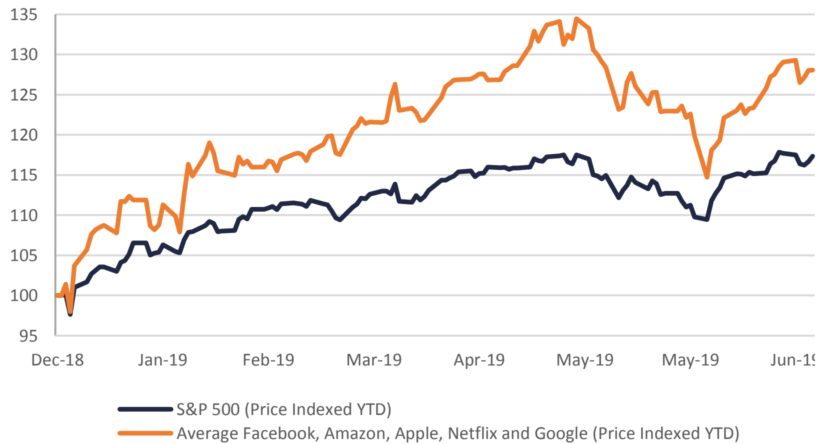
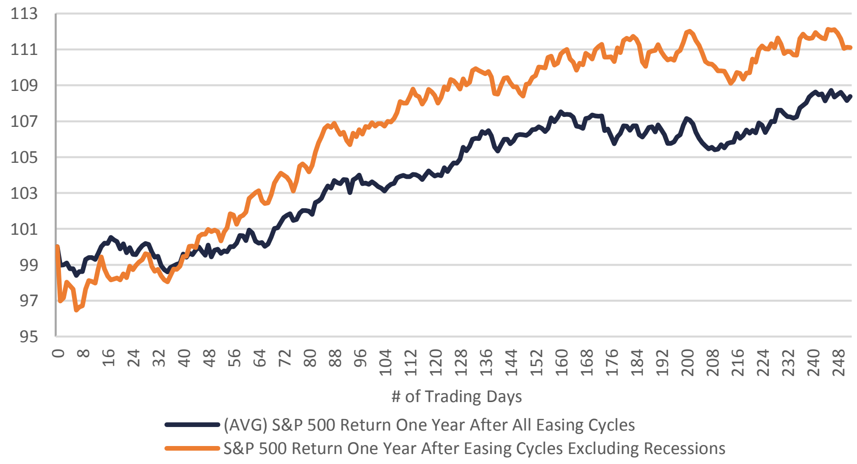


Chart 9: Rate Cuts Historically Supportive of Equities

Footnotes: Time period reflects 1971 to 2007 easing cycles. Easing cycles are classified as at least three consecutive rate cuts and at least one year before next hike.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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At the same time, patience is a virtue! We are holding a healthy overweight cash position until valuations look more attractive and opportunities arise. Within our current global equity exposure, we recommend the following:

- **Slightly underweight the U.S. but opportunities under the surface:** Given the recent rally and elevated valuations, we favor the small/midcap space and value stocks over the more expensive large cap growth equities. Small/midcap and value stocks should benefit from lower interest rates, lower taxes and a pick-up in domestic growth. Small/midcap and value stocks have also lagged the broad U.S. growth rally and are trading at a healthy discount to both their own history and to large cap growth stocks **(Chart 10).**

- **Favor international over U.S. equities with a focus on EM:** International equities are lagging the rally in the U.S. as trade and domestic growth weigh on sentiment about economic and earnings growth. Therefore, the MSCI AC World Index ex U.S. remains historically cheap from a pricing perspective versus the U.S. **(Chart 11).** Europe remains attractive compared to the U.S. but we are patiently looking for a more attractive entry point. Current European valuations may be reflecting the benefit that a weak Euro may have on earnings as well as the ECB's more accommodative monetary policy. There is opportunity in select emerging markets. We continue to favor Asia and believe the domestic fiscal stimulus in China and the potential for positive news on trade with the U.S. is not fully priced in at current levels. In addition, even if the trade "squabble" continues for an extended period, there are other Asian emerging market economies that may benefit from trade shifting outside of China.

Chart 10: SMID Cap Stocks Trading at a Discount to Large Cap

Footnotes: Data as of July 10, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

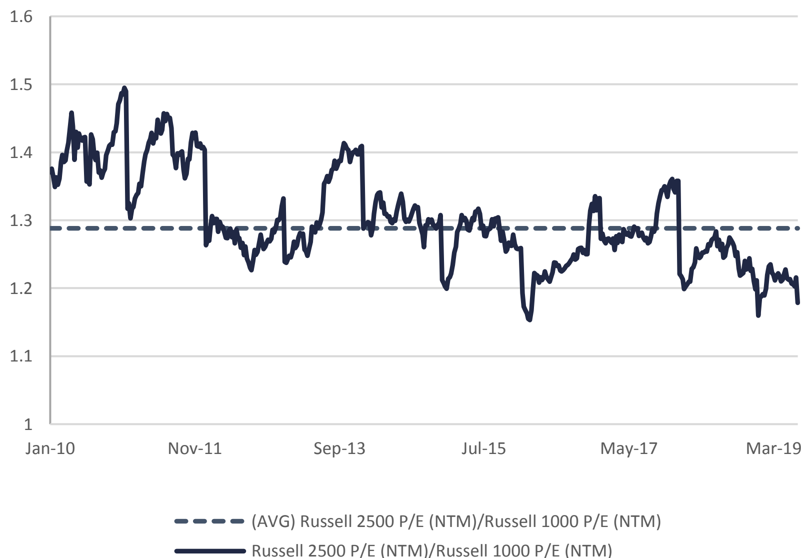


Chart 11: International Equities Historically Cheap Compared to U.S. Equities

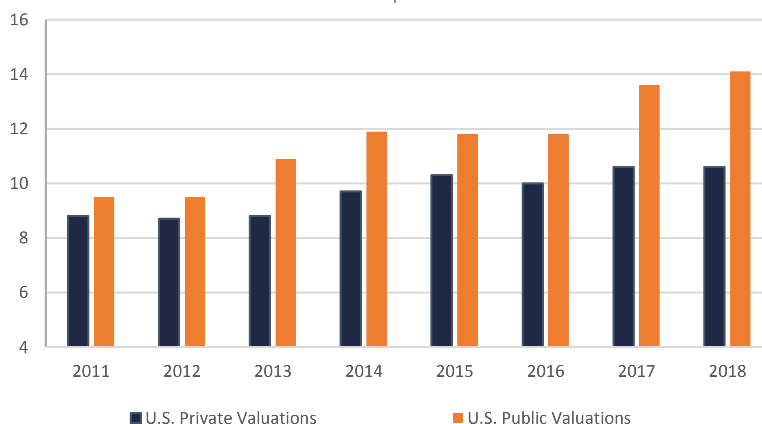
Footnotes: Data is as of July 18, 2019.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Alternatives – Diversify at this Stage of the Economic Cycle

We continue to favor a healthy allocation to alternatives to capitalize on the expectation of the continued economic expansion (albeit a bit slower), lower interest rates, higher volatility with public valuations stretched and diversification. Hedge funds, specifically credit alternatives, are an attractive way to find opportunity in a credit market that looks expensive with spreads near pre-crisis lows. Real assets (e.g. commodities) have also proven to outperform both bonds and stocks in the late stages of an economic expansion. Commodities can also benefit from a stable to weaker U.S. dollar and would likely rally if the probability of a trade agreement between the U.S. and China increases. We continue to look for attractive private equity opportunities for long term investors. With the recent rally in the public market, valuations are attractive for private equity and coverage ratios are strong, especially given the expectation of an extended period of low interest rates. **(Chart 12)** At this time we favor private real estate (especially in office space) and income producing credit opportunities.

Chart 12: Private Market Valuations More Attractive Than Public Markets

*Footnotes: *Valuations represent EV/LTM EBITDA.*
Data Source: Neuberger Berman, S&P Capital IQ, S&P Leveraged Buyout Quarterly Review, Verdence Capital Advisors



The Bottom Line:

We remain cautiously optimistic about the outlook for economic growth. However, we are not complacent either and acknowledge that risks to the downside have increased through the second quarter. With valuations stretched in many of the major asset classes (e.g. growth stocks and bonds) it is more important than ever to be patient and hold a healthy cash position, opportunistically. We will not chase momentum driven investments as we have seen the damage it can create for a client's returns when investor sentiment shifts (e.g. FAANG stocks in 2018). Instead we will focus on our client's long-term objectives and balance underlying fundamentals with valuations. We will be patient and assess all market conditions, including the underlying economic environment and make changes to asset allocation in the best interest of our client's long-term objectives. We will continue to favor active management, especially as the cycle matures and bottom up analysis is crucial. If you have any questions or feedback, please feel free to reach out to your financial advisor.

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