

Are We Reaching the Tipping Point?

In the midst of a global slowdown, the U.S. has been the best house in a bad neighborhood. The dominos of negative economic data keep falling, and we're edging closer to the tipping point into a recession. The Fed says the U.S. economy is sound and their two rate cuts are simply due to potential trade war risks that haven't fully materialized. Can we still achieve a soft landing? Or, will we reach a point of no return where a trade deal will be too late and incapable of reversing the negative economic trends we see?

U.S. Economic Data is Trending Down...

The negatives

- **Increasing weakness in manufacturing** with the September purchasing managers' index (PMI) falling from 49.1 in August to 47.8, the lowest reading since June 2009. The weakness in manufacturing is now spilling over to the services sector
- **Weakness appearing in the services sector**, with the September non-manufacturing PMI falling from 56.4 in August to 52.6 last month. This level is consistent with about 1% real GDP growth, not exactly inspiring
- **Falling earnings growth and business confidence** over the past 12 months
- **Falling business investment** since the 3rd quarter of last year eventually affects business hiring behavior (which is already slowing)
- **Weakness in auto and housing markets** (although recent drop in rates has helped housing)
- **Global economic slowdown** affecting U.S. exporters
- **The inverted yield curve**, a well-known precursor of previous recessions (see our recent blog)
- **Fed recession indicators rise above 30%**

Last week's consumer confidence number was the most worrying domino to fall yet

September consumer confidence fell from 134.2 to 125.1, the largest drop in nine months, and a potential harbinger of lower spending and further slowing economy. To date the consumer has been an important bright spot in the economy.

The oft mentioned positives

- **Consumer spending**, the workhorse of the U.S. economy, representing 70% of GDP, remains strong to date, but may be affected if consumer confidence continues to fall
- **Employment growth** has been strong but now plateauing, important to watch because employment is the driver of consumer spending
- **Wages** have been slowly growing but now plateauing
- **Worldwide reserve banks** are lowering rates to stimulate their economies

The Political Landscape is Getting Increasingly Complex...

Regardless of who wins, both parties have abandoned living within their means. Voters will just have to pick whether they prefer deficit creation for defense, corporate tax cuts, Medicare-for-all or student loan forgiveness. With interest rates at such low levels, debt issues don't weigh heavily on anyone's mind.

The Democratic Nominee

With betting odds favoring Elizabeth Warren as the Democratic nominee, we are concerned about the market impact. While intended to help hard working Americans, her policies appear detrimental to many U.S. companies, putting capital formation and employment growth at risk. Although Senator Warren believes her increased taxes will offset increased social program costs, we would take the under on that bet. Her endorsement of the green new deal, while good for the environment and human rights, is equally threatening to a trade deal with China.

The President

While it makes political sense for Trump to do a trade deal closer to the election (after we've had a few more stimulative rate cuts from the Fed), the President may also be worrying about his ability to reverse the trends in place. A trade deal is likely necessary for his re-election and continues to be a wild card for the market.

Regarding a second term for Trump, what happens when the desire for re-election no longer provides a governor for his behavior? In addition to market concerns and more volatility with every new tweet, who knows what havoc might be wreaked on the environment and basic human decency.

Attacks of Saudi Oil Fields

We hardly think this story is over. An eye for an eye is the Middle East mantra. It is hard to believe that a country who allegedly dismembered and killed a journalist for the power of his speech is going to turn its back on terrorists who threaten the country's main source of income.

Oil stocks make up less than 5% of the S&P 500 and their performance year-to-date hasn't mirrored the rise in the price of the commodity. If there is another disruption in Middle East supplies, energy stocks could rise sharply. Depending on the amount of the spike and how long it lasts, there could be negative economic consequences.

What Does This Mean for Markets and Portfolio Positioning?

Despite deteriorating economic data and political concerns, the S&P 500 flirted with the 3000 level several times over the last quarter, but never sustained a rally above 3000. The on-again off-again trade negotiations make it risky for managers to reduce equity allocations too far, since a sudden deal could easily spark a quick rally and a resurgence of growth.

With very low yields on bonds and reduced inflation concerns, TINA (there is no alternative) continues to be a positive theme for the stock market, particularly the S&P 500. There are few signs of stock market euphoria and plenty of cash on the sidelines. The supply of public stock continues to shrink as buybacks have outpaced the volume of IPOs. So, **everyone wants to dance while the music is playing.**

We have reduced equity exposure, but embraced repositioning more than reduction, taking profits and reducing risk by going out of high growth names (especially non-earners) and into higher quality dividend paying names, a tactic we started employing in the second quarter.

We don't think the tipping point has yet been reached, and we do expect further economic weakness to be met with continued easing by the Federal Reserve. However, we will look to the following data for more recessionary warning signals: Spikes in initial jobless claims, further weakening of consumer confidence, or gut-wrenching market selloffs that may cause consumers to pull back spending.

In the meantime, **we will proceed with caution into the 4th quarter**, taking profits and continuing to move to more conservative stocks. We are adding gold when prices pull back as it currently behaves more like a hedge than a barbarous relic.

Please call us with any questions or concerns, we are here to help.

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