

# INVESTMENT STRATEGY QUARTERLY

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## Letter from the Chief Investment Officer

### The Wizard of Oz – Dreams versus Reality

The “Wizard of Oz” celebrated a magical milestone in August, returning to the town of its original screening to commemorate its eightieth anniversary. Decades after its release, many of the movie’s characters and themes provide parallels to today’s economy and financial markets.

The state of the economy is paramount in determining the return potential of the major asset classes. We forecast that US gross domestic product (GDP) will grow 2.2% in 2019 and 1.7% in 2020, averting a recession through at least the 2020 presidential election. Similar to Dorothy’s companions on her journey, the symbolism of the **Scarecrow**, the **Tin Man**, and the **Cowardly Lion**, who were in search of a **brain**, a **heart**, and **courage**, respectively, frame our optimistic outlook. Our ‘brain’ relies on the facts, and although there has been a spike in recessionary fears, the mosaic of data we observe (such as Leading Economic Indicators, real-time activity metrics, employment conditions and history), all point to an extension of this already record-setting economic expansion. While many pessimists point to the yield curve inversion, inversions historically precede a recession by approximately 22 months. The US consumer is the ‘heart’ of both the US and global economy. Collectively, US consumers represent approximately 70% of the US economy and US consumption is greater than the economies of Japan, Germany, and the UK combined. With healthy job creation, rising wages, and high consumer confidence, this ‘heart’ should continue pumping. Business spending is the next largest component of the economy. For the economy to grow more rapidly, businesses will need to find the ‘courage’ to deploy investment capital and reverse the decline we have seen recently.

In this real-life rendition, investors seek guidance from not one, but **two ‘wonderful wizard(s)’**—President Trump and Fed Chairman Powell. Trade frictions are beginning to weigh on the economy as a recent poll<sup>1</sup> suggested that for the first time since President Trump took office, more respondents believe the economy is getting worse rather than better. The full implementation of a third tranche of tariffs (on \$300 billion of Chinese imports) will squarely affect the consumer. With a presidential election looming in 13 months, it would be detrimental to increase consumer costs and potentially send the economy into a tailspin. As a result, this last tranche will

likely be postponed or not fully implemented if a deal is not secured. With the Federal Reserve (Fed), it is simple. It will cut interest rates enough to maintain the momentum of this economic expansion. The specific number of cuts is of less importance. As long as the economy does not fall into a recession, riskier assets like equities should move higher.

The ‘wicked witches’ that need to be watched include oil prices and the dollar. We estimate that the consumer can absorb oil prices up to \$70/barrel (our base case) as that keeps gasoline prices below the psychologically important \$3/gallon level. However, festering geopolitical risks from the Middle ‘East’ and new International Maritime Organization (IMO) sulfur regulations could place upward pressure on oil prices. In the ‘west,’ the race to the bottom with interest rates has caused declines in many currencies like the euro. With the dollar at its highest level since May 2017, concerns are mounting that it is hampering the competitiveness of US exports. However, our forecast is that the dollar will stabilize over the next year, alleviating some pressure on the US economy.

As for the bond market, we are “**not in Kansas anymore.**” Fundamental factors (such as domestic economic growth and inflation) that traditionally dictate the level and direction of interest rates are overshadowed by massive global central bank bond purchases and global growth fears. With a record level of negative-yielding debt (which technically guarantees an investor a loss if the bond is held to maturity), many roads lead to the US bond market when it comes to the search for positive yield. In some countries, such as Germany, the entire yield curve is negative. With international investors seeking positive yields and baby boomers adjusting their portfolios to include more exposure to bonds, the extra demand for US Treasuries should keep US rates lower for longer. In the credit space, the best start to a year in more than 20 years has narrowed spreads and made these bonds less attractive.

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1 <sup>1</sup> Pew Research Center

We favour investment-grade bonds and emerging-market bonds over high-yield bonds, which at current yields do not adequately compensate investors for their level of risk.

We reiterate our preference of large cap over small cap. From a sector standpoint, we prefer Technology, Communication Services, and Health Care and find many of the defensive sectors, such as Utilities and Consumer Staples, expensive. For less risk averse investors, emerging-market equities are attractive but remain dependent upon the outcome of the trade dispute.

Dorothy's quest to return home began when her house was caught in a terrifying **tornado**. For investors, President Trump's tweets, a divided Fed, recessionary fears, Brexit, and Iran are swirling around financial markets causing elevated uncertainty and turbulence. History suggests that trying to time markets around these types of events is a 'fantasy' and the outcome is usually investors making poor, emotionally-driven decisions. Thus, regardless of the daily

'noise,' successful investors follow a well-thought out financial plan, just as Dorothy followed the **yellow brick road**. The 'bricks' along the road include assessing your asset allocation, investment objectives and risk tolerance, selecting appropriate investment vehicles, and periodically reviewing your portfolio with your advisor. So before making a hasty portfolio change, click your **red ruby slippers** three times and remind yourself that having a disciplined investment strategy is the most likely path to realizing your financial dreams **somewhere over the rainbow**. ■



**Lawrence V. Adam, III, CFA, CIMA®, CFP®**  
Chief Investment Officer, Private Client Group

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## Brexit, Tariffs, and Protests, Oh My!

Chris Bailey, *European Strategist*, Raymond James Investment Services Ltd.

*'Happiness is when what you think, what you say, and what you do are in harmony.'* - Mahatma Gandhi

National stereotypes tend to always have a hint of truth about them. The British can always be relied upon to run a good administration, the Germans are efficient and forward moving, Hongkongers are obsessed about money and property prices to the apparent detriment of everything else, and in Italy it is best to focus on the food and local culture rather than try to get something done. But the times they are a-changing – at least from the perspective of events so far in 2019.

### RIDDLES, MYSTERIES AND ENIGMAS

Winston Churchill once described Russia as “a riddle, wrapped in a mystery, inside an enigma,” and this form of words also almost perfectly describes how I perceive the Brexit debate in the United Kingdom must be viewed around the world. Well over three years into the debate – with two prime ministers already sacrificed on its political altar and the country still horribly split down the middle – an end is still not clear. Attempts to forge an agreement (or leave with no deal) on 31 October have been unsettled by a British constitutional crisis involving the British Supreme Court, Parliament, the Prime Minister, and even Queen Elizabeth the

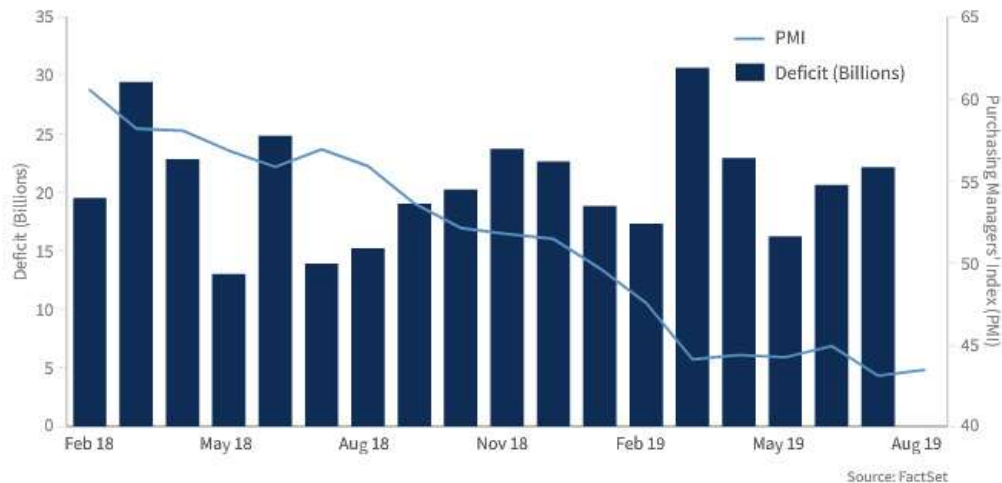
Second. Brexit sits like a handbrake on the country, a suppressor to economic forecasts, business investment or employment decisions and, of course, consumer confidence.

### LOOK! IT'S BIG BEN AND PARLIAMENT

It is amazing, this long into the debate over Brexit, that multiple finale scenarios still exist. This is due to complexities around issues that have now become central to British political life, such as the backstop underpinning the land border in Ireland. Predictability around a further election occurring, let alone its precise result, remains very low, as well as whether any of this may persuade the European Union to exhibit more flexibility to induce some form of a deal. Most strikingly, however, the average allocation to UK assets by global investors versus recent history is at very low levels. So much is factored in, but the cost in national credibility and cohesion has been material, as well as leading to a fall in value of the pound. As one commentator put it, ‘We want control of our borders... but still an opportunity to buy all our favourite imports.’ Both having cake and eating it tends only to happen after striking a deal. However, the real irony of Brexit is that whilst a compromise (a ‘soft Brexit’) that maintains a good amount of the trade and general coordination infrastructure that has been built up between the UK and the continuing European Union is the least disliked option for a majority of voters, it is far from a favourite option for a majority of voters. It is, however, the sensible option to pursue.

## PMIs & Surpluses: Surpluses to Spend

As Germany's manufacturing sector slips further into contraction, the German government will be under renewed pressure to loosen the fiscal purse strings and inject more of its budgetary surplus back into the economy.



Talking about the continuing European Union, unsurprisingly the region has been extremely worried about both the political and economic fallout from Brexit. However, as Brexit is still yet to formally occur or unduly influence performance, the 2019 economic travails seen in Germany have been cut from broader issues.

### NO FEST IN OKTOBER?

Germany's superior average productivity and ongoing commitment to innovation within its core manufacturing competencies helped make the country the dominant economic actor within Europe. This position was only strengthened over the past decade by the seemingly insatiable desire of neophyte Chinese manufacturers to buy German capital goods know-how and equipment, a situation replicated in many other emerging nations. Fast forward to today, however, and an almost perfect storm has developed for Germany. Economic growth has been sluggish across Europe for over a decade and bilateral trade discussions between the United States and China have contributed to a deterioration in the global trade backdrop, impacting key industrial, chemical, and automotive exports from Germany. The net result is an economy on the brink of a formal recession.

Politically, these are sensitive times in Germany. The lengthy chancellorship of Angela Merkel is within a couple of years or so of ending, and a newer generation of political leaders has yet to really establish itself. Coalition governments that span the mainstream

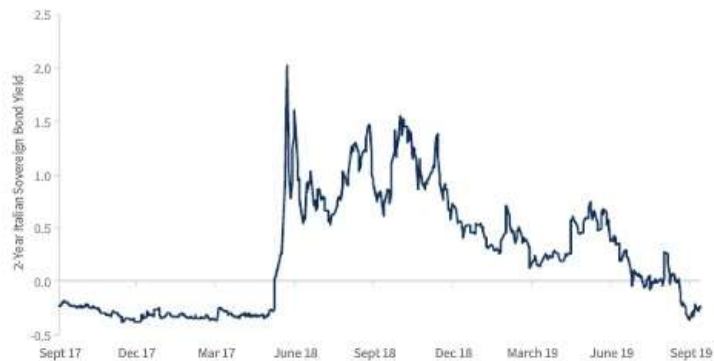
political spectrum that once gave a stable leadership backdrop are now struggling to find new ideas. Meanwhile, a rigid orthodoxy to a balanced fiscal budget may appear laudable to many other countries struggling with fiscal (or trade) deficits, but it has led to a growing feeling of inertia. In short, Merkel is yet to pass the point domestically where she feels able to give the green light to more stimulus, but can live with the European Central Bank - in policy moves announced in December - moving deeper down the rabbit hole of quantitative easing and negative interest rates. This halfhearted approach to tackling contemporary challenges is apparent in the country's global trade policies too. Germany is a quiet player on the global political stage given its economic and export prowess, but would be wise to find its (fiscal) voice fast.

### AN ITALIAN RENAISSANCE?

If true dynamic regional leadership is missing from Germany, in Italy there has been something of a renaissance in political dynamism. The summer that just passed may have seen yet another Italian government break up, but the strange union between two populist parties lasted longer than many expected and shook up the Italian political establishment. The current forging of a new government, composed of one of the populist parties in combination with a centrist mainstream political group, appears to offer more potential for longer-term stability. The question now is whether the country can move away from the situation of economic intensive care it has been in.

## Italian Bond Yields: A Return to Negative Territory

As Matteo Salvini's bid to take over the Italian government disintegrated, a newfangled coalition between the 5 Star and Democratic Party factions witnessed rates return to negative levels.



Source: FactSet

**“The challenge for leading politicians and other policymakers is to devise ways to embrace change more as an opportunity than a threat.”**

Italy also has been struggling with low growth. However, unlike Germany, Italy has material debts to worry about as well, a situation that naturally causes a lot of concerns. Yet, the tone of the debate within the country has started to change and there is a realisation that this is a time for action. Additionally, the financial markets are giving an opportunity for change with compressed global bond yields reducing any shorter-term burdens from the weak Italian fiscal position. It really is now or never for Italy. A period of technocratic government focused on building both growth and confidence levels in the local economy can go a long way.

### FOR KONG AND COUNTRY

Finally, we have to look east to Hong Kong, where an unprecedented level of public protest against progressively tighter oversight from China has led to violence, disruption, and a new uncertainty that is already impacting local property prices and economic performance. So, are the times a-changing in Hong Kong too? Certainly, high income inequality, the challenges of getting into the local housing market, and a feeling that the best days for economic growth have passed are very apparent. But the real fear is centred on what a developing China really means for the city state that for so long has been the natural gateway into the broader East Asia region. This longer-term focus is why Chinese authorities have not gone beyond the threat of mainland military and policing forces on the streets of Hong Kong. Go to mainland Chinese cities today proximate to Hong Kong and it is increasingly difficult to tell the difference on the ground. Hong Kong retains the advantage of capital flow freedom and a

convertible currency, but this will not last forever. What today is centred around freedoms may still be ultimately influenced by longer-term economic realities.

Change is a constant but also can induce uncertainty. Across the UK, Germany, Italy, Hong Kong, and many other countries, we are seeing the political, economic, and social impacts of an evolving world. These challenges are going to keep on coming in new and varying ways in the 2020s. The challenge for leading politicians and other policymakers is to devise ways to embrace change more as an opportunity than a threat. Where this is achieved, or at least perceived more positively, investment returns will follow. In a changing world, this most commercial of observations, at least, does not change. ■

### KEY TAKEAWAYS:

- Brexit suppresses economic forecasts, business investment or employment decisions and, of course, consumer confidence.
- Germany is on the brink of recession. Sluggish European growth and the US-China trade discussions have impacted key industrial, chemical, and automotive exports from Germany.
- Italy has seen a renaissance in political dynamism. The new government appears to offer more potential for longer-term stability.
- The challenge for politicians and other policymakers is to devise ways to embrace change more as an opportunity than a threat.



## Trade Like a Dragon, Tweet Like an Eagle

Ed Mills, *Managing Director, Washington Policy Analyst, Equity Research*

This summer saw a new chapter develop in the trade fight between the US and China, with rapid escalation in a period of just a few months. This opens the door to tariffs on virtually all Chinese goods and increasingly threatens a significant commercial decoupling between the world's largest economies.

The driving forces of the latest period of elevated hostility are threefold:

1. President Trump's frustration with China's lack of follow-through on what he sees as key commitments.
2. The trade conflict taking on additional elements of a battle for primacy in global affairs.
3. Trade issues taking on greater political significance as the 2020 presidential election season intensifies.

Fears over a protracted trade war have been mitigated by the belief that Trump's style as a 'winner' will resurface closer to Election Day and make a comprehensive trade deal likely. However, we view the role of the 'fighter' as more consistent with

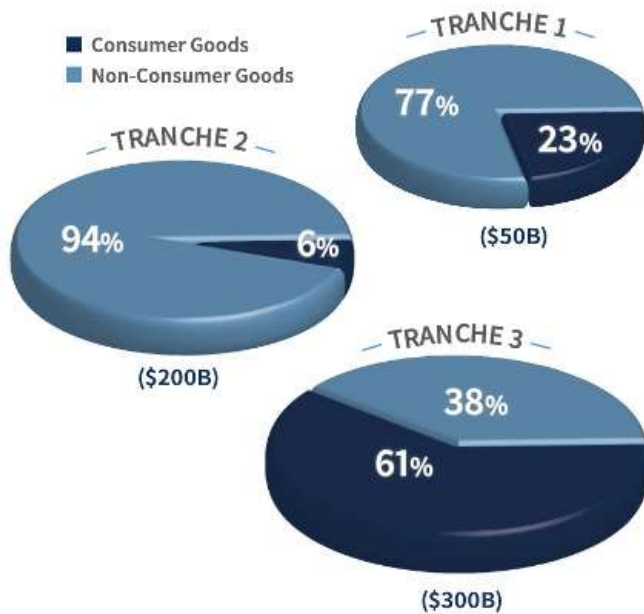
Trump's personal brand, raising the likelihood that any resolution to the trade dispute will not materialise until after the 2020 election.

### TASTE OF THE SAME MEDICINE

The post-June G20 stalemate illustrates the difficulty in de-escalating the current conflict. Large-scale agricultural purchases and an easing of the US export restrictions targeting Huawei were the key short-term bargaining chips. Ultimately, neither materialised and President Trump's frustration at the slow pace of progress led to a new round of tariffs on an additional \$300 billion of Chinese imports. Further, President Trump has called on China to make progress to stem the flow of fentanyl into the US for well over a year, and the lack of follow-through has seemingly contributed to the eroded trust between the two sides. Trump clearly views China as responsible for the continued endangerment of the US population via a modern day 'Opium War,' not unlike the Opium Wars of the 19th century (when western powers illegally smuggled opium into China). This reinforces the belief among the more hawkish White House advisors that the US and China are fighting a much broader battle. This view can be seen in the rhetoric the administration associates with China, which is slowly undergoing a shift from a 'strategic competitor' label to 'foreign adversary.' If this trend continues, the case for a national emergency declaration under

## Tariff Tranches: Consumer in the Crosshairs

Unlike previous tranches of tariffs that primarily targeted manufacturing inputs and industrial goods, this third tranche of tariffs primarily targets consumer goods.



Source: US Trade Representative

the International Emergency Economic Powers Act (IEEPA) to exert greater control over commercial ties with China may see increased political support.

### THE GREAT WALL TO NEGOTIATION

The erosion of goodwill between the two sides can also be seen in unfolding geopolitical events. An ever-present barrier for China's leaders in trade talks has been what they see as an encroachment on China's sovereignty by the US given the specific changes to China's economic and legal system sought by the Trump administration. The sovereignty sensitivity has flared up with the latest protest movement in Hong Kong, which China's leaders have vocally blamed the US for inciting. The question of Taiwan's independence is also a source of friction, and may become a more significant issue in late 2019/early 2020. The US has recently approved significant arms sales to Taiwan, and a looming January 2020 election, which is likely to pit pro- and anti-China parties against each other, appears ready to further inflame US-China political tensions in the global arena.

### THE BOXER'S REBELLION

These issues will be difficult to fully resolve to the liking of President Trump or China's leaders in the next year, especially in the heat of a presidential campaign during which Trump's policies will see intense scrutiny from political opponents. China trade issues have emerged as a central topic at the Democratic debates, and are due to see greater prominence on the campaign trail going forward in agricultural/manufacturing states specifically impacted by the trade fight.

President Trump has used the trade battle to attack potential Democratic opponents, arguing that a changeover in administration would ease the current pressure applied by the Trump administration and benefit China.

Some progress remains possible over the next year – particularly on more clear-cut issues of fentanyl flows or agricultural purchases. However, we believe a broad-scale deal will continue to be elusive until after the election given the complicating factors. If Trump is given the choice between a weak deal or showing voters in key swing states that he is a fighter, we expect him to decide to play the role of the fighter through the 2020 election. ■

### KEY TAKEAWAYS:

- This summer saw rapid escalation in the trade fight between the US and China.
- Three driving forces of elevated hostility: President Trump's frustration with China's lack of follow through, the trade conflict taking on elements of a battle for primacy in global affairs, and trade issues taking on greater political significance.
- Some progress remains possible over the next year – particularly on more clear-cut issues of fentanyl flows or agricultural purchases.
- We believe a broad-scale deal between the US and China will continue to be elusive until after the 2020 election, given the complicating factors.





## More Stimulus: Fools Gold?

Chris Bailey, *European Strategist*, Raymond James Investment Services Ltd.

*'Real economic stimulus comes from real investment'* -  
Tim Bishop

I almost started these thoughts with a quote from George Osborne - the Chancellor of the Exchequer from a handful of years ago - who observed during his tenure in one the U.K.'s top political jobs that 'Britain can choose, as others are, short term fixes and more stimulus. Or we can lead the world with long-term solutions to long-term problems'.

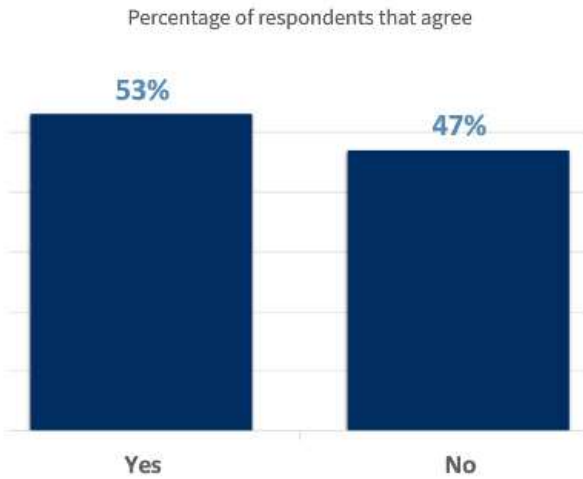
Such sentiments have not aged particularly well even if we get beyond the Brexit navel-gazing, with much of the talk in U.K. economic policymaking being focused on a desire for greater stimulus efforts. Indeed, I even heard one minister, cut from broadly the same political cloth as the aforementioned Chancellor, bemoan the slow nature of recent U.K. fiscal expansion efforts compared to - for example - the actions of the current American President a couple of years ago.

Yes, joining ever lower global interest rates is so much talk about extra fiscal stimulus that it would even make John Maynard Keynes blush. And at a time of concern about the prospective health of the global economy with trade angst and mature economic cycles but, importantly, still low inflation rates, what could be worse?

Certainly the juxtaposition of low bond yields and a renewed willingness of governments around the world to use the tax and government spending fiscal levers appears to offer opportunities for lower risk stimulus efforts, akin to those continued low inflation opens up for ultra-loose monetary policy. Certainly in complete contrast to the 'debt trap' books of my formative years, modern fiscal stimulus offers observations such as 'so long as the rate of GDP growth exceeds the interest rate charged on the debt, then the ratio of accumulated debt to GDP will fall over time, steadily eroding the share of national income that must go to interest payments on this debt'.

Now I know this all sounds terribly economically wonkish, but it is rather important - and potentially revolutionary. After all, this is a world where in late September even the under pressure fledgling Italian government issued billions of euros worth of ten-year duration debt at an interest rate of just 0.88%. Of course, Italy has struggled to grow at above a 0.9% per cent growth rate recently, but if you apply similar maths to (say) a France, and especially a Germany, then this magic money tree looks exceedingly attractive from this very narrow perspective. As for the U.K., this would normally be absolutely achievable too with ten-year gilt yields under 0.6%... assuming any Brexit outcomes are not too negatively impactful.

## "I am Too Old to Learn Data Skills"



Source: Splunk and TRUE Global Intelligence

There is, of course, one big reason why Germany - in apparent contrast to the U.K., France, Italy and the United States (among many others) - have preferred to stick with a well-documented approach with still priorities a balanced budget. They are worried - probably excessively so in their specific case - that the use of low/negative interest rates and/or bond yields for longer time periods are reflective of a deeper and bigger malaise, as best reflected by the experience of Japan over the last quarter of a century.

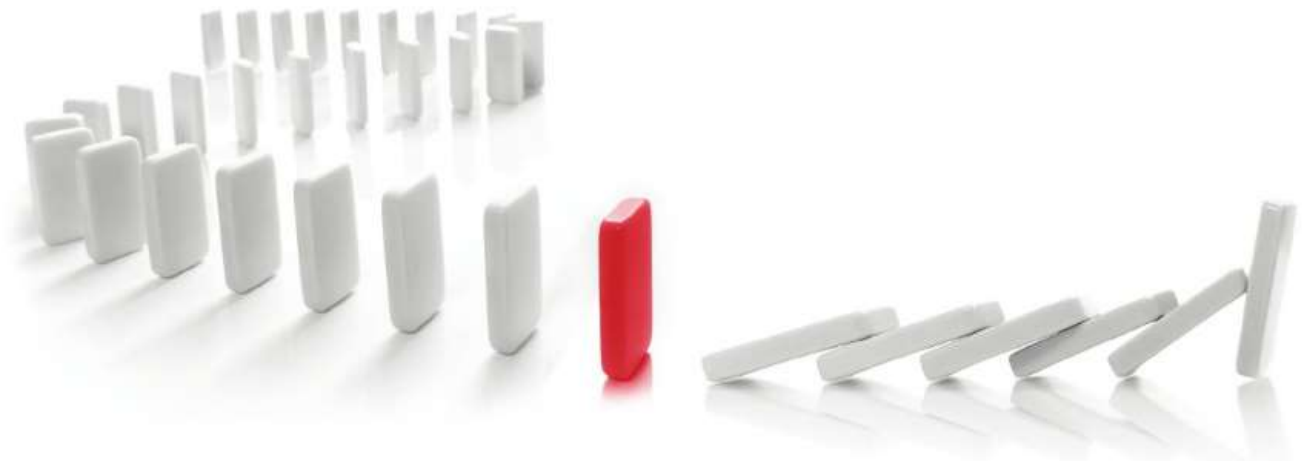
Ah... Japan. Certainly the Land of the Rising Sun can provide some insights for other progressively more demographically challenged 'developed' economies struggling to work out their place in the global economy of the next generation or so. However, I have two big problems with why Japan's continuing material use of stimulus techniques should not be a case study for countries such as the U.K. or the United States. First, as the quantum of debt rises, basic demand/supply concepts suggest that pressure for the interest rate required by investors to buy ever more goes up. Shorter term - as we saw with the Italian example above - the circle can maybe be squared in a desperate search for some yield, but these are the fiscal salad days. Japan's almost unique domestic self-funding of its bond market is not the experience of almost any other large

advanced economy out there, which have to take their chances more with the global capital markets. The second point is that the relatively high homogeneity and depth/rigidity of Japanese society should also not be underestimated as a force that underpins stability. Again, I am not convinced a similar backdrop exists in other parts of the world, meaning that broad economic stability alone is unlikely to be enough for society at large.

'In short, a bit of tactical fiscal loosening is probably quite smart across economies to supplement efforts by central banks, but if you believe near permanent levels of economic stimulus is an end in itself then it will turn into fools gold. Clever maths can only get you so far, especially if the quantum of debt rises too much, too fast, and even before interest rates / bond yields start to push back up in response to stagnant productivity rates. Far better is to believe over time in the magic tree of innovation and economic dynamism improving reform, rather than any magic money tree. Policies that encourage entrepreneurs to take risks, established companies to invest in productivity enhancing technology and disenfranchised employees to seek retraining seem like smarter moves over time. As the graphic to the left shows there is much work to be done to make even the average citizen believe. Pragmatically, the best we may have to hope for, are seeing such efforts to boost economic dynamism being complemented by stimulus efforts sufficient to win elections. ■

### KEY TAKEAWAYS:

- Extra monetary and fiscal policy stimulus talk is currently highly prevalent in most geographies around the world.
- Low inflation rates and compressed bond yields appear to give policymakers lots of room to move.
- Japan has seen a lengthy period of stimulus and is often cited as a guide to the future, but such comparisons have difficulties.
- Policymakers are wiser to supplement stimulus measures with innovation and economic dynamism improving reform.



## Regarding Recessions

Scott J. Brown, PhD, *Chief Economist*, Raymond James

We are never 'due' for a recession. The likelihood of entering a downturn does not depend on the length of the expansion. However, we do know that recessions are inevitable.

### The National Bureau of Economic Research (NBER) defines a recession as:

A significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real gross domestic product (GDP), real income, employment, industrial production, and wholesale-retail sales.

**It is not two consecutive quarterly declines in real GDP** (there were not consecutive quarterly declines in real GDP in the 2001 recession).

### LONG IN THE TOOTH?

The normal state of an economy is expansion (that is, growing). A recession begins when the economy stops growing (and begins contracting) and ends when the economy starts growing again. The NBER's Business Cycle Dating Committee (BCDC), a group of senior academic macroeconomists, is the official arbiter of

recessions. The BCDC determines the beginning and ending dates of recessions and its job is to be definitive, not timely. It may be a year or more before it declares that a recession has begun and it may be a year or more before it declares that a recession has ended.

Recessions are marked by their breadth, magnitude, and duration. Each has its own characteristics, but there are some common similarities. Typically, a recession is preceded by a period of over-investment or malinvestment, which leads to a correction. Think of the savings and loan crisis or the dot-com bubble. Individuals postpone big-ticket purchases, such as a car or new home, and as the economy rebounds, this pent-up demand fuels a robust recovery.

The 2007-09 recession was a different sort of animal. We know that recessions that are caused by financial crises tend to be more severe. They last longer and the recoveries take a long time. The collapse of the housing bubble meant the housing sector and areas fueled by the extraction of home equity would recover only slowly at best. It would not be a V-shaped recovery.

Can a recession be forecasted? We have only had 11 recessions since World War II (and just three in the past 37 years). That's a very small sample size. The economy has evolved in significant ways over time. So, past experience may not tell us much.

## Snowballing to a Slowdown

As businesses fear a weakening economy, they curtail spending and hiring. This, in turn, crimps consumer spending, which leads to further declines in business confidence. This self-reinforcing cycle ultimately perpetuates a snowball-style effect that exacerbates an economic slowdown.



### CURVEBALL

The yield curve has historically been the single best predictor of recessions. As the yield curve inverts, long-term interest rates fall below short-term interest rates. That's because short-term interest rates are expected to decline (think of long-term rates as a series of short-term rates). Why? Because the Federal Reserve (Fed) would cut rates in the face of a weakening economy. In this sense, expectations of recession may become self-fulfilling. If consumers expect the economy to weaken, they would be less likely to buy a new home or a new car. If businesses expect a recession, they would be less likely to invest in new plant and equipment or hire new workers. The economy would weaken. A positively-sloped yield curve creates incentive for banks to lend. Conversely, an inverted curve dampens loan growth, and in turn, economic growth. Note that it may be a year or more between yield curve inversion and the start of a recession.

There are few signs that the overall economy is currently in a recession. The household sector fundamentals (job gains and wage growth) have remained strong, and consumer spending (68% of GDP) should provide support for overall economic growth in the near term. However, the odds of a recession developing over the next 12 months have been rising. A simple yield curve model of recession now puts the odds of

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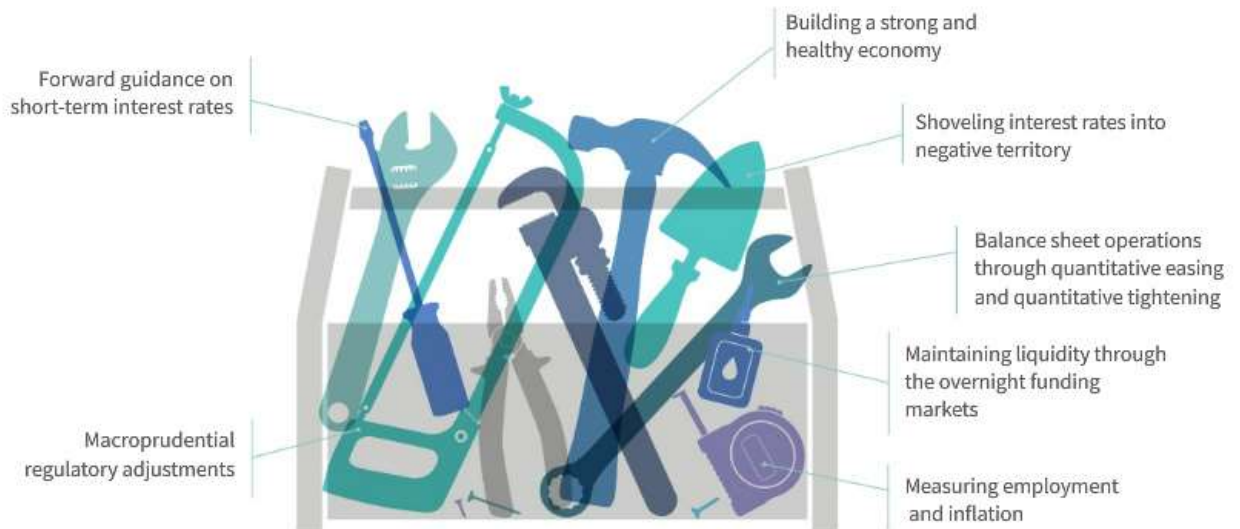
entering a recession within the next 12 months at about 40%, too high for comfort.

Moreover, interest rates are lower than in the past, which means that the odds could be even higher. The model only signaled a 50% chance of a downturn ahead of the Great Recession.

Factory output has been weakening since the start of this year, down 1.6% from December to July. However, we have often had recessions in the manufacturing sector without a recession in the overall economy. In contrast, a recession in the overall economy essentially guarantees a recession in manufacturing.

## Central Bank Toolbox

Most central banks are tasked with price stability, but the US Federal Reserve is also required to foster maximum sustainable employment. The Fed's primary tool is the federal funds rate, the overnight lending rate that banks charge each other for borrowing excess reserves – and will lower the target rate to boost growth if needed. As we saw during the financial crisis, the Fed has a number of non-standard tools to support the economy. These include forward guidance, the conditional commitment to keep short-term interest rates low for an extended period, and large scale asset purchases (or quantitative easing). This year, the Fed is revisiting its monetary policy strategies, tools, and communications policies, but the focus has already turned to maintaining an ample level of bank reserves in the system.



### TRADING CERTAINTY FOR TARIFFS

Trade policy has been a factor this year. Tariffs raise costs for US consumers and businesses, invite retaliation, disrupt supply chains, and undermine business investment. Should the US reach a trade agreement with China, uncertainty would decrease and that may help avoid a recession in 2020. However, if the trade war continues to escalate, the downside risks to the economy will increase. Disruptions to supply chains have been costly, and the May 10 increase in tariffs (from 10% to 25%, now 30%) has pressured margins in manufacturing. The final round of tariffs on Chinese goods (15% on \$300 billion of goods), 60% of which were delayed to December 15, falls on consumer goods, most of which come only from China. The trade conflict threatens a permanent separation of the world's two biggest economies.

### FEDERAL (RE)ACTION

Stimulative fiscal policy means cutting taxes or increasing government spending. In 2009, Congress enacted an \$831 billion

“Should the US reach a trade agreement with China, uncertainty would decrease and that may help avoid a recession in 2020.”

package of tax cuts and spending, spread mostly over two years. That helped to reduce the damage, but as large as it was, it wasn't big enough to offset the magnitude of the economic downturn.

While we typically focus on the federal budget, state and local governments also matter. Most have balanced budget requirements. In the Great Recession, tax revenues dried up, eventually leading to sharp cuts in state and local government jobs. This was a significant difference from previous recessions, where government spending provided a base level of support for the economy. Cuts in spending restrained the recovery.

“Stimulative monetary policy means that the Fed lowers short-term interest rates to support growth. In a normal recession the Fed cuts rates by 5%, or 500 basis points. The central bank currently has a lot less room to work with.”

#### ADDING AUSTERITY TO ADVERSITY

With the annual federal budget deficit nearing \$1 trillion, fiscal stimulus may be constrained in the current environment. We can expect the deficit to rise further in a recession. This may lead to calls for austerity (tax increases or spending cuts), which would make the downturn worse and dampen the recovery. After providing fiscal support during the recession, many European countries turned to austerity, dampening their recoveries. The US also embarked on austerity, but on a limited scale.

#### DESENSITIZED TO STIMULUS

Stimulative monetary policy means that the Fed lowers short-term interest rates to support growth. In a normal recession the Fed cuts rates by 5%, or 500 basis points. The central bank currently has a lot less room to work with. In response to a downturn, once rates are taken down near zero, the Fed would employ forward guidance, a conditional commitment to keep short-term interest rates low for an extended period. We may also see another round of large-scale asset purchases, commonly called quantitative easing. Comments from the Fed indicate that officials are unlikely to pursue negative interest rates, as has been adopted by other central banks.

There's some concern that more accommodative monetary policy may not do much to turn the economy around. Business fixed investment does not appear to be sensitive to interest rates and consumers may not want to take on additional debt. The idea that the Fed would be 'pushing on a string' is a worry we have during every recession. However, Fed rate cuts improve financial conditions, setting the stage for economic recovery.

#### THE BUST OF THE BABY BOOM

Demographic changes brought on by an aging population and slower trend growth in the workforce mean that the recession/recovery scenario will differ from past cycles. A few decades ago, baby boomers were still entering the workforce and female labour force participation was on the rise. The labour force was growing at 2.5% per year in the late 1970s. Those trends are now well behind us. Labour force growth is now rising about 0.5% per year, further dampened by restrictions on legal immigration.

Barring an unprecedented surge in productivity growth, the underlying trend in real GDP growth is now seen as 1.5-2.0%, compared to 3.0-3.5% in the 1980s. Slower trend growth in GDP means that recessions may become more likely and recoveries more muted than in the past.

In summary, there are few signs that the US economy is currently in a recession, but the odds of entering a recession next year have been rising. We don't see the kind of excesses that would lead to a more pronounced economic downturn, but the tools for fighting a recession are likely to be constrained. Investors should consider that while recessions are transitory phenomena and the prospects for longer-term expansion remain good, demographic changes will have a dominant impact on the economy in the decades ahead. ■

#### KEY TAKEAWAYS:

- We are never 'due' for a recession. However, recessions are inevitable.
- The yield curve has historically been the single best predictor of recessions. It may be a year or more between yield curve inversion and the start of a recession.
- There are few signs the overall economy is currently in a recession. Job gains and wage growth have remained strong, and consumer spending (68% of GDP) should provide support for overall economic growth in the near term.
- Should the US reach a trade agreement with China, uncertainty would decrease and that may help avoid a recession in 2020. However, if the trade war continues to escalate, the downside risks to the economy will increase.
- While recessions are transitory phenomena and the prospects for longer-term expansion remain good, demographic changes will have a dominant impact on the economy in the decades ahead.



## A Time (Finally) for Value?

Chris Bailey, *European Strategist*, Raymond James Investment Services Ltd.

*'Only the ideas that we really live have any value' - Hermann Hesse*

The whole 'value' versus 'growth' story has got very distorted in the last fifteen years. Now, it would be very easy to blame the return of the reverse yield gap where - in contrast to the norms of most of the last fifty plus years - many equity investments yield more than many fixed income instruments. Given the former have unfettered capital growth potential whilst the latter have fixed principals structures, this seems very surprising.

All this may be surprising but it is popular, especially in an era where widespread global quantitative easing has been apparent. In its simplest form, quantitative easing is the printing of money to buy government bonds and the widespread - despite efforts by central banks such as the Federal Reserve in the United States - continuing application of this policy has certainly been a help in compressing bond yields, along with a relative lack of inflationary shocks over recent years.

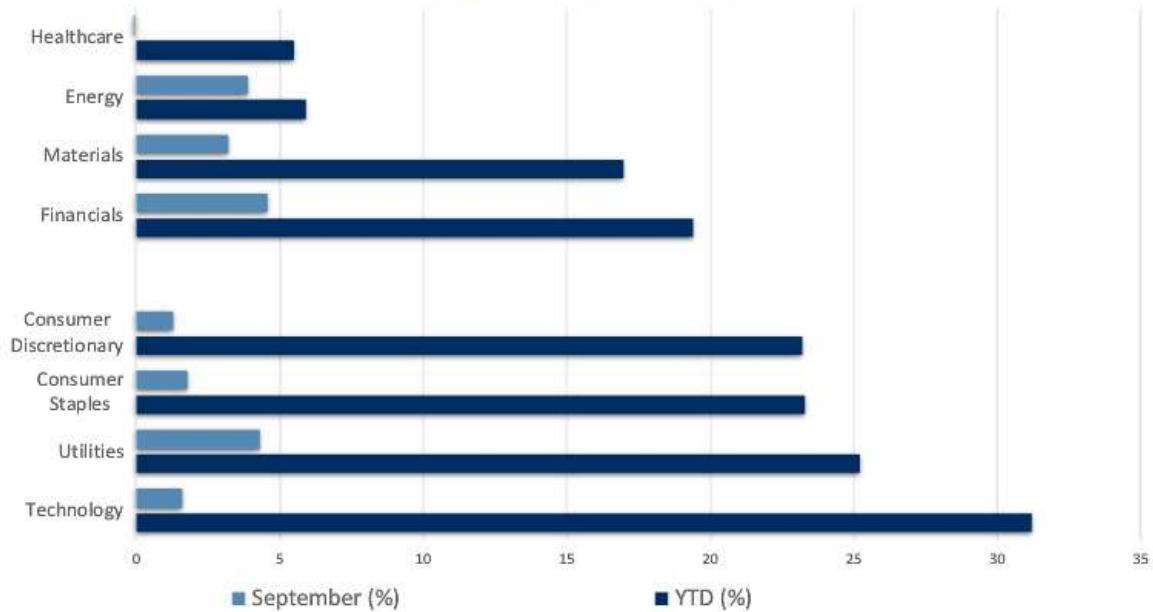
Ever lower bond yields have set off a search for yield by investors which has impacted bond and equity markets alike. Negative yielding government and corporate bonds feel like a misnomer in a sophisticated fixed income market, but the combination of the

quantitative easing purchasing flow and the muted inflation statistics have allowed a squaring of the circle. Areas such as 'high yield' bonds seem worryingly misnamed in today's markets but all this has led to a certain type of equity to become more and more popular.

Personally, I blame the discounted cash flow measure of analysis. Simply put, when the cash flows of a business are being discounted by a lower and lower interest rate, the value given to these anticipated cash flows goes up. Now this is good news especially for two types of shares: growth companies and perceived 'quality' names. This is because big hope (growth shares) can lead to big valuations today as we have seen by the excitable nature of both the technology and initial public offering markets over recent years. Meanwhile areas that appear quite predictable ('quality' shares) are easy to model out deep into the future, again allowing some big valuations to be given to a cadre of global consumer facing shares. By contrast, such attributes are not so easily applicable to a range of more cyclical areas encompassing the financial, commodity-facing and industrial sectors.

Now this all seems like a set-up for a good old rant about the attractions of sector selection and stock picking, but it has led to some overt bigger picture asset allocation performance biases. Most global indices are composed of many tens, if not hundreds of companies, but look at a sector level and exposure traits become

## Sector Performance



Source: Bespoke. Data refers to the US large cap equity market on 30/09/19

apparent. Whilst one rationale for the outperformance of the stock market indices in the United States over the last decade has been superior economic growth levels compared to the pan-European economy or Japan, a much heavier technology sector bias has also contributed. By contrast, indices in the pan-European markets, Japan or - indeed - the emerging markets have typically a greater component of these 'value' sectors.

The question today - and looking forward into the early 2020s - is whether this enthusiasm for growth/quality shares has got far too extended. Certainly, very short-term performance trends during August and September have been much more mixed up and talk about 'sector rotation' has started to creep into market lexicon.

My tip would be to look at the level of the U.S. dollar, a currency which has performed very well but now is facing some new pressures. The dollar has been both a beneficiary of flows into the American market chasing more exposure to technological and 'quality' shares and a justification for continuing such actions, a relationship which has looked more like a momentum frenzy in recent months. A dollar fade here would start to impact this justification circle and maybe open up a broader re-appreciation of some of the more 'value' sectors of the equity market. As for the recent extraordinary enthusiasm to chase down bond yields, then

maybe a fuller realisation that quantitative easing (supplemented by other stimulus efforts) forever is probably not a strong basis on which to run an economy longer-term, may ultimately impact. Or maybe an unanticipated inflation shock is just around the corner. As always with the notoriously fickle financial markets, having a range of different sorts of investments tends to make a bit more sense for most investor risk profiles over time. ■

### KEY TAKEAWAYS:

- Ever lower bond yields have set off a search for yield by investors which has impacted bond and equity markets alike.
- Beneficiaries from recent market trends have included growth and 'quality' shares.
- Short-term performance trends during August and September have been much more mixed up.
- A dollar fade here maybe open up a broader re-appreciation of some of the more 'value' sectors of the equity market.



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