The Long & Short of It

Quarterly Newsletter
Second Quarter 2019

Who's Winning?

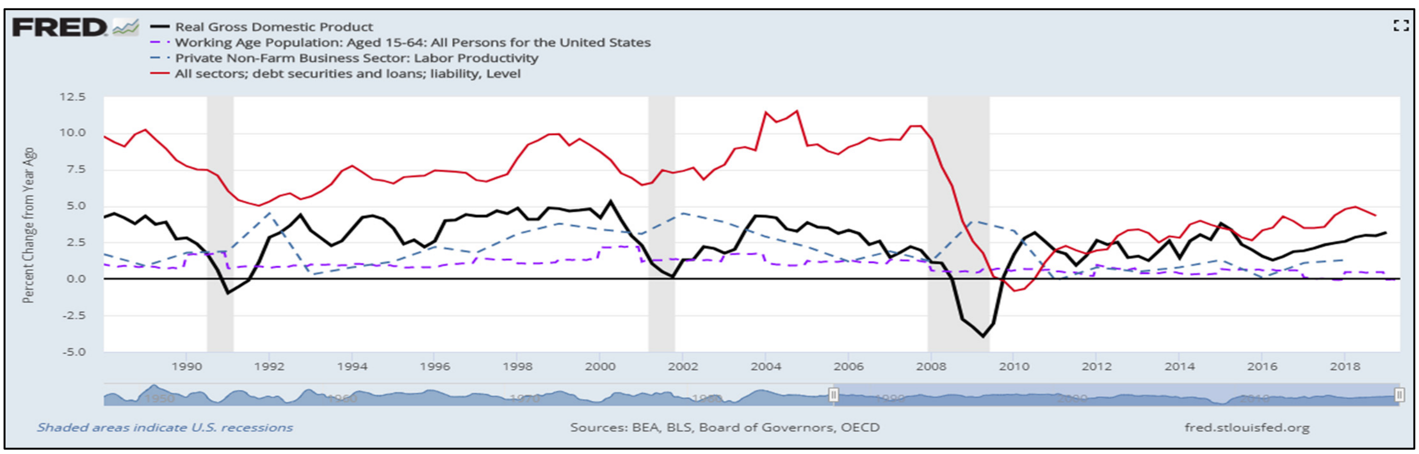
In June 2019, the current economic expansion tied the March 1991-March 2001 expansion for the longest in US history. The S&P 500 had its best June since 1955 and the Dow its best June since 1938. The stock market pushed into record territory despite unresolved trade disputes, escalating tensions in the Middle East, and an unprecedented increase in low-quality corporate debt issuance.

The major stock market indices show one-year returns at close to 10%, but they are heavily weighted toward a few of the very biggest companies. Many more companies are represented in the international, mid-cap, and small-cap indices, whose one-year returns are close to 2%, 1%, and -5%, respectively. The broader market struggles while leadership at the top continues to narrow.

As the 10-year bull market heads into overtime, who will keep the game going?

Not America's Workers

In the chart below, you can see that real GDP (black line) has been growing since late 2009. In prior market cycles, increases in the working age population provided a tailwind for economic growth (purple line). But the working age population's growth rate has recently declined to just below zero. Productivity gains, though recently somewhat



improved, remain anemic in historical context. At this point, the only paths to economic growth are increased participation in the workforce or debt issuance to stimulate spending by consumers, corporations, or government. Although the labor force participation rate has room for improvement, an aging population makes fewer people available to work, leaving debt issuance as the primary driver of economic growth.

Not Corporations

During the quarter, rates of growth for US manufacturing and industrial production slowed or turned negative. Pending home sales and rail traffic remained in contraction. GDP estimates came down. Businesses appeared weak but stable and were, on average, very highly leveraged. As recently noted by Jim Grant in *Almost Daily Grants*: "The domestic quantity of loans outstanding has reached $1.2 trillion according to S&P's Leveraged Commentary and Data unit, more than doubling since 2012 and exceeding the supply of high-yield bonds last May for the first time ever."

Early in an economic expansion, growth occurs without much increase in debt. Later, debt and GDP growth track each other until late in the cycle, when debt expands without GDP rising in kind. Currently, the credit cycle and ensuing asset price expansion are thriving despite their declining abilities to significantly impact economic growth. In other words, not only is GDP responding less to corporate debt growth, but corporations are becoming so leveraged as to make themselves vulnerable in a credit contraction.

Perhaps the European Central Bank

Over the past three months, most regions of the world saw growth estimates revised downward for 2019. Yet optimism remains for widespread improvement in 2020 and thereafter. Part of the reason is the appointment of Christine Lagarde to the presidency of the European Central Bank. Formerly head of the International Monetary Fund, Lagarde is widely expected to lower interest rates as much as needed to stimulate EU economies, even to negative rates if necessary. This should provide some bullish influence to the US and global stock markets, but only a mild tailwind would be expected.

Congress Might Be a Player

The Budget Control Act (BCA) of 2011 mandates that spending limits return to their original level for both defense and non-defense at $576 billion and $543 billion, respectively. The coming fiscal restraint already written into the 2019 budget and the potential for sequestration in 2020 could potentially shackle economic growth. However, Congress is first and foremost a body politic. There may be an opportunity for bipartisan cooperation over the 2020 budget in the fall. Republicans will likely not tolerate the 2011 mandated defense cuts and could seek opportunities to gain Democratic cooperation on defense in exchange for concessions on spending priorities. The resulting bipartisan spending bonanza could further inflate asset prices and temporarily reenergize the bull market in late 2019 and 2020, but this windfall would come at the expense of future economic growth. Before the 2008-2009 recession, the US federal debt-to-GDP ratio was around 60%. The 2008-2009 bailouts pushed that ratio to 90%; today, it is in excess of 100%. Future recessions will not be so easy as the government finds it harder to borrow for stimulative spending and bailouts.

Chairman Powell and Co. Remain in the Game

Last quarter's newsletter noted that "[i]f the current semi-restrictive fiscal and monetary policies lead to greater-than-expected slowing in 2019, long-term US Treasury rates would decline and further invert the yield curve without any further action by the Fed." Reduced growth estimates did indeed lead to lower interest rates and an inversion of the yield curve in the first quarter of 2019. It also led to monetary policy feeling tighter without any actual change to the Federal Funds rate. At its June meeting, the Federal Reserve shifted to more accommodative language; expectations of easier monetary policy are now priced into the stock market. As long as inflation remains subdued, the door is open for the Fed to lower interest rates to sustain the expansion. Furthermore, in the coming quarter, President Trump will appoint two new governors to the Fed's board. These appointees have already stated that they are in favor of lowering interest rates, which would be stimulative to the economy and the stock market. Historically, the Fed rarely adopts restrictive monetary policy during a presidential election year.

The economic expansion and bull market continue but the longer the expansion, the further off the ground the economy levitates and the further it will fall when the cycle ends. The current environment requires discipline, patience, and a stomach for volatility. We remain on defense as this stock market heads into overtime. Fleeing to the sidelines is not an option. Mitigating risk one investment at a time allows us to stay in the game and make the most of select opportunities.

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