The Capital Management Corporation

FOCUS Newsletter

Economic Comments | January 2020

RECESSION PREDICTIONS PROVE ELUSIVE

Three years ago, pundits said that a recession was imminent, because there had not been a bear market since 2009; yet, a recession did not occur.

In prior cycles, recessions lessened energy demand and led to lower energy prices. Two years ago, rising US oil and gas production resulted in declining energy prices. Wall Street traders conditioned to sell upon seeing recession indicators went into action. However, energy prices are not a leading indicator and booming domestic energy production actually helped the US economy.

Similarly, over the last year a flattening and eventual, temporary inversion of the yield curve (where ten-year US Treasury bonds yield more than two-year notes) created recession fears. Many Wall Street computers were programmed to sell upon such interest rate developments.

Inverted yield curves that foretold recession over the last seventy years tended to be caused by the Federal Reserve (the Fed) hiking overnight interest rates above 5%. However, last year the Fed actually cut rates to 1½%. The yield curve is no longer inverted as the two-year note yields 1.6% which is less than the 10-year bond yield of 1.9%.

The 2019 yield curve inversion resulted from buying of US bonds by foreigners seeking positive interest rates. Strong inflows of cash into the US bond market and declining long-term interest rates actually boosted the US economy.

A plethora of negative news headlines will likely continue in 2020, including geopolitical strife and predictions of a recession; however, current economic data and leading indicators both suggest continued growth.

PRINTING MONEY & CUTTING INTEREST RATES

In mid-September, the Fed resumed printing money in order to keep overnight interest rates low. It did this through "repurchase agreements" (or Repos) that effectively gave banks newly created

Key Dates

01/10	Unemployment Report
01/14	December Consumer Inflation (CPI)
01/20	Martin Luther King, Jr Day – Stock Market Closed
01/30	FOMC Press Conference
01/30	GDP 4Q and 2019 Advance Estimate
02/07	Unemployment Report
02/13	January Consumer Inflation (CPI)
02/17	President's Day – Stock Market Closed
02/27	GDP 4Q and 2019 Second Estimate
03/06	Unemployment Report
03/11	February Consumer Inflation (CPI)
03/20	FOMC Press Conference
03/26	GDP 4Q and 2019 Third Estimate

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cash in exchange for short-term bonds.

So far, these repos have increased the Fed's balance sheet from $3.8 trillion in September to $4.2 trillion on January 1st. $60 billion of new funds per month might be created through this spring.

In October, the Fed also cut its target range for overnight interest rates by ¼% to 1½%-1¾%. The Fed's July, September and October interest rate cuts mark its first cuts in ten years.

These interest rate cuts were meant to stimulate the economy enough to offset declining inflation rates, an inverted yield curve, and a slow manufacturing environment.

Trade tensions, the GM strike, Boeing 737 Max grounding and lower energy equipment spending have pressured manufacturing growth. These may prove to be short-term issues.

Meanwhile, 55 other central banks cut their countries' respective overnight interest rates a combined 126 times in 2019 (the most cuts in ten years). As it can take up to a year to achieve the full economic effects of an interest rate change, a reacceleration of global economic growth may become apparent during the second half of 2020. Such activity would further stimulate US economic growth.

DOMESTIC ECONOMIC GROWTH POISED TO REACCELERATE

Resolution of trade agreements, strikes and groundings combined with higher energy prices could result in a surge in aircraft and energy equipment spending, reaccelerating economic activity and higher inflation by mid-2020. The Fed's hands may be tied due to its tradition of not changing monetary policy ahead of a Presidential election leading to stable overnight interest rates.

Meanwhile, with the most employed Americans in history (159 million), employers are challenged to find and retain good workers. Solutions include both wage gains and capital expenditures to increase productivity and lower costs, such as reshoring and automation. Lower paid overseas workers might be replaced with robots and a few, well-paid US technicians.

Due to 3½% wage growth of blue-collar workers, record US employment and rising education, energy, healthcare and housing prices, inflation in 2020 should rise above 2%. This results in negative inflation-adjusted interest rates for all of today's US Treasury debt maturing within ten years.

While it may be a good year to be a debtor, holding those bonds might not be as worthwhile. After market interest rates rise, no one will pay today's price for a negative yielding bond.

Even if bond prices don't fall, taxable investors take home less since the federal government taxes US Treasury interest income at ordinary income tax rates.

FISCAL POLICY & IRA LAW CHANGES

In the US, monetary policy (interest rates and money printing) is controlled by the Fed, while fiscal policy (federal government spending) is controlled by Congress. In 2019, Congress approved the federal budget and changes to retirement savings rules.

Fiscal 2020 will see record federal spending of $4¾ trillion. Short-term, this spending boosts economic growth. As a full budget (not a sequester or a continuing resolution), large, multi-year budget items can progress. This is good for the economy over the intermediate term.

Retirement savings rules were also changed and can even affect the intergenerational transfer of wealth. IRA’s inherited by adult children after January 1st of this year must be fully disbursed within ten years. IRA holders who had not turned 70½ by January 1st do not have to make their first withdrawal until the year they turn 72. Some exceptions were written into the law and the labor department should create and provide more details later this year.

THE GEOPOLITICAL MIX

Continued Middle-East turmoil, uncertain global growth, demographics, EU trade negotiations and Brexit ramifications could provide negative headlines in 2020.

On the other hand, implementation of China, Japan and North American trade agreements could help to increase annual US exports by over $100 billion, adding at least ½% to overall economic growth. Furthermore, central bank stimulus, movement from negative interest rates, a growing global middle class, lapping an inventory correction, advancing technology and productivity improvements may lead to a stronger global economy by year-end.

VOLATILITY

There will be volatility. In the typical year, the major US stock markets have three setbacks of 5% or more (one of which being 10% or more).

The largest pullback in 2019 was only 7% as the markets recovered from the October-December 2018 bear market. Lasting just 2 ½ months, it was the fastest bear market of our lives (with major indices declining 20% to 28%).

Despite short-term volatility, the 100-year average annual return of US large-cap stock indices remains approximately 10%. Over long periods of time, an investors best friend has been the power of compounding. In order to benefit from that, long-term investors had to bear volatility while remaining invested.

FUTURE CHANGES: WHERE TO INVEST

Since World War II, it has been quite rare for US stocks to yield more than bonds. Such low interest rates combined with a positive economic backdrop suggest long-term bond prices may fall. Where given latitude, lessening bond exposure appears prudent.

However, target date funds tend to move in the opposite direction. Each target fund has a stated date when investors are expected to make withdrawals. This feature has made target date funds a popular holding in retirement and 529 accounts. As the respective target dates get closer, target date funds tend to lower their equity (i.e. stock) exposure and raise fixed income (i.e. bond) and money market exposure. After a strong year for stocks, more equities must be sold and bonds purchased in order for target date funds to meet their ever more “conservative” asset allocation target.

As target date funds buy large amounts of bonds this month, they may provide good exit prices for investors who wish to trim bond holdings.

A better income producing option may include dividend paying stocks. Investors can select stocks of companies that have long-term prospects of revenue, earnings and dividend growth. Many of these can be purchased at lower valuations and higher yields than the major large-cap indices.

Investors do not have to own a stock index and its specific characteristics. Stock selection may include a collection of small-cap, mid-cap and value stocks that have low prices and prospects of recurring growth.

Particular opportunities in 5G (telecom), biotechnology (medical advancements), lithium (rechargeable batteries), and logistics (internet sales) appear extremely attractive on a multi-year basis.

- Timothy C. Call, CFA, President & CIO

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