INVESTMENT STRATEGY OUTLOOK

REGIONS
ASSET MANAGEMENT

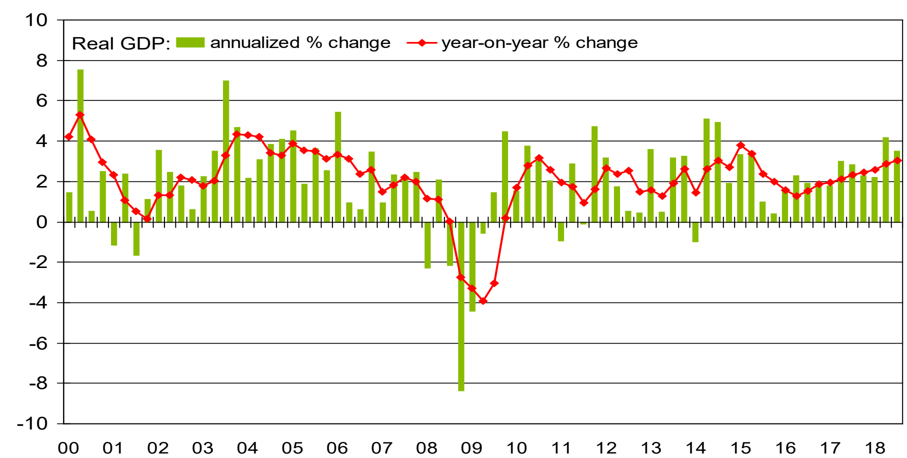
THE ECONOMY

November 2018

U.S. Economy Expansion Still Intact

While it may be tempting to attribute the recent volatility in the financial markets to a deteriorating economic outlook (to be sure, there have been some unable to resist this temptation), the high frequency economic data continue to paint a positive picture of the U.S. economy. While there are signs that growth is settling into a more sustainable pace, this is neither surprising nor alarming. At least it shouldn't be – one recent headline proclaimed "it's downhill from here" which, to this publication, is called news. We, on the other hand, call it our baseline forecast, which for over a year now has anticipated the same pattern of growth – 2018 may be one of the best, if not the best, year of economic growth of this entire expansion (now in its tenth year), with growth slowing in 2019 and slowing further in 2020. With 2018 thus far having played out pretty much as we had anticipated, we've seen no reason to change our view. It does, however, help to be aware of the distinction between slowing growth and the end of growth, even if the recent volatility in the financial markets leads some to fear we're seeing the latter, not the former.

Can The U.S. Economy Sustain Its Momentum?



Source: Bureau of Economic Analysis; Regions Economics Division

The initial estimate by the Bureau of Economic Analysis (BEA) shows real GDP grew at an annualized rate of 3.5 percent in Q3 2018, on the heels of 4.2 percent growth in Q2. The details of the report on Q3 GDP, however, were a mixed bag. Real consumer spending grew at an annualized rate of 4.0 percent, adding 2.69 percentage points to top-line real GDP growth, and a sizeable build in nonfarm business inventories added 2.07 percentage points to top-line growth. On the flip side, a significantly wider trade deficit lopped 1.78 percentage points from top-line growth. Real business spending on equipment and machinery grew at an annualized rate of just 0.4 percent in Q3, well below the average 8.6 percent growth seen over the prior six quarters. We do not, however, think business investment has suddenly fizzled, and expect a faster rate of growth in Q4.

Neither the sharp increase in business inventories nor the sharp widening of the trade deficit seen in the Q3 data will be repeated in the Q4 data, so in terms of the effects on top-line growth, it will be pretty much of a wash. But, these swings do illustrate the drawbacks of taking quarterly changes and annualizing them as the basis on which to assess economic growth. We prefer to look at real GDP on the basis of year-on-year percentage changes, which we see as a better gauge of the underlying trend rate of growth. Real GDP was up 3.0 percent year-on-year in Q3, which is right in line with our forecast for full-year growth, and Q3 marks the ninth consecutive quarter in which year-on-year growth was faster than in the prior quarter, the longest such streak on record. That streak will end at some point but, when it does, it will be the end of the streak, not the end of the expansion.

To our point about growth settling into a more sustainable pace, the ISM Manufacturing Index slipped to 57.7 percent in October, well below levels seen over recent months but nonetheless the 26th consecutive month in which the headline index was above the 50.0 percent break between contraction and expansion. Though ISM reports many survey respondents are increasingly concerned about the adverse effects of tariffs, new orders and backlogs of unfilled orders continue to grow, suggesting continued growth in production and employment over coming months.

Indeed, a 32,000-job increase in manufacturing payrolls was one of the highlights of a standout October employment report. Total nonfarm employment increased by 250,000 jobs in October, with private sector payrolls up by 246,000 jobs as job growth remained notably broad based across private sector industry groups. While some of October's job growth reflects payback for Hurricane Florence having held down job growth in September, of more relevance is that over the past 12 months the U.S. economy has added an average of 210,000 jobs per month.

At first glance, the 3.1 percent increase in average hourly earnings in October may be seen as a sign that wage growth is finally responding to tighter labor market conditions. While wage growth is accelerating, however, the year-on-year increase in average hourly earnings has more to do with how weak hourly earnings were last October than with how strong they were this October. Last October saw sizeable numbers of lower-wage workers return to the employment rolls after having been displaced by Hurricanes Harvey and Irma. This biased hourly earnings lower – they fell by 0.2 percent last October, thus setting up the large year-on-year increase seen this October. That said, the Q3 Employment Cost Index and the Q3 data on labor productivity suggest the underlying trend rate of wage growth is accelerating, even if still a bit short of the 3.0 percent mark.

Though some have cited the recent turmoil in equity markets as grounds for the FOMC to hit the pause button, our view is that the FOMC is not, at least not yet, uncomfortable with the tightening in financial conditions brought about by lower equity prices. Indeed, Fed Chairman Powell has frequently pointed out that, rather than inflation heating up, unduly loose financial conditions may pose a bigger threat to the expansion, and the focus on financial conditions is consistent with what Mr. Powell has described as a risk management approach to setting monetary policy. As such, with the inflation-adjusted effective Fed funds rate still negative (as has been the case since late-2009) and the high frequency data pointing to solid, even if decelerating, economic growth, we do not expect the FOMC to pause any time soon, and expect another 25-basis point hike in the Fed funds rate at the December FOMC meeting.▲

Source: BEA; BLS, ISM; Federal Reserve Board

STOCKS

Silver Linings

Unless you're a short seller or just enjoy pain, you're likely happy to have October in the rearview mirror. Domestic markets experienced bouts of volatility coinciding with sharp daily declines – the S&P 500 didn't experience back-to-back positive performance days until the last two trading days of the month. Without a 2.6% rebound on the 30th and 31st, things would have looked and felt much worse. Once October had mercifully come to an end and the dust had settled, the S&P 500 had declined 6.9%, while the small-cap Russell 2000, which outpaced the S&P 500 for most of the year through September, had fallen 10.9%. International markets, even after posting year-to-date losses through September, again failed to garner much interest from those taking profits in domestic markets, as the MSCI EAFE fell another 8% while the MSCI Emerging Markets Index dropped 8.8%.

We've read a litany of commentaries, articles, musings, and diatribes in which an author attempts to pinpoint, ascertain, or explain away the root cause of the sell-off in domestic stocks – we're going to add our two cents here. Most pundits appear to have settled on the premise that U.S./China trade "reality" hitting home, a perceived slowdown in domestic economic growth, and out of touch or ill-advised comments from FOMC Chair Jerome Powell related to how much higher the Fed funds rate might need to go as drivers of the most recent market pullback. Additionally, corporate buybacks were halted in advance of earnings season as companies entered black-out periods, while at the same time hedge funds and other large institutional investors attempted to beat peers to the profit-taking punch as the third quarter wrapped up. These were contributing factors, as was algorithmic or program trading, which likely exacerbated intra-day moves to the downside. There have been fewer large buyers willing to step in while there have been plenty of computers willing to sell/short mid-afternoon as stocks fall. The sell-off has been painful for those overweight risk assets, but we see silver linings amid the chaos.

Third quarter earnings, broadly speaking, have surprised to the upside. With 75% of S&P 500 companies having reported, year over year EPS growth has been 26.4% – this after 25.2% year over year growth in 2Q. While earnings have remained strong, valuations based on projected forward earnings have become more attractive. The S&P 500 traded at 16.4X expected full year 2019 earnings at the end of September, but earnings estimates remained stable as stock prices gapped lower during October, and the S&P traded at 15.2X projected '19 EPS at the end of the month. After making a beeline higher in early October, rates were range bound over the back half of the month. The 10-year U.S. Treasury yield closed October at 3.15% - 6 basis points higher than where it began the month. Interest rates stabilizing should benefit stock prices as analysts aren't being forced to revise assumptions related to discount rates on projected future cash flows, boosting the present value of those cash flows. Earnings multiples tend to compress as rates move higher, so avoiding another rate spike may allow the S&P 500 earnings multiple to expand a bit.

It's notable that the yield curve steepened a bit during October, relegating those calling for an imminent recession due to economic "signals" sent from a flattening yield curve to the backburner. U.S. economic growth should slow from around 3% in 2018 to the mid-2% area in 2019, but a recession remains far away. Interest rates are low, wages and productivity are gradually rising, consumer and small business confidence remain high, and the potential exists for capital expenditures to accelerate into year-end. U.S. stocks appear fairly valued, while international stocks appear cheap, but for good reason. As we close out 2018, investor attention will remain on U.S./China trade relations and FOMC monetary policy. ▲

Source: Bloomberg

BONDS

Rookie Move

Comments by FOMC Chair Jerome Powell related to the Fed funds rate being a "long way from neutral at this point" rattled markets during October as investors took this to mean that the FOMC was indeed on a path destined for a policy mistake. Chair Powell reiterated prior statements that the FOMC doesn't know exactly what the long run neutral rate should be, but expressed a willingness to go beyond it if necessary. The neutral rate is the rate at which monetary policy neither stimulates nor restrains economic growth – thought to be between 3% and 3.5% on Fed funds at present. Chair Powell's remarks were unsettling for markets and a rookie move from the FOMC chair in our view, but that doesn't mean he's mistaken, or that he communicated anything beyond what the dot plot was trying to tell us. This may serve as a valuable lesson as Powell must be cognizant of how even the most innocuous comments in his eyes can move markets, and when less is more as it relates to forward guidance.

We kicked off November with the release of the October nonfarm payrolls report, as addressed in greater detail in the Economics section of this outlook. In October, payrolls grew by 250,000 jobs, easily besting the consensus estimate of 190,000, while the unemployment rate remained unchanged at 3.7%. The overall strength of the report pushed bond yields higher across the curve, with the benchmark 10-year yield up 7 basis points on the day of the release. Talking heads have posited that the U.S. economy was perhaps weaker beneath the surface than meets the eye, which might provide the FOMC with the necessary cover to delay its next hike into 2019. The payrolls report throws cold water on those espousing the economic slowdown theory. The issue at hand is whether the data is so good that it's bad for investors as a tight labor market keeps the FOMC in play and on a path to hike rates an additional two or three times in 2019 after another quarter-point hike in December.

With the 10-year portion of the yield curve settling into a trading range between 3.08% and 3.25% over the past month, we wouldn't be surprised if the curve gradually flattens into year-end. Shorter-term bonds, asset-backed securities, and U.S. dollar-denominated emerging markets debt continue to be areas of interest for us. Amid the sell-off across global equities in October, high yield corporates experienced a flight to safety, with the Bloomberg Barclays U.S. High Yield Index generating a -1.6% return during the month. Through October, the high yield index remained one of the few fixed income indices to post a positive total return year-to-date. While high yield spreads remain tight relative to historical norms, the yield to worst on the index at month end was 6.86%, a much more attractive level versus where it entered the month. With our expectation that defaults will remain around current levels well into 2019, it's difficult to forego the yield/carry on high yield by moving into another pocket of the fixed income market. The time to trim or jettison high yield is coming, we just don't think it's right now. ▲

Source: Bloomberg