



# 2019 In Review:

## Year End Economic Assessment





## We Aren't There Yet

I used that phrase a lot over the last year in reference to the recession everyone seemed to think was lurking right around the corner. I have a shoulder injury right now so I won't pat myself on the back, but almost nothing that happened this last year in the economy was a surprise to us here at Alhambra. Now, if you want to talk about the stock market, that's a different story. I sure didn't anticipate a 30% romp higher, but I never bought into the recession fear mongering either:

*"If investors have been selling stocks because they fear a recession, there is nothing in our indicators right now to support that belief."*

### *Living in the Present – 1/5/19*

I've been writing since at least last November about the US economy slowing back to its old, pre-tax reform, trend. That didn't require a sophisticated model to figure out. Common sense was more than sufficient to understand that the corporate tax cuts and increased government spending would have a fairly short shelf life. The only way it could have been different would be if the changes actually spurred the investment boom the President and his advisors claimed it would. That was a dubious prospect from the beginning for a whole bunch of reasons and it didn't happen. And as it didn't, in month after month of economic data, it became easy to just observe that growth was falling back to the 1.5% to 2% trend we've been in since the 2009 recovery.

*"I never bought the idea that the 3% growth of the last couple of quarters was*

*sustainable so the idea that growth is falling back to the low 2s just isn't a big surprise."*

### *Monthly Macro Monitor – 11/29/18*

*"The Fed has raised rates steadily over the last two years and has now reached a level that many believe threatens to push the economy into recession. That is, of course, always possible, but right now the market-based indicators we monitor do not support the recession scenario. It appears to me, based on the available information, that what we've just witnessed is markets pricing in a return to normalcy – or at least the "new normal" that has prevailed in recent years. The spurt of growth we got from tax cuts and the anticipation of tariffs was not sustainable. After a couple of quarters of above trend growth, the US economy is falling back to the previous trend."*

### *A Return to Normalcy – 1/24/19*

The recession fears started last year as the yield curve continued its flattening trend and hit a crescendo this year when the curve finally inverted, a condition normally associated with recession. But there is a danger in relying on that one silver bullet indicator.

*"Everyone seems to have latched onto the yield curve as the definitive recession indicator, absolutely certain they know what it means and that even with everyone watching it will act as it always has and conveniently invert before the next recession. Here's a news flash for you – there are no definitive recession indicators and the yield curve does not have to invert prior to recession. In fact, I'd bet that one of two things is about to happen. Either the curve will invert and we won't get a*



*recession – at least not before we see numerous articles about how the yield curve is no longer a good recession indicator – or we'll get a recession without the yield curve inverting at all."*

#### ***Living in the Present – 1/5/19***

The problem with relying on one indicator is that the nature of these indicators can change, especially as they become better known. When I started in this business nearly 30 years ago, almost no one was aware of the recession predicting prowess of the yield curve. Heck, I didn't know what a yield curve was, much less what it meant. Today though, everyone knows about the yield curve:

*"In case you haven't heard – and I don't know how you could have possibly avoided it – the yield curve inverted last week. Or at least some yield curves inverted last week, not all of them but enough to get the headline writers excited. And everyone knows, based on the breathless reporting, that the yield curve inverts prior to recession. But everyone knows that everyone knows the yield curve inverts prior to recession and everyone knows that everyone knows that everyone knows the yield curve inverts prior to recession and so I am left wondering if the fact that everyone knows all these things they think they know means that the yield curve in fact doesn't mean what it has always meant in the past and so maybe all these people who think they know something, in fact know absolutely nothing."*

#### ***Well Worried – 3/26/19***

Like an economic Heisenberg uncertainty principle, our observation and reaction to the yield curve has probably changed its fundamental nature. It just

doesn't mean the same as it once did. Investors who are aware of the yield curve act differently than they did prior to attaining that knowledge. And by acting differently, they change how the yield curve is shaped today versus how it would have been shaped prior to the knowledge becoming widespread.

Not only has investor behavior changed the yield curve, the inversion itself has ***never*** been the signal that recession is imminent. Curve inversions have indeed preceded modern recessions – although that hasn't always been true – but the lead time can be as much as two years. That's an eternity in investment time and markets can provide excellent returns after an inversion. No, the real recession indicator, at least in the past, is the rapid steepening that happens much closer to the onset of recession. Ironically it is known as a bull steepener in bond market lingo.

*"We understand the fears pulling the market in all directions over the last couple of weeks. The administration's trade policies create vast uncertainty for investors and business operators today in exchange for, hopefully, fairer trade tomorrow. Unfortunately, fairer – assuming such can be achieved – does not necessarily mean better for everyone. That wasn't true of freer trade and it won't be for less than free trade. There will be winners and losers and no way to know today who they might be. But we see most of this as distributional anyway, with the US economy mostly absorbing whatever damage the tariffs do without much impact on growth. The economy has slowed back to the trend that prevailed before Trump took office. That's not great but it isn't recession either. So forget the yield curve until it does something that really deserves your notice."*

#### ***Does Anyone Not Know About The Yield Curve? – 8/21/19***



A merely steepening yield curve is not a recession signal; the form of the steepening matters. In the past, it has always taken the bull steepener form, where short-term interest rates fall faster than long-term rates. That is, in general, the market telling the Fed they need to cut rates. And the faster short rates are falling, the more urgent the need. And so today, some of the same nice folks who brought you the **YIELD CURVE IS INVERTING AND RECESSION IS COMING!** meme are now out there telling everyone that recession is again imminent because the **THE YIELD CURVE IS STEEPENING!**

But the yield curve has steepened because long-term rates have risen faster than short-term rates. That's a bear steepener in bond market lingo and is generally associated with a rise in nominal growth expectations (inflation + real growth). It isn't necessarily good if it is entirely due to rising inflation expectations but it isn't a recession signal. And, just to be clear, the steepening isn't all from rising inflation expectations. Real interest rates have risen too, an indication that real growth expectations have risen as well. Those who are calling this a recession signal aren't just misinterpreting the change in the yield curve; they are misinterpreting it by 180 degrees.

I've said many times that we are not in the business of predicting the future. We spend our efforts trying to interpret the *present* - which is not nearly as easy as it sounds. The US economy is a complex beast, fiscal and monetary policy interacting with human nature to produce an outcome that no one can predict. And don't forget our policies and people interact with the rest of the world's policies and people at the same time. What happens in London or Tokyo or Beijing or Hong Kong matters for us here. The only thing that can take all that and process it in any way that makes sense is the markets. Treasury notes, junk bonds, stocks, commodities, gold, all these markets provide valuable information available to anyone. Markets aren't infallible - see the dot com and real

estate bubbles - but the wisdom of crowds is better than anything produced by Wall Street or academia.

What follows is a snapshot, our observations on the economic data and how markets are interpreting that data. What you'll find is that not much has changed from what I wrote last year. The economy has slowed with weakness concentrated in the manufacturing sector. Global trade is contracting - slowly - but that is a trend that preceded the Trump administration. It has probably accelerated due to the Trump trade wars but it isn't the big drag so many seem to think. The shale industry is the real source of much of the slowdown in manufacturing and I expect that to continue - even if oil prices rise, by the way. More on that in coming weeks. Housing was a big bright spot last year as interest rates fell. I've been saying for years that the uptrend in home construction will continue because, with our population continuing to expand, it has to.

What we really see right now is that the economy has settled back into the trends that have prevailed since 2009. Personal income is up 4.9% in the last year and has averaged 4.4% over the last 10 years. Retail sales are up 3.3% over the last year while the 10-year average yearly change is 4.4%. Personal consumption, 3.9% vs 4.0%, durable goods orders - 3.7% vs 5.1%, core capital goods orders 0.5% vs 3.2%, payrolls 172K/month vs 182K/month. Economic data is volatile so some readings above average and some below is normal. But when you look at the charts on the following pages, just try to look at them with no preconceived idea of what they will show. If you do that, you will no doubt conclude that not a lot has changed. And there is good reason for that.

Economic growth, as I've talked about in these commentaries repeatedly over the years, can really be boiled down to two things - population (or workforce) growth and productivity growth. In short,





you can raise output by putting more people to work or by making each worker more productive. That's all there is and it is as simple as that. Economic policy can be judged by how it affects those two variables. Productivity growth is generally a function of investment in all its forms (education, technology, etc.). Workforce growth is generally associated with population growth and so depends on immigration policies and the fertility rate. The participation rate can also change and affect growth.

The Trump administration's tax reform was designed to increase investment and therefore raise productivity growth. Unfortunately, that didn't happen and so there was no permanent impact on economic growth. There are any number of potential explanations but the simple one is that taxes were not the factor limiting investment. Something else was – and is – holding companies back from investing in their business or keeping entrepreneurs from investing in new businesses. What exactly is causing that is up for debate, but it isn't really relevant to assessing the economy from the view point of an investor. It is enough to observe that investment has not changed materially and deduce that neither will economic growth. As for workforce growth, there has been little change there either despite the administration's immigration policies.

One thing I didn't waste a lot of time worrying about last year – and probably won't this year either – was the trade war. The stock market seemed to respond to every press leak by the Chinese and tweet by the President but other market reactions were much more muted. And for good reason in my opinion; the dollar amount of the tariffs is just too small to have much impact in any direct way. Don't get me wrong, I'm in favor of free markets and free trade and there are long-term consequences to reduced global interaction on trade. But a lot of the impact is of the geo-political variety that will take years to assess. In the short term, people and companies find ways to function with the new trade barriers. Chinese

companies trans-ship products via Vietnam, some US companies move production from China to Korea or Taiwan. There is a cost involved but compared to the size of our economy, it is fairly small.

The trade wars are what I call “well worried”, things that everyone is focused on and therefore aren't worthy of our attention. It is possible that the Trump administration does something on trade that is new and worse than what they've done so far – and just for the record, I think Peter Navarro is, at best, misguided and at worst, an idiot with no savant – and if they do, I'll pay more attention. But until then I think the crowd worried about trade is large enough without my presence.

The economic data continues to slow but markets are starting to price in another upturn in growth. Interest rates are low but now rising, commodity prices have recovered from their lows, gold has pulled back, the dollar has weakened, stocks are printing new highs, the yield curve is no longer inverted and credit spreads are near the lows of the cycle. This is not what we see just prior to recession. As I said above, markets are not infallible so these moves could be false dawns but I have no way of knowing. And if we take markets at face value, recession is not on the horizon. **We still aren't there yet.**

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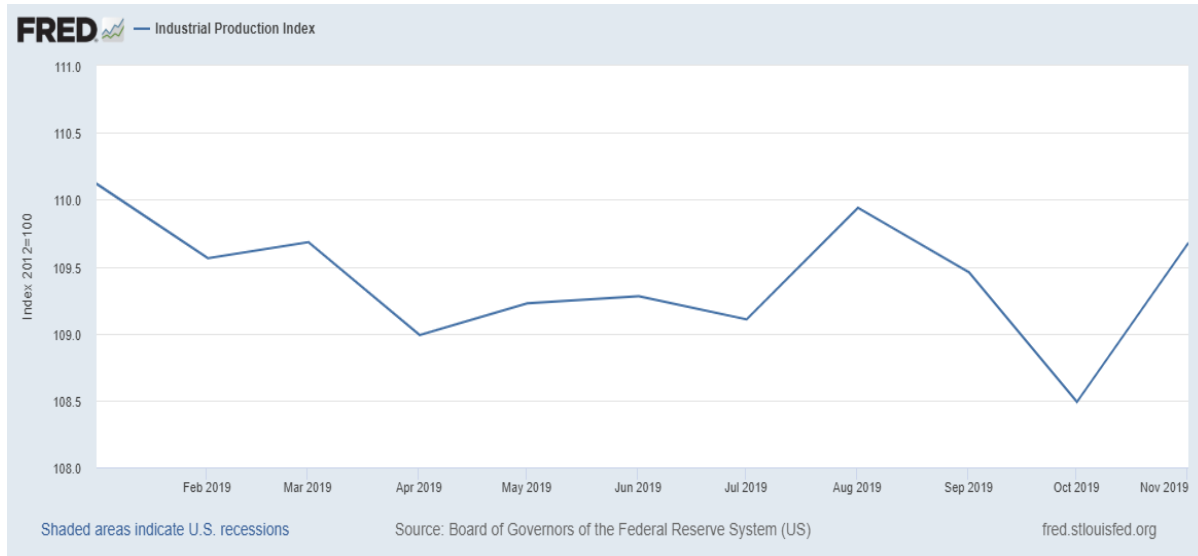
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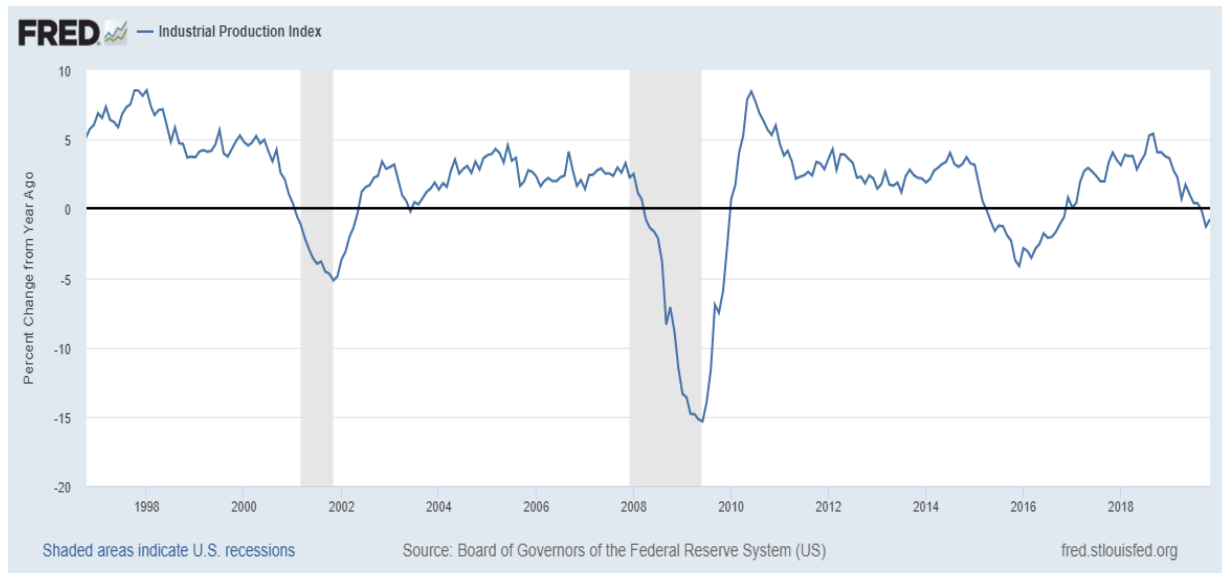


## Industrial Production

Industrial production was down for the year but the change is fairly minor. The most common explanation has been trade issues but the more likely one is the slowdown in shale.



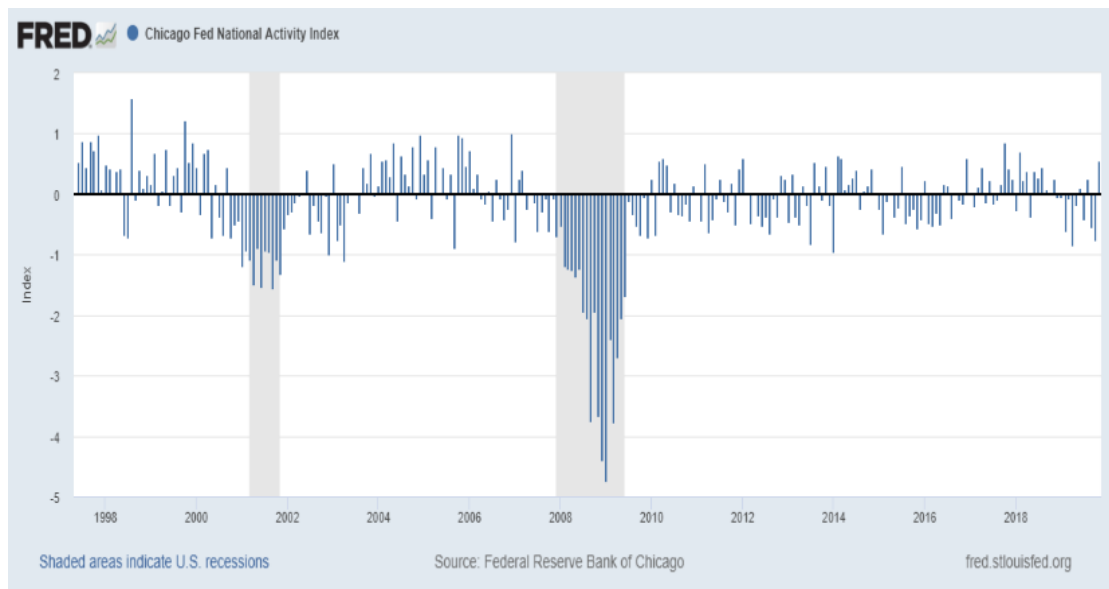
The year-over-year rate of change has turned negative, but this isn't even as bad as the 2015/16 shale implosion. In case you've forgotten, that did not result in recession. We're slowing, not falling off a cliff.



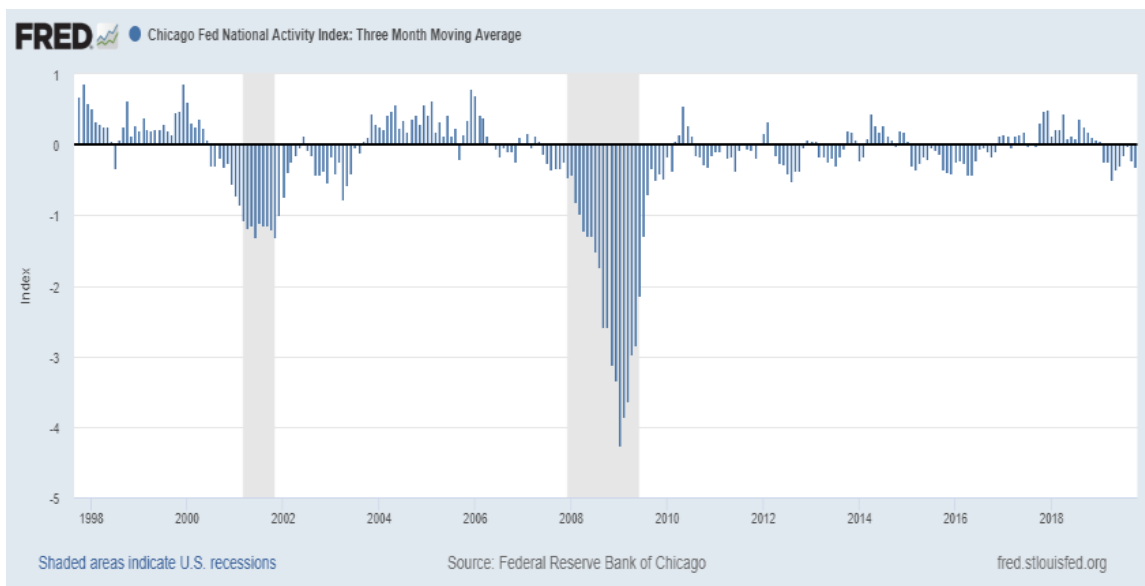


## Chicago Fed Nat'l Activity Index

The CFNAI, a very broad indicator of economic conditions, turned negative in February and stayed that way until the latest reading in November of 0.56. Negative readings indicate growth below trend, positive above trend.



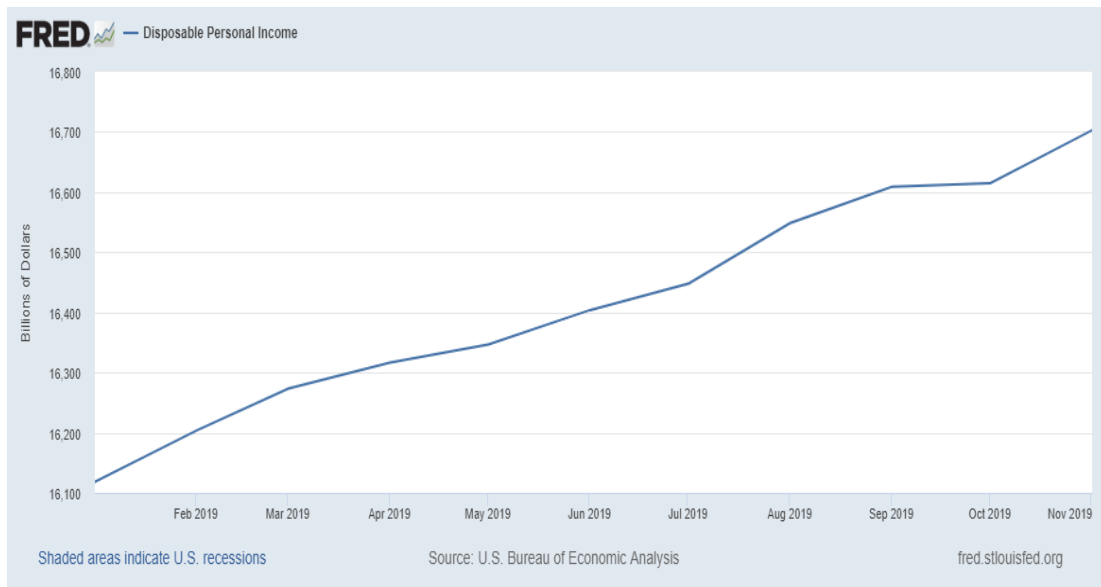
The 3-month average smooths out the changes. The November reading was -0.25, negative but well above the -0.75 we associate with imminent recession.



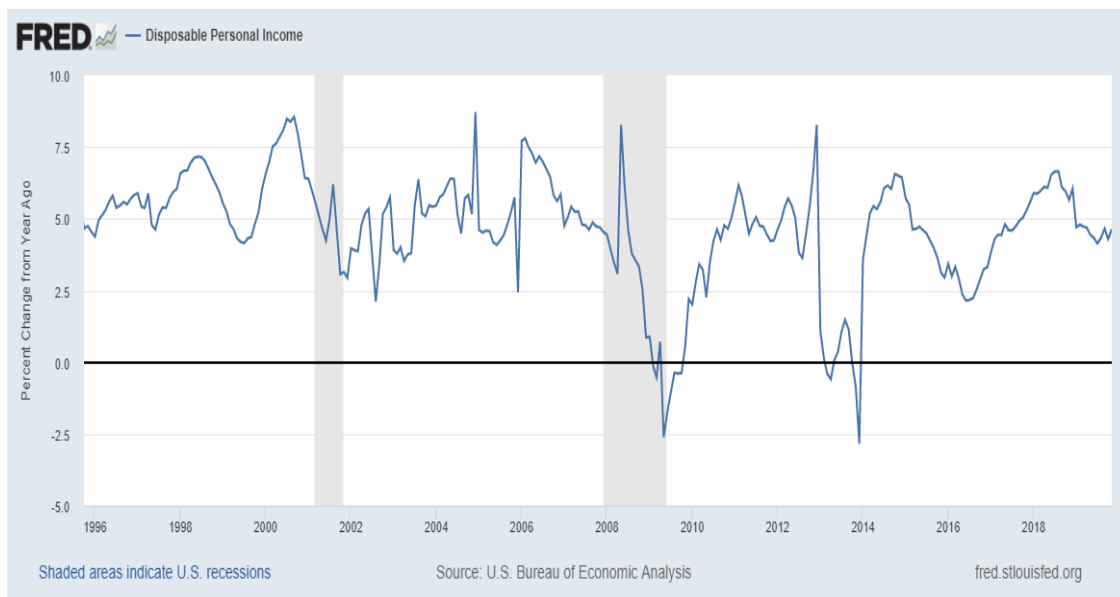


## Disposable Personal Income

Disposable (After-Tax) Personal income rose for the year.



The year-over-year change is 4.6% as of November. The rate of change peaked early in the year. The current pace is about the same as it's been this entire cycle, which in turn is below that of previous cycles.

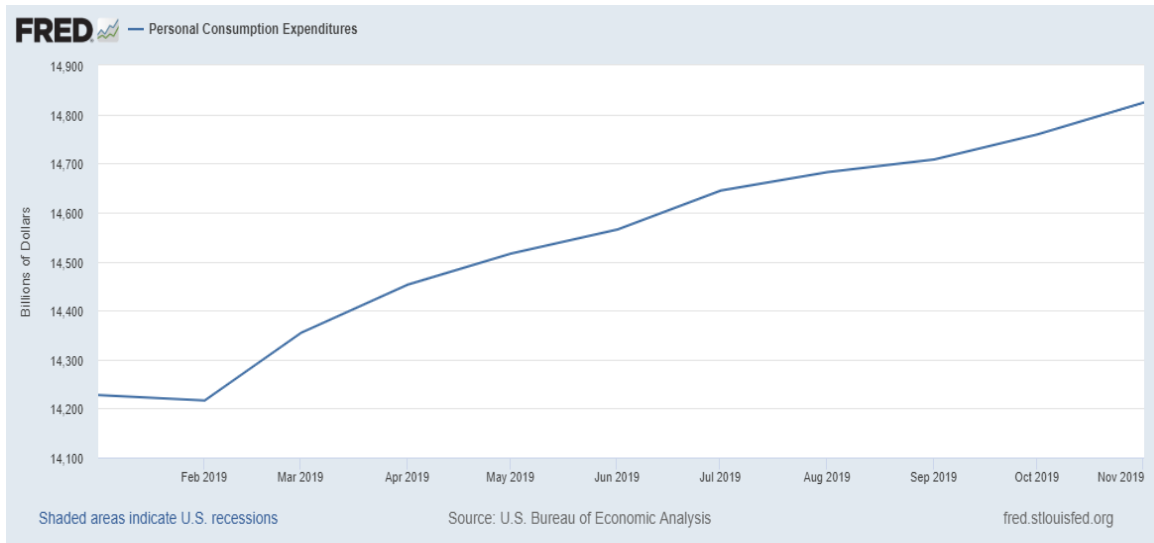




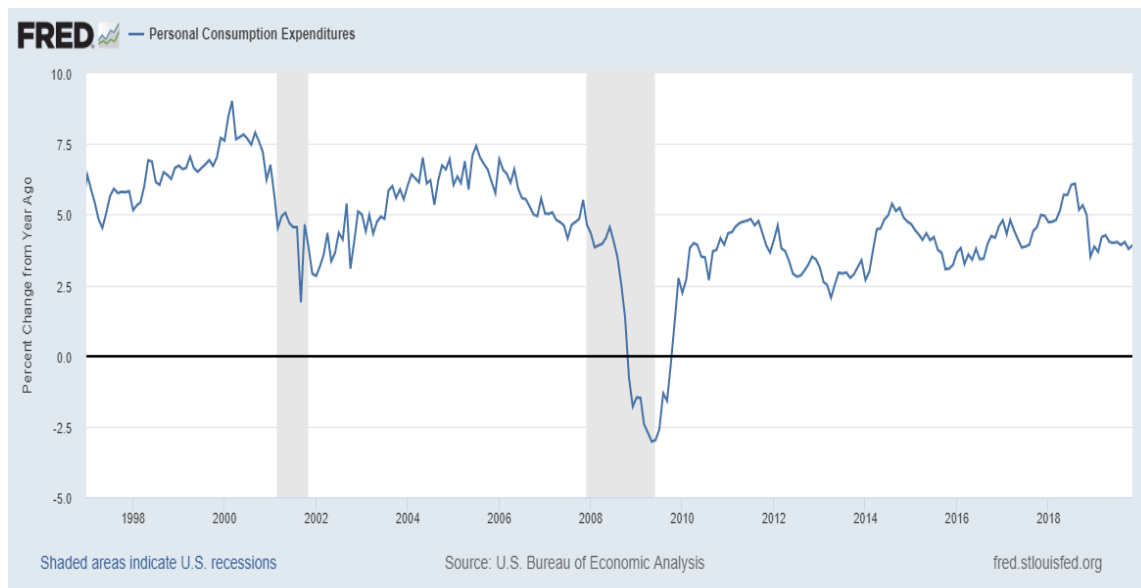


## Personal Consumption

Consumption was down in the first month of the year after last year's stock market selloff but did rise for the year.



Year-over-year consumption rose at a 3.9% pace, down significantly from the 2018 peak around 6%. The current rate of change is pretty much in the middle of the range for this cycle but well below previous cycle norms.



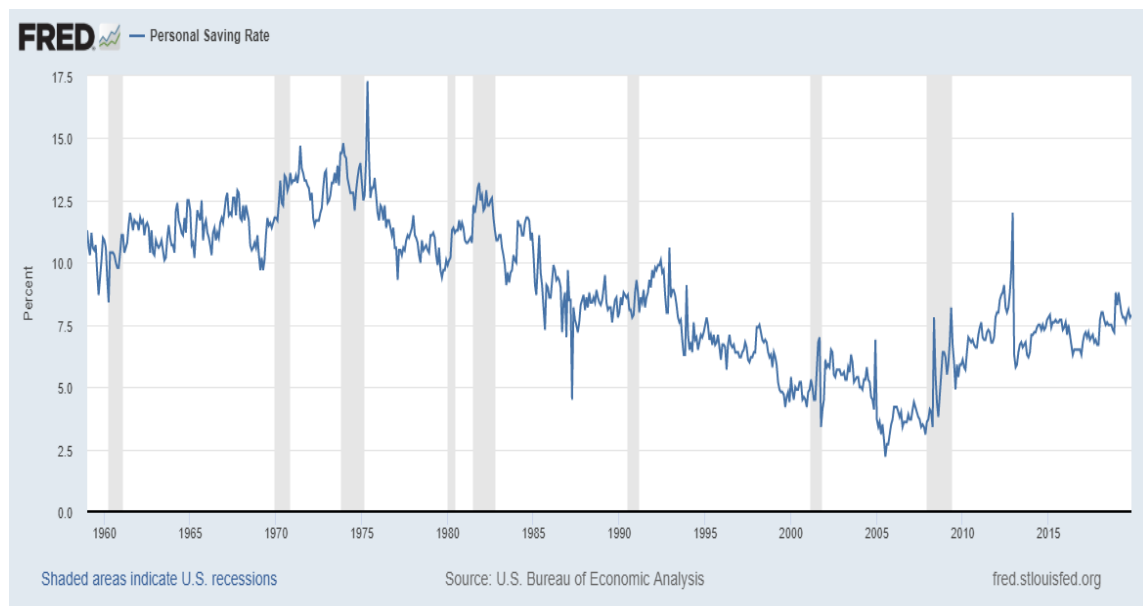


## Savings Rate

The savings rate fell for the year.



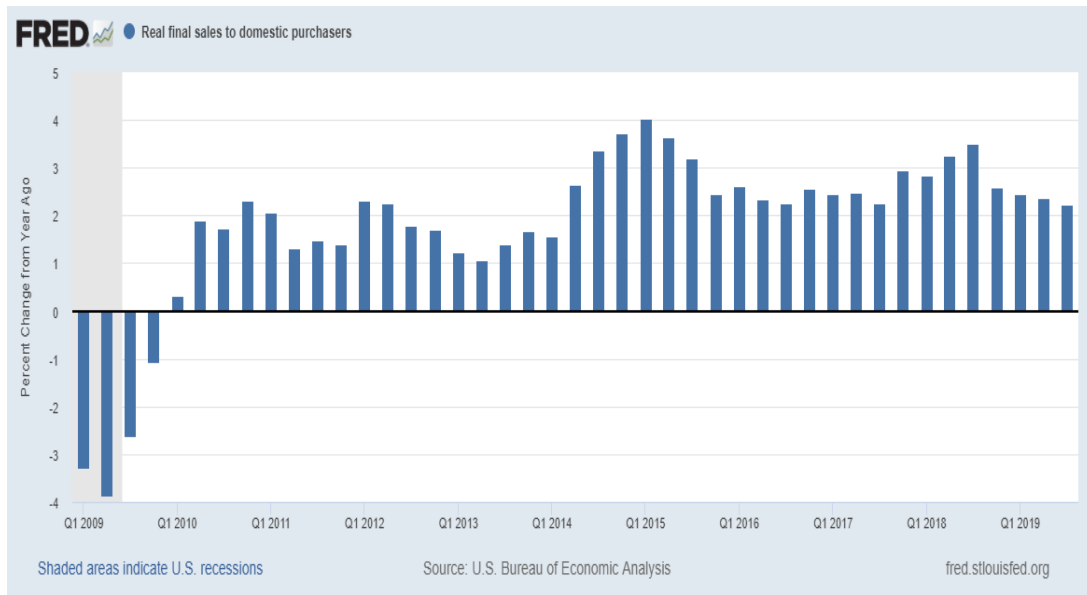
The savings rate has been rising since 2005 but it is still well below the rate of previous generations.



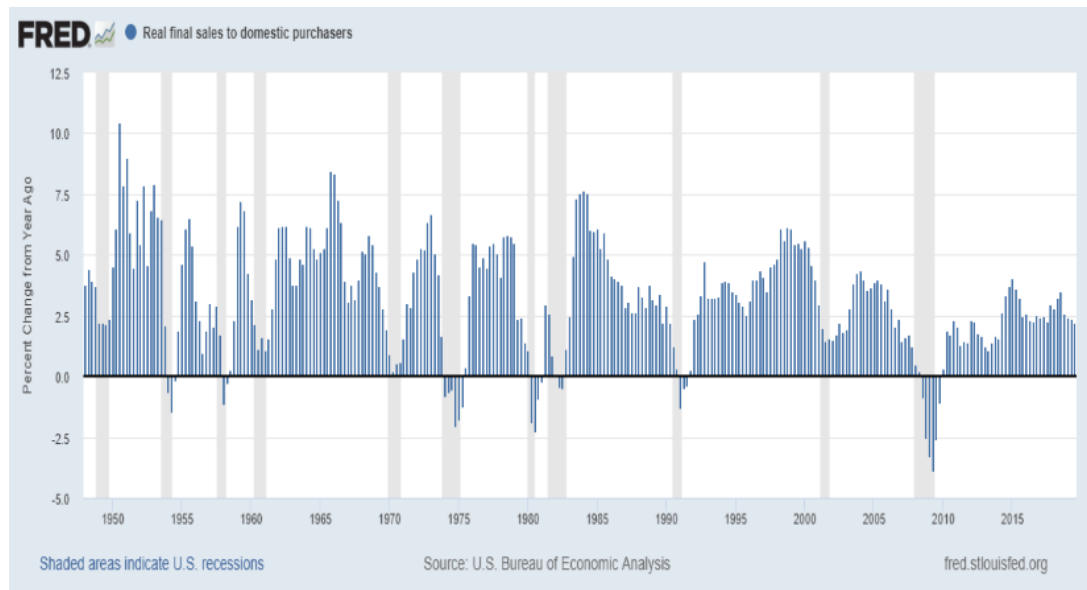


## Gross Domestic Product

Through Q3, the year-over-year change in GDP was 2.2%. Growth has fallen back to trend since the peak in Q3 2018, just as we expected. The peak for the cycle remains Q1 2015 at 4%.



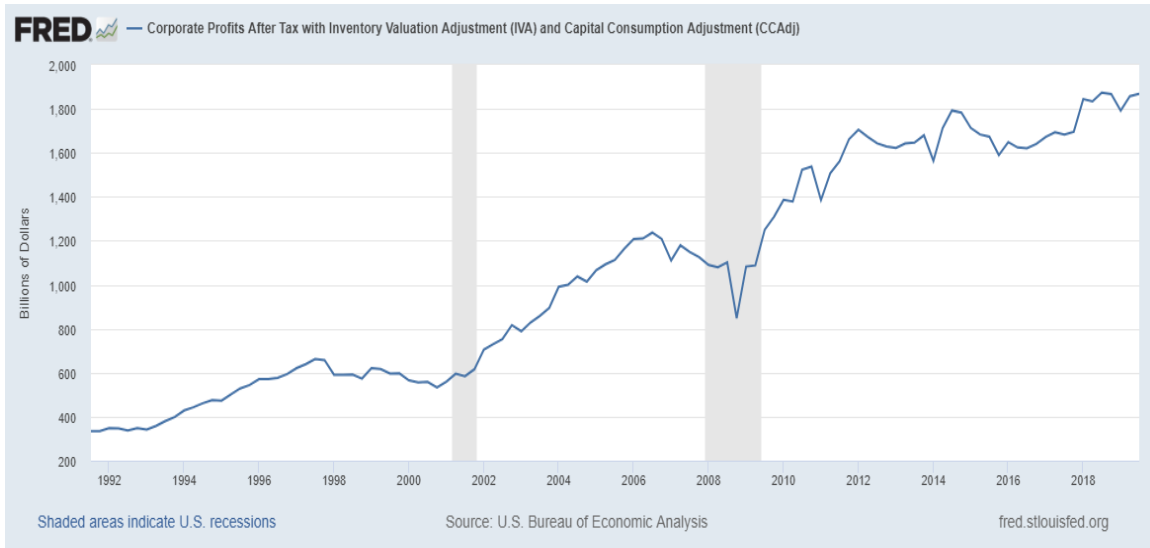
What's more interesting is that the peak of this cycle is so much lower than previous cycles. It has been a long cycle, but not a robust one. This is a combination of weak workforce and productivity growth.



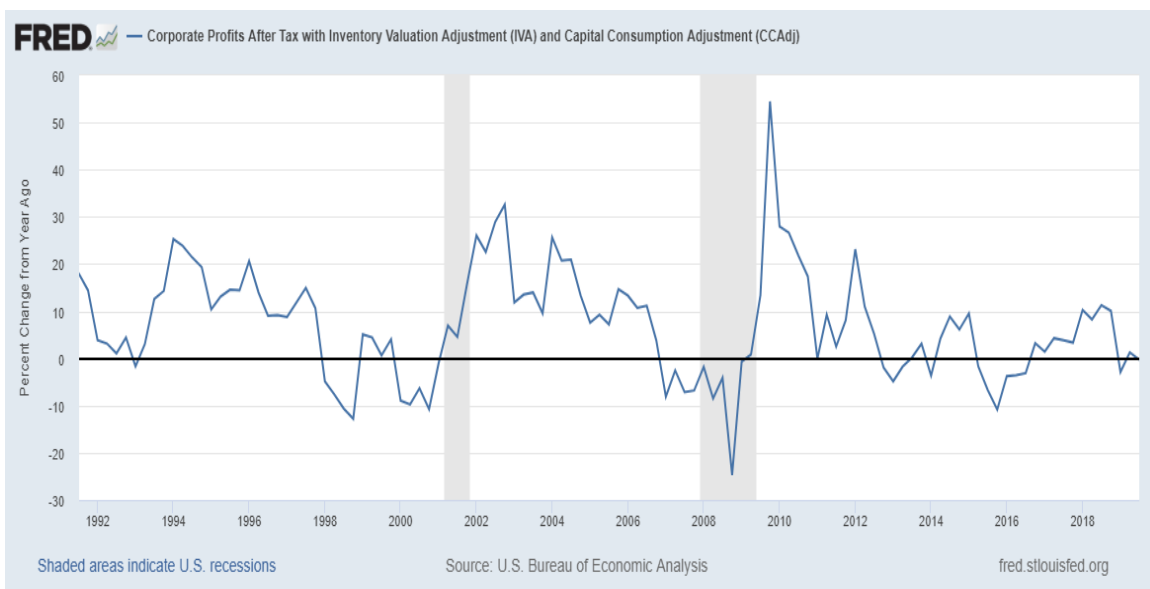


## Corporate Profits

Corporate profits, after tax, are near all-time highs. Unfortunately, that is only 4% higher than 5 years ago (Q3 2014).



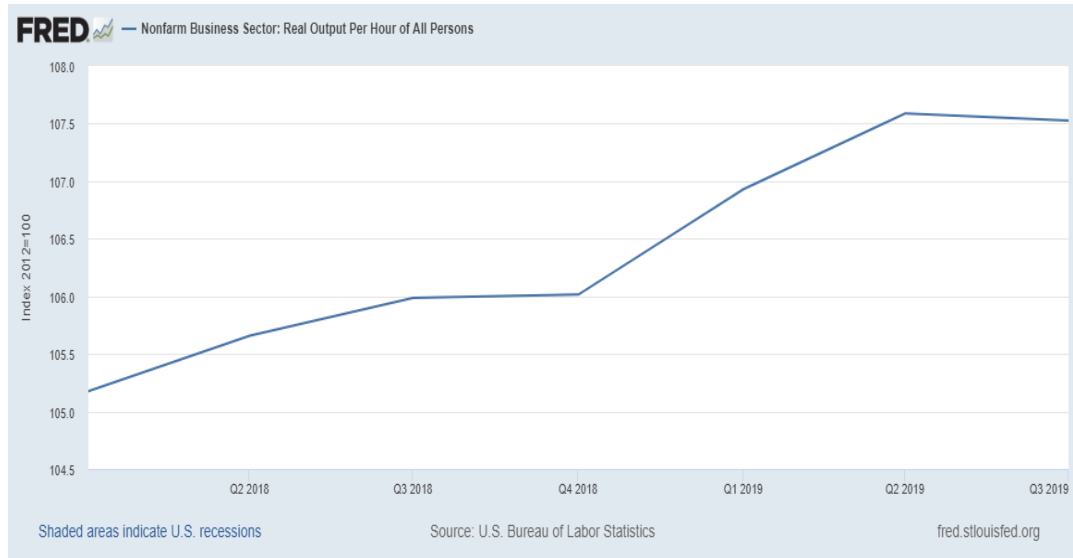
Through Q3 2019, profits are down 0.3% year-over-year. Stocks have soared despite the lack of profit growth due to corporate stock buybacks and multiple expansion. Stocks are very expensive by any measure.



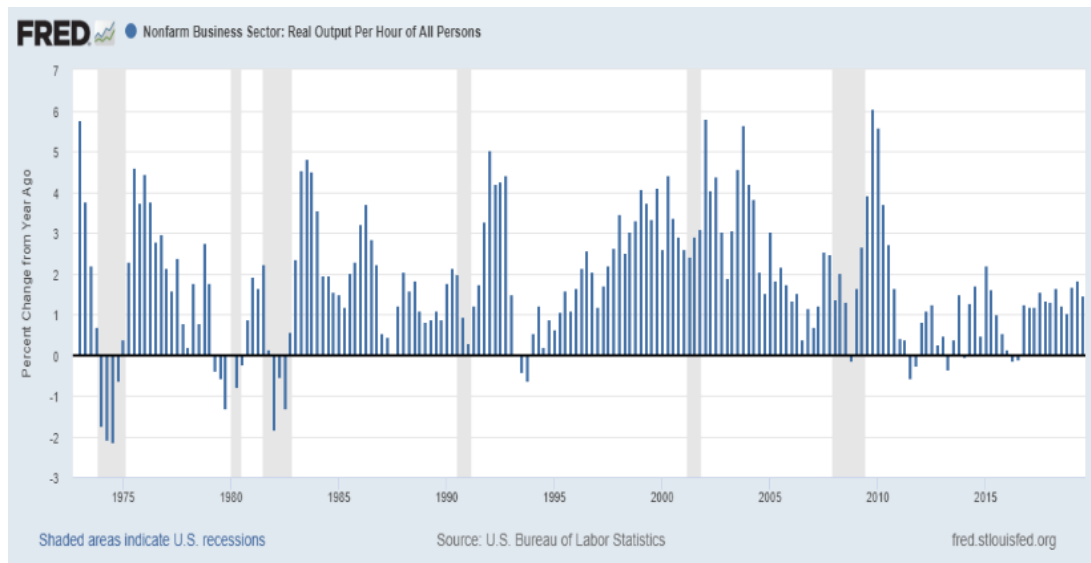


## Productivity

Productivity has grown over the last two years but the gain is anemic.



The problem really goes back to the early 2000s. Except for the spike after the last recession – when output recovered quicker than jobs – the trend has been down. Year-over-year change right now is 1.5%, about average for this expansion and way below what we need to get growth up to a 3% rate. Productivity growth of 1.5% + 0.5% population growth = 2% economic growth.

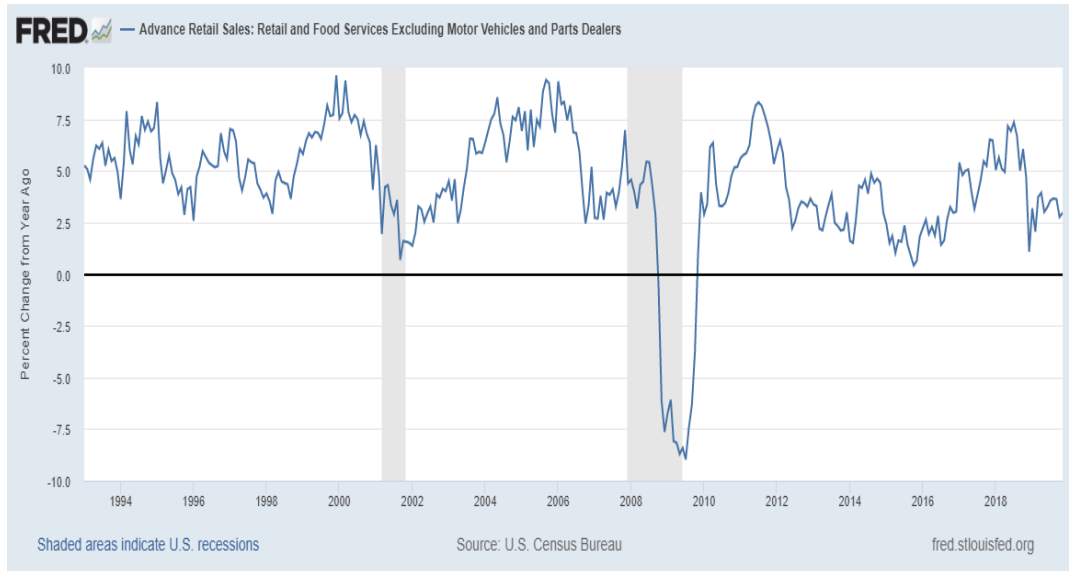




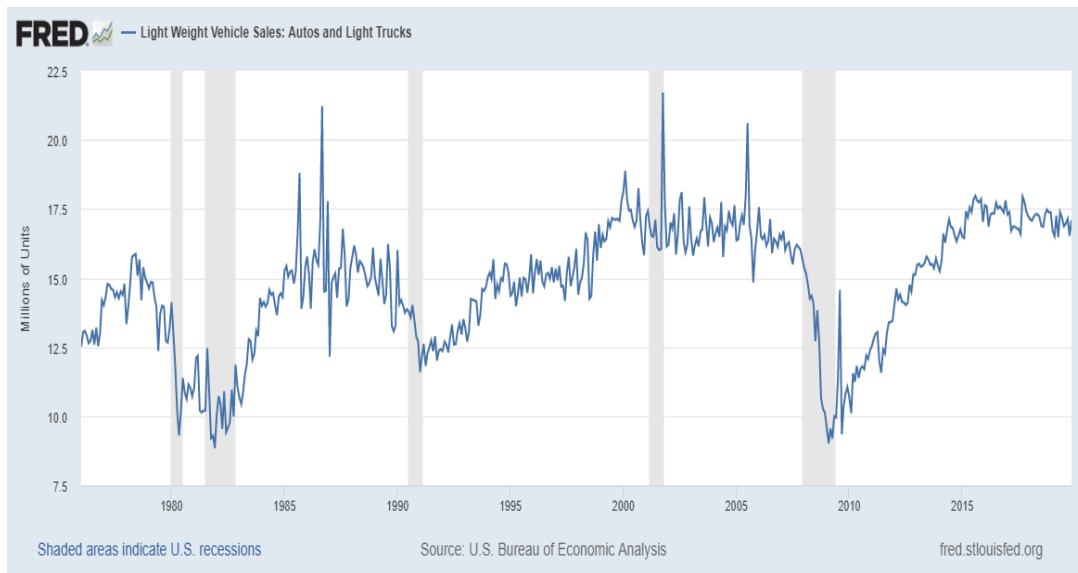


## Retail Sales

Retail sales are up 3% year-over-year through November. That's closer to the bottom of the range for this cycle and well off the 7% growth rate we saw at the recent peak in 2018.



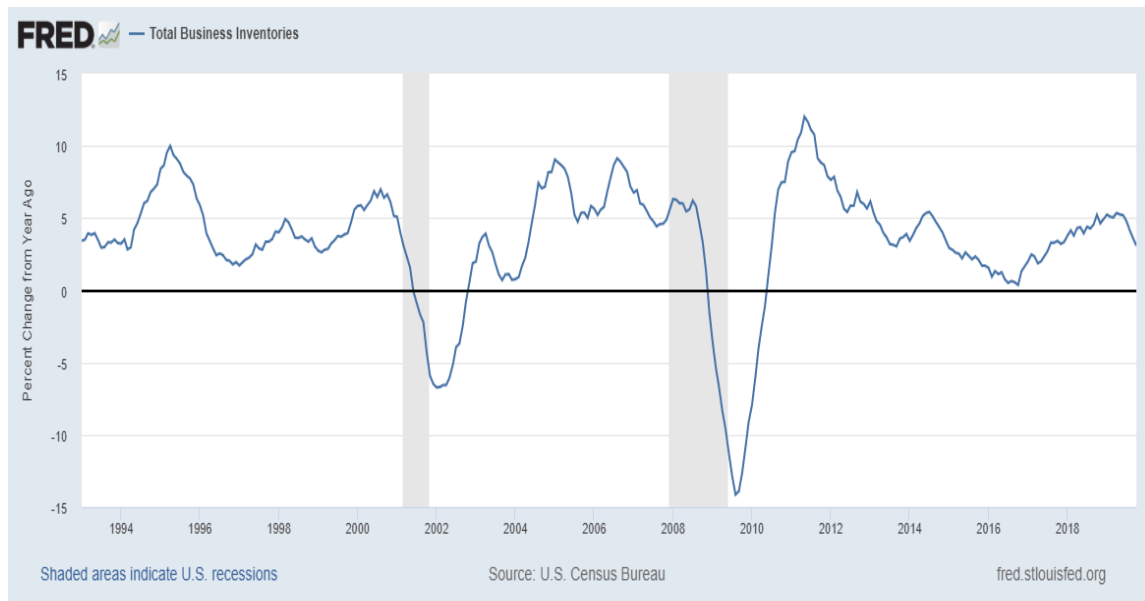
Auto sales are down 1.7% over the last year and appear to have peaked for this cycle. Sales trending sideways near the peak is pretty normal behavior.



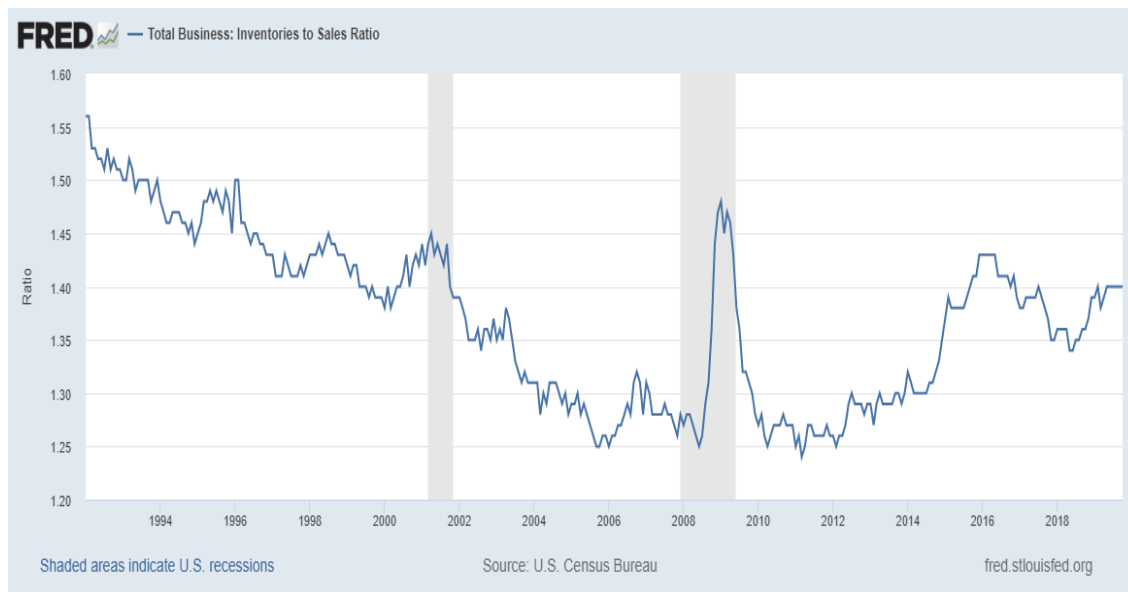


## Inventories

The rate of inventory accumulation peaked in Q1. Some of that accumulation was likely a front running of expected tariffs.



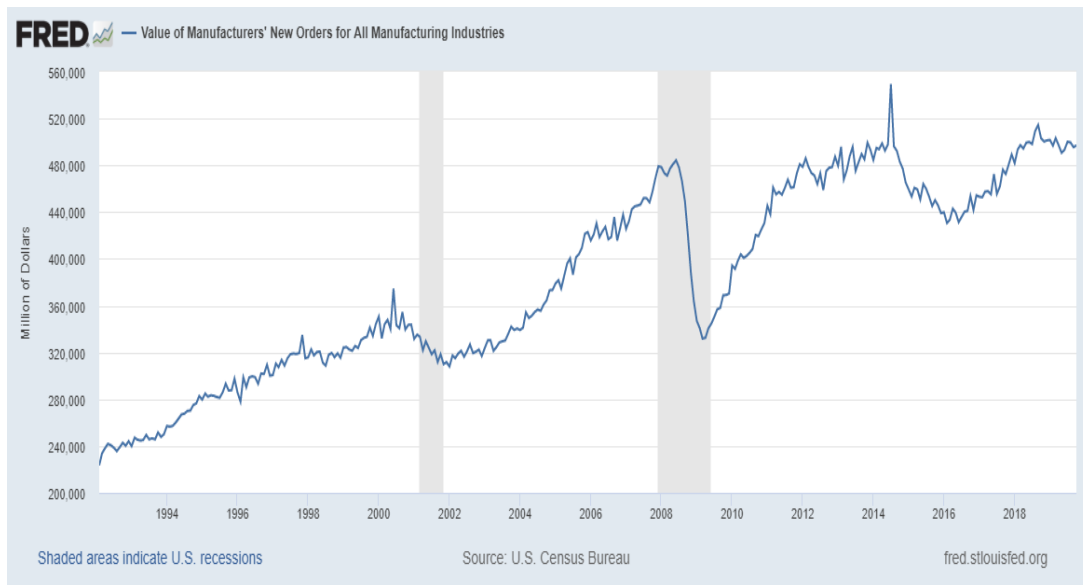
The inventory-to-sales ratio has stabilized at a slightly elevated level. Total inventories are coming down but this ratio is not. Sales need to pick up for this ratio to fall back to the lows.



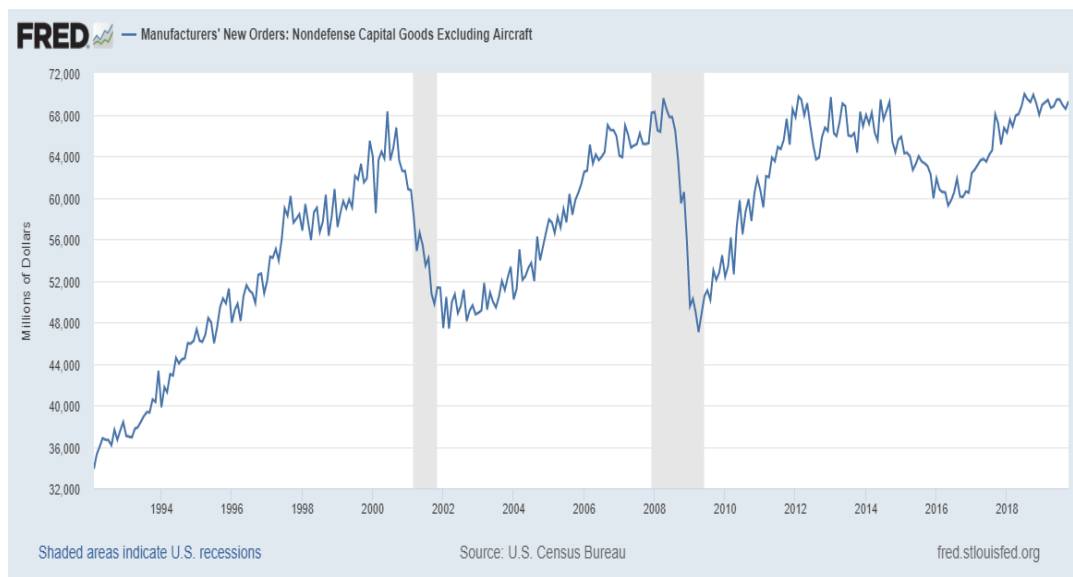


## Factory Orders

Factory orders are not significantly higher today than 5 years ago and are down 1.2% from a year ago.



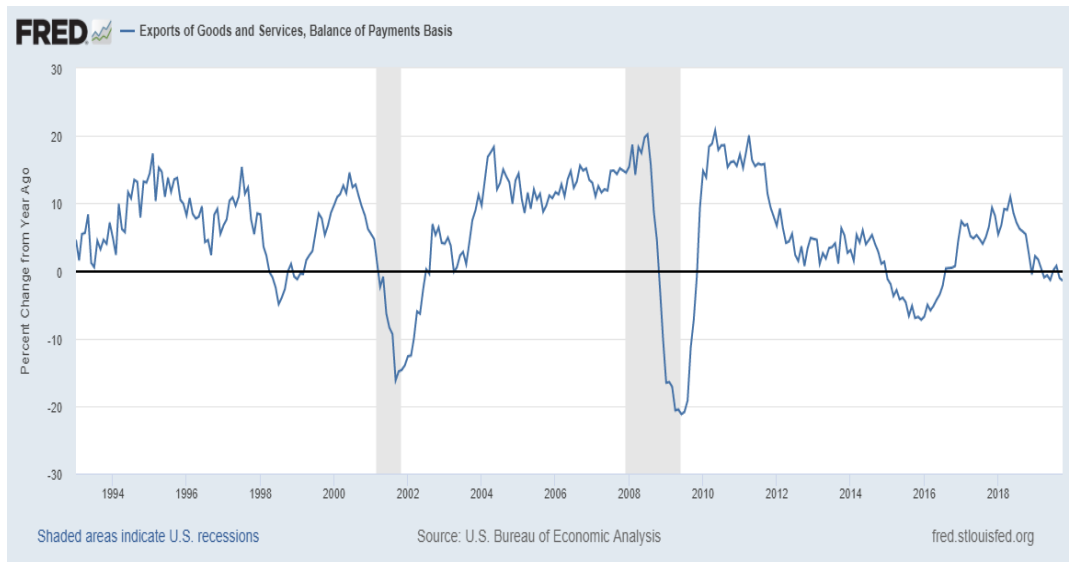
Core capital goods orders are barely higher today than they were nearly 20 years ago. This is the source of our low growth problem. Orders are down about 1% over the last year. The corporate tax reform had little impact on investment spending and therefore productivity growth.



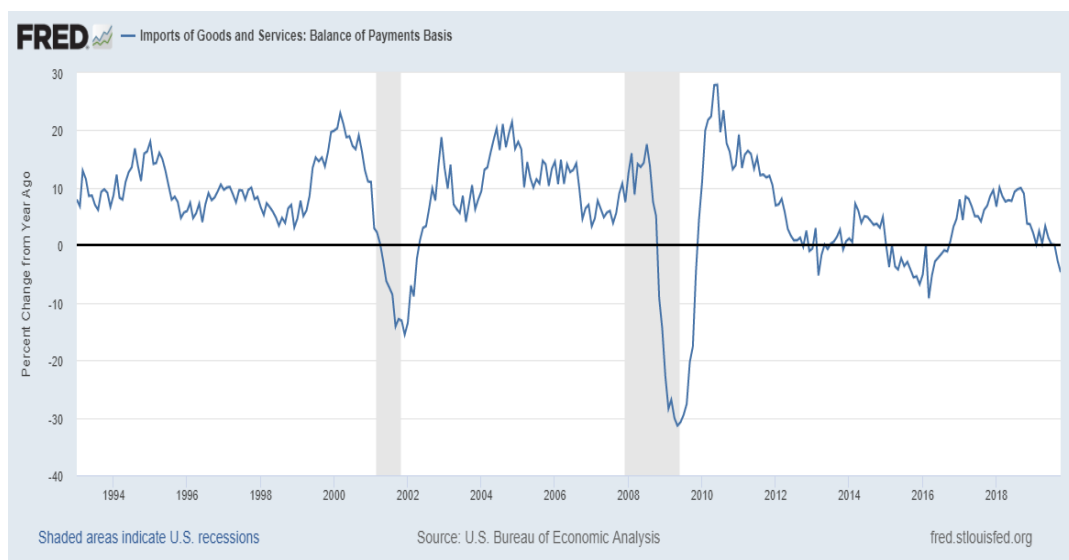


## Trade

Exports were down 1.4% year-over-year as of October. Some of this could be tariff related but trade is also suffering from the ongoing dollar shortage outside the US.



Imports are down 4.7% year-over-year but that is more likely about energy than tariffs. The trade deficit did shrink some this year but with the big shift in our energy position, one would have expected a larger contraction. That just goes to show the deficit isn't about trade so much as our own fiscal problems. We won't reduce our trade deficit until we reduce our budget deficit.

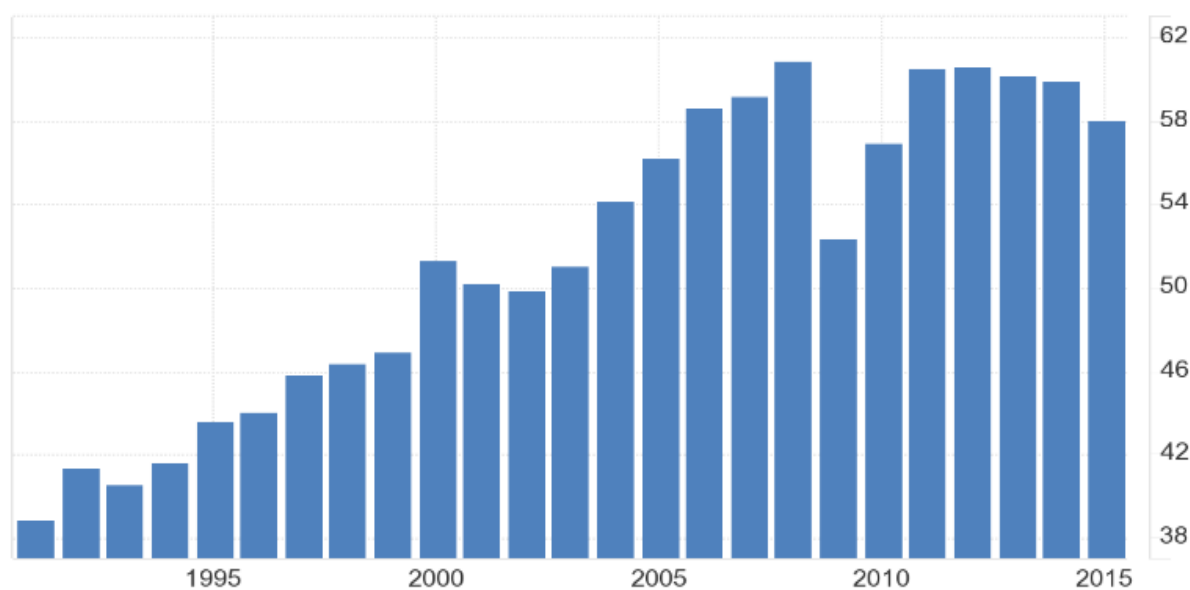




## Trade as a Percentage of Global GDP

Trade as a percentage of global GDP peaked in 2008. The contraction this year merely continues the trend. I am not a fan of tariffs but they aren't the cause of this trend.

World Trade (% of GDP)



Source: tradingeconomics.com | World Bank

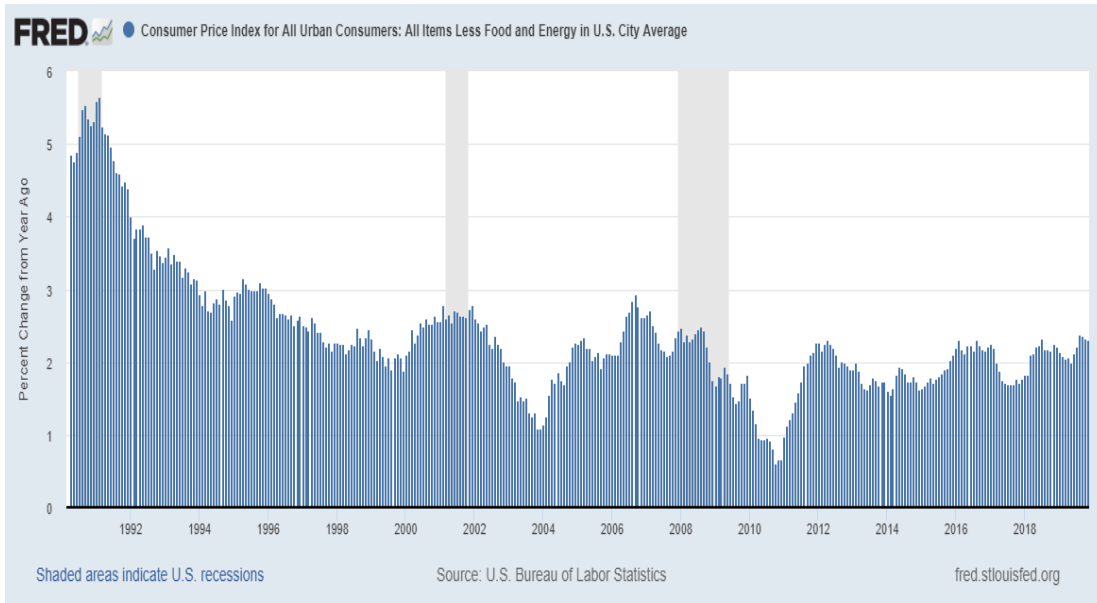




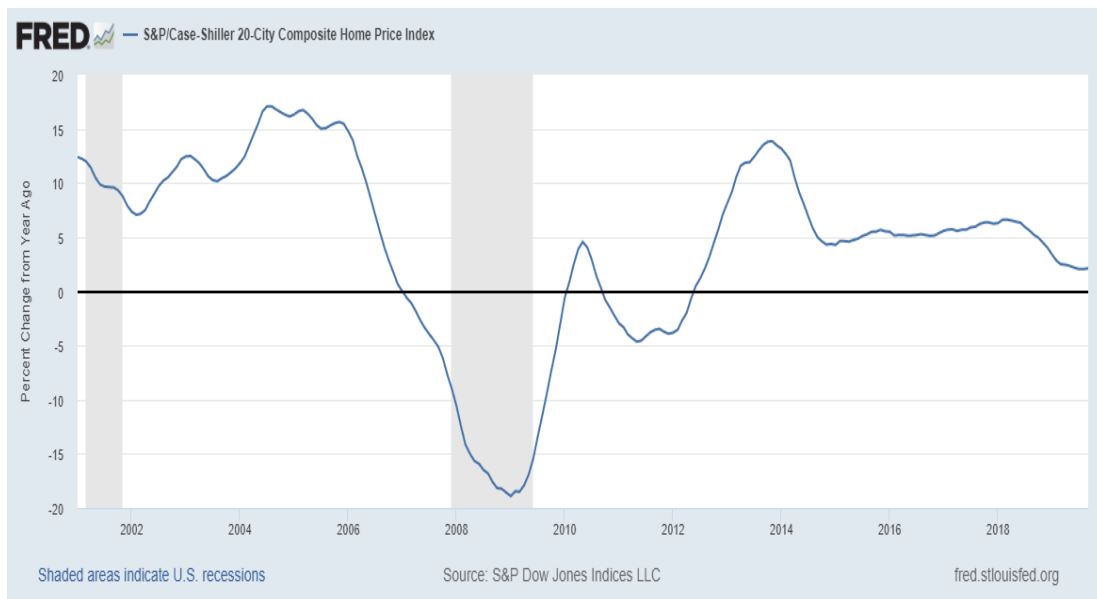


## Inflation

Core CPI inflation is running at 2.3%. Inflation may not be as contained as the Fed believes.



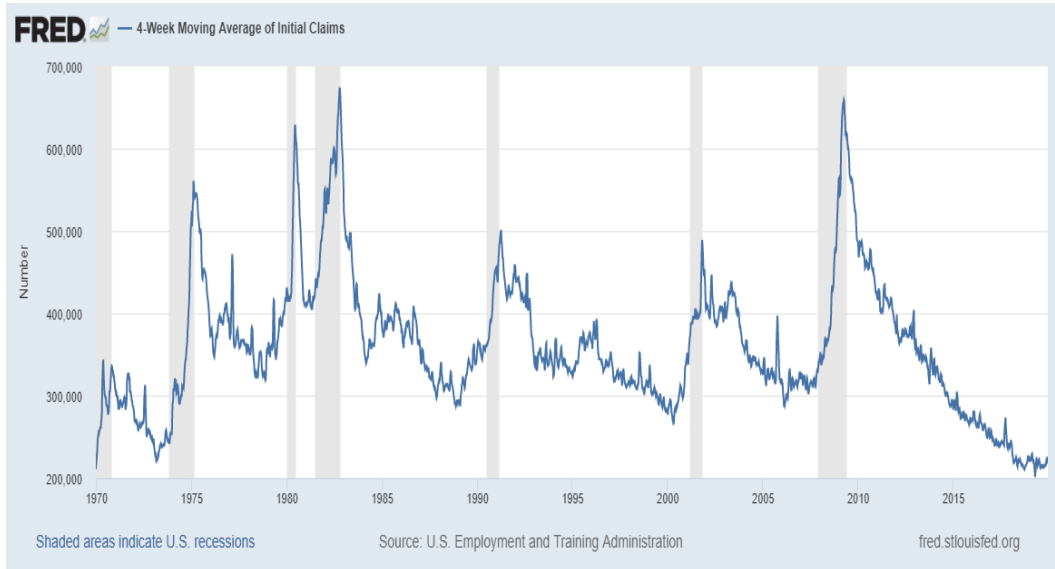
House price inflation continued to moderate in 2019. Year-over-year change is down to 2.1% from the 5% and 6% rates we saw 2014 to 2018.



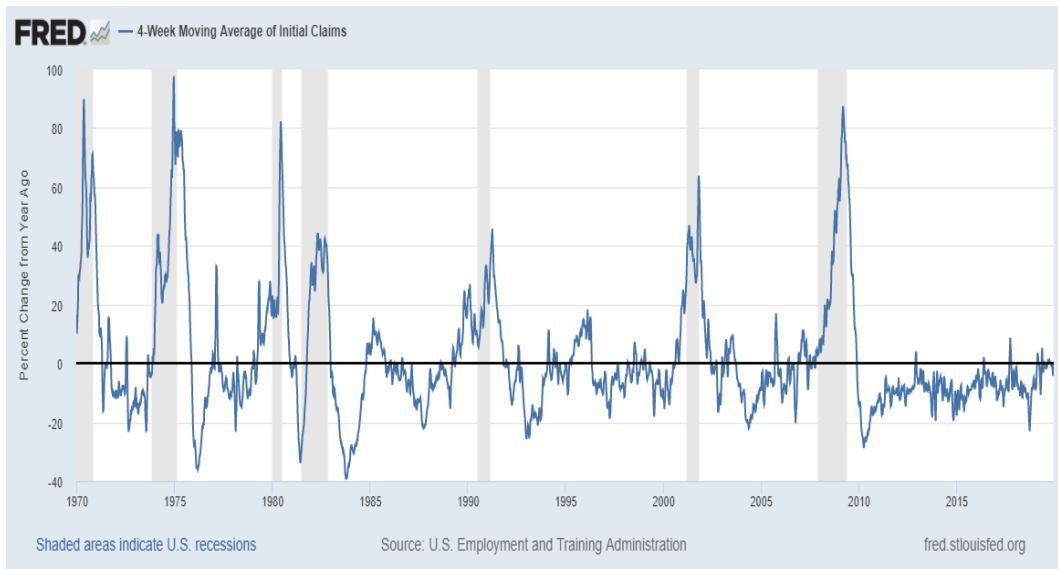


## Unemployment Claims

The 4-week average of initial jobless claims is near lows not seen since the early '70s. That has been true since 2015, so it isn't exactly news.



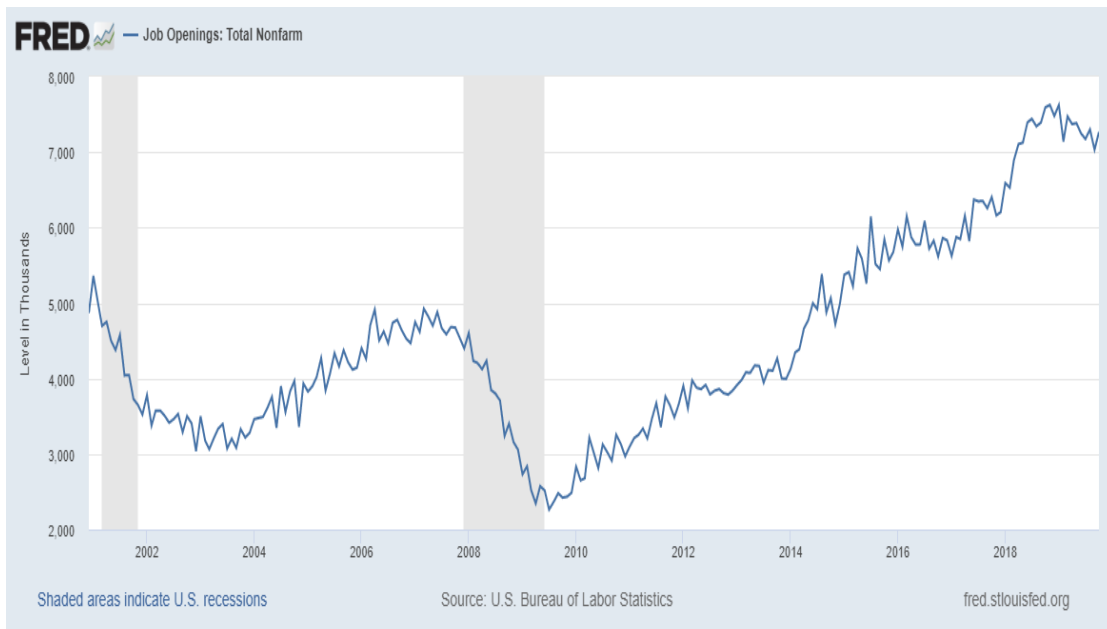
The year-over-year change is slightly positive but as you can see that happens fairly frequently and isn't cause for alarm. At least not yet.



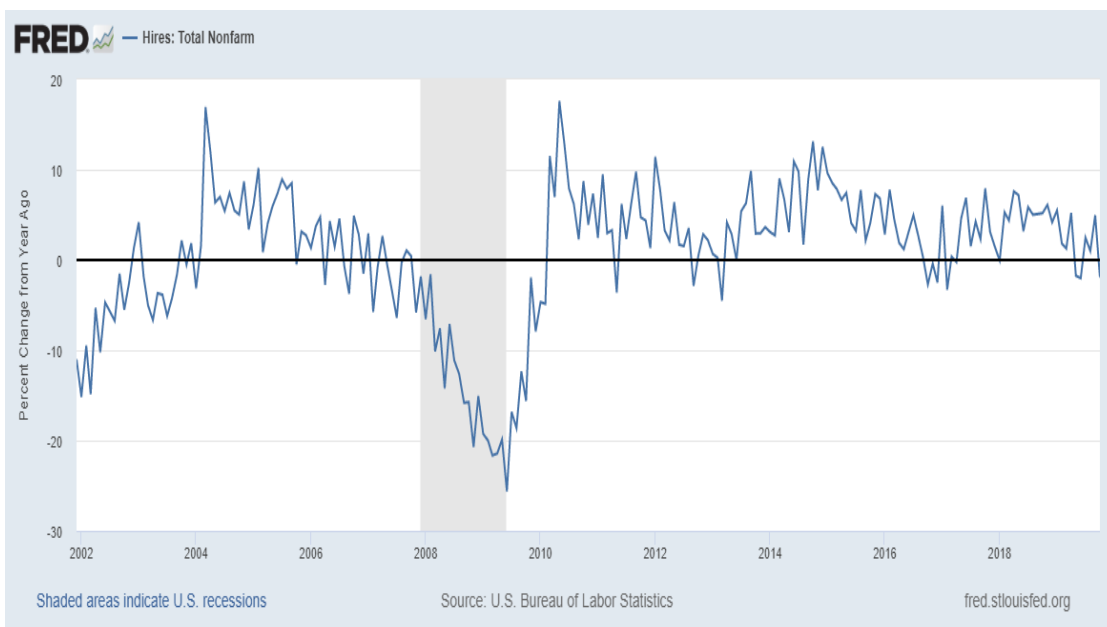


## JOLTS

Job openings peaked over a year ago in November 2018.



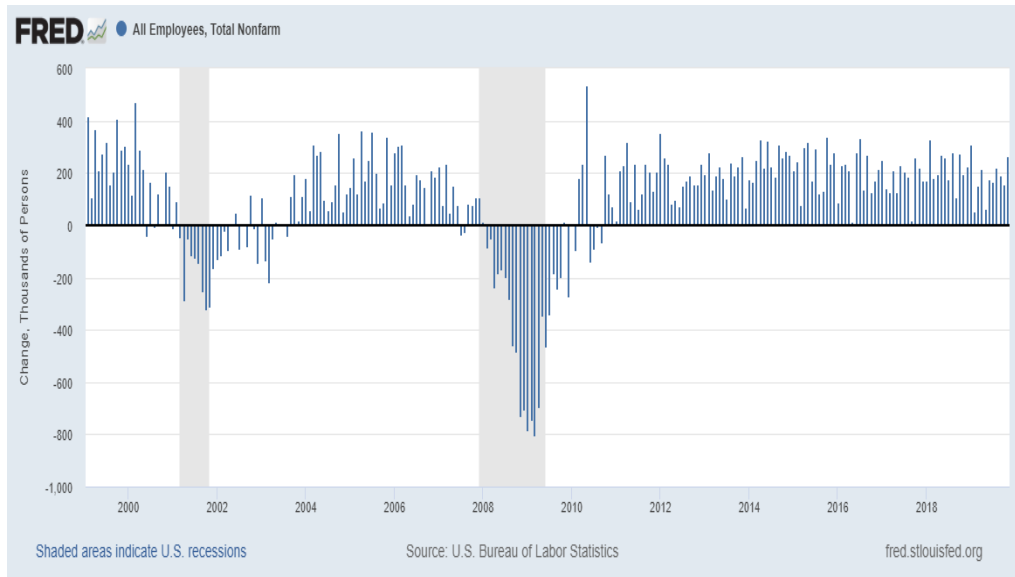
Hires have turned negative year-over-year, but as you can see that isn't particularly unusual. It also isn't a boom.



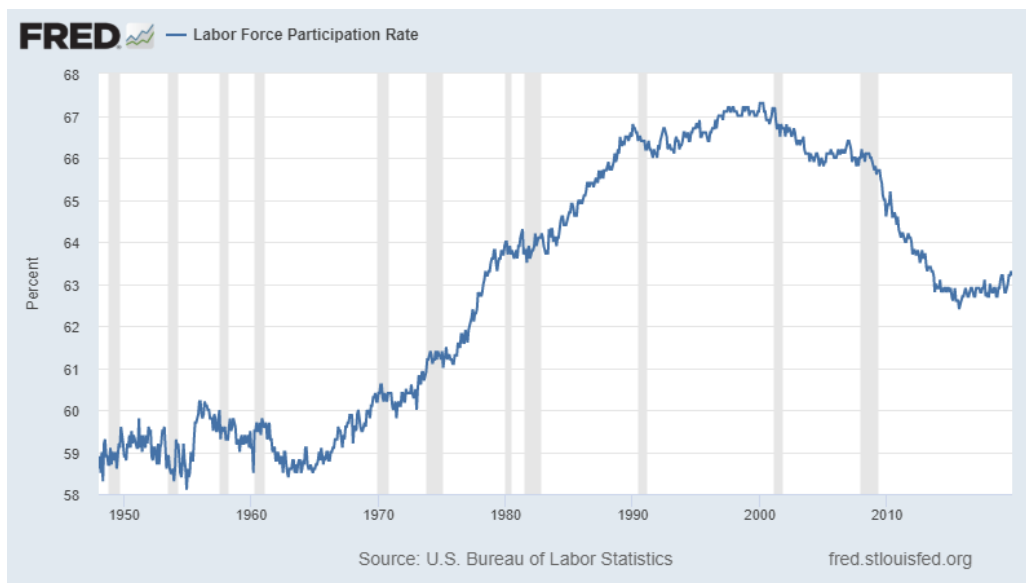


## Non-Farm Payroll Report

Non-farm payrolls continued to expand last year. The monthly average was down slightly from previous years in this expansion, but the only thing that really matters, from the perspective of predicting recession, is the sign.



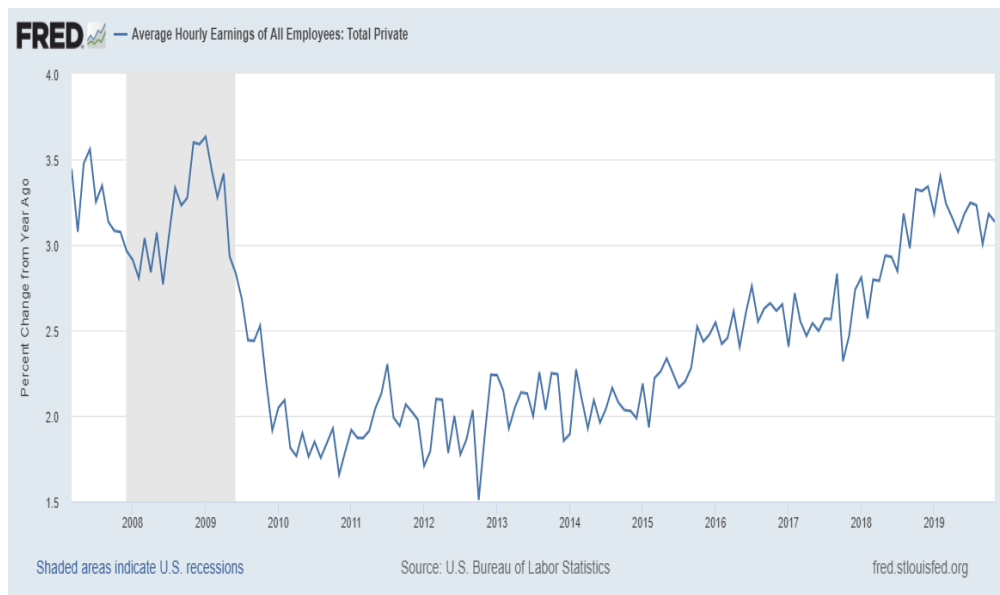
The participation rate has ticked slightly higher recently but we are still a long way from where we were in the late 90s. Good or bad? That's a lot harder to answer, from a societal standpoint, than it seems.



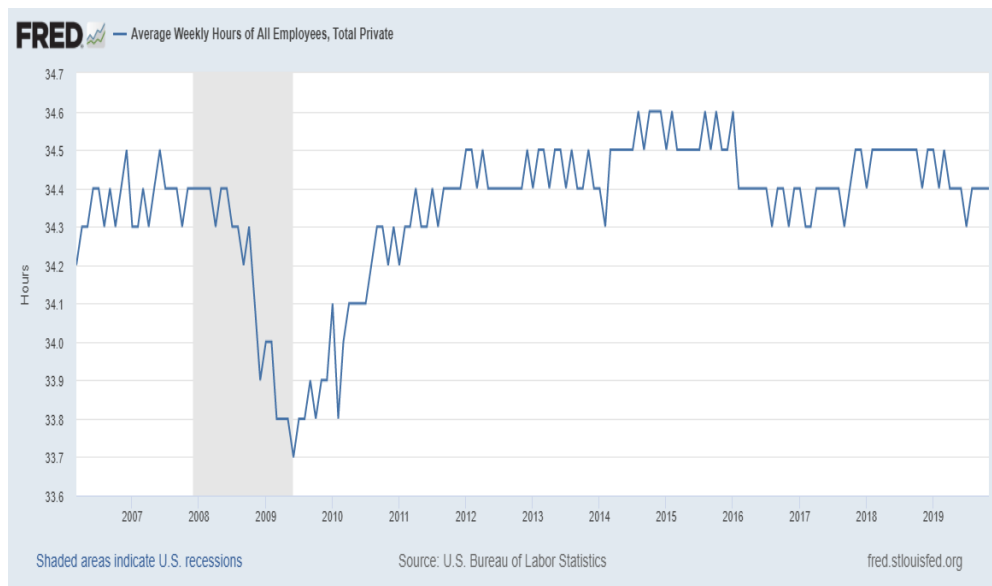


## Wages/Workweek

The pace of wage gains moderated in 2019 after rising more rapidly in 2017/18. Some of the increased pace was due to changes in minimum wages.



The average work week fell to 34.4 hours in 2019. The workweek peaked in 2015 and the slight fall since then is also probably due to changes or anticipated changes in minimum wage laws. There are no free lunches.







## Housing

New home sales continued to trend higher in 2019, up almost 17% year-over-year through November. Housing has generally turned lower before past recessions so if that holds true, recession odds look pretty low right now.



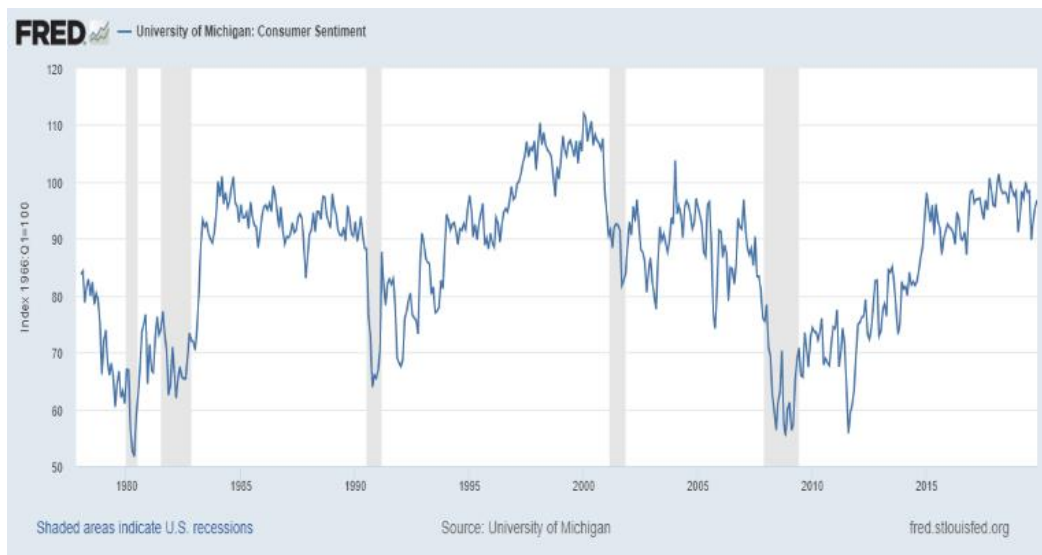
If you sell more, you have to build more. Housing starts are up nearly 14% year-over-year through November. This trend should continue as population continues to grow. Supply is constrained and rents continue to rise.



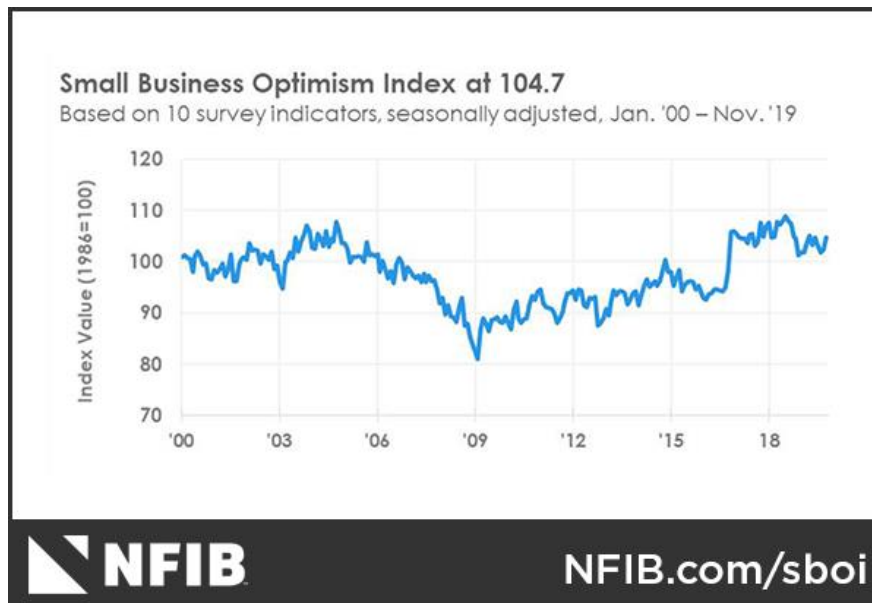


## Sentiment

Consumer sentiment was actually down a little in 2019 from 2018, but it has just stabilized at a fairly high level. As it has in past expansions.



Small business optimism remains fairly high too. It is lower than the 2018 and 2005 peaks though.





## 10-Year Treasury Rate

The 10-year Treasury yield peaked at the beginning of Q4 2018 at 3.25%. It spent most of this year in free fall, a reflection of falling growth expectations. Rates hit bottom in September and have recovered some into the end of the year.



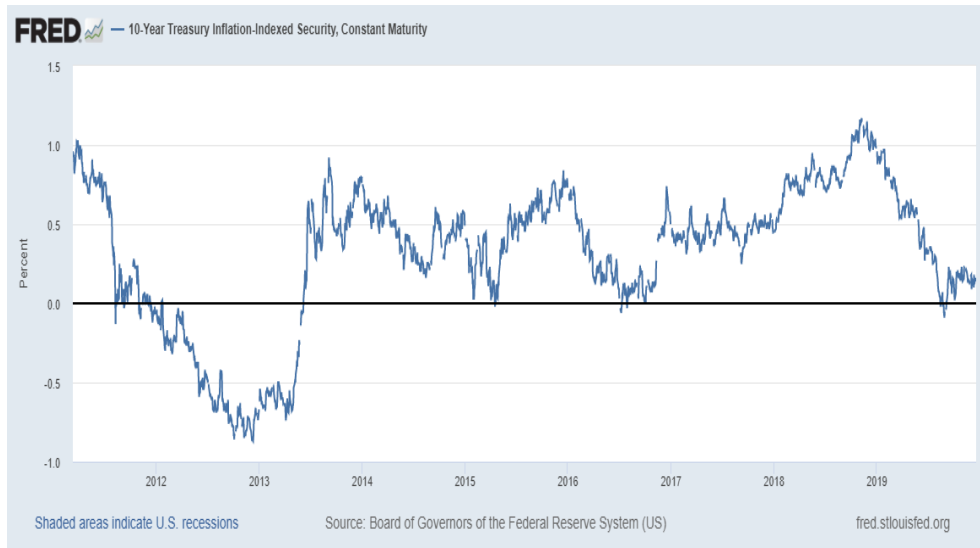
This is the fourth time in this cycle we've had rates fall to the mid 1% range. That is not unusual; there are always cycles within cycles, the economy accelerating and decelerating as it moves through the business cycle. Are we on the verge of another upcycle? Maybe, but there is little evidence of it yet.



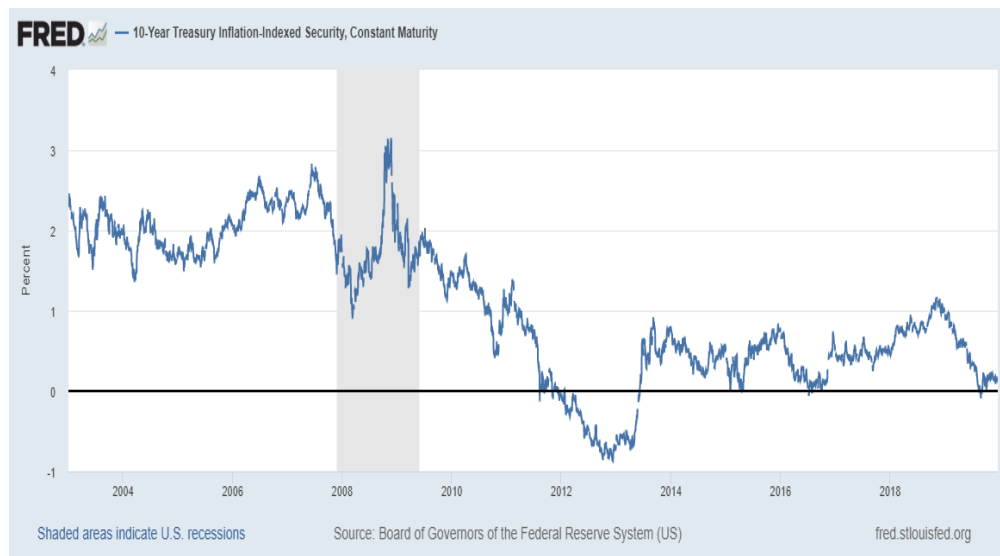


## 10-Year TIPS Yields (Real Rates)

We see a similar pattern in real interest rates. Falling real rates is an indication that real growth expectations are falling. Like nominal bond yields, TIPS yields hit an inflection point in early September and recovered some at the end of this year.



A longer-term view shows how much lower growth expectations have been in this cycle versus last. Real growth expectations hit their highest of the cycle in Q4 last year. The slowdown this year puts us right back on the previous trend.





## 2-Year Treasury Note Yield

The 2-year Treasury yield also fell in 2019, but has recently stabilized. The 2-year generally reflects expectations regarding Fed policy and Powell has made it pretty clear that rates are on hold.



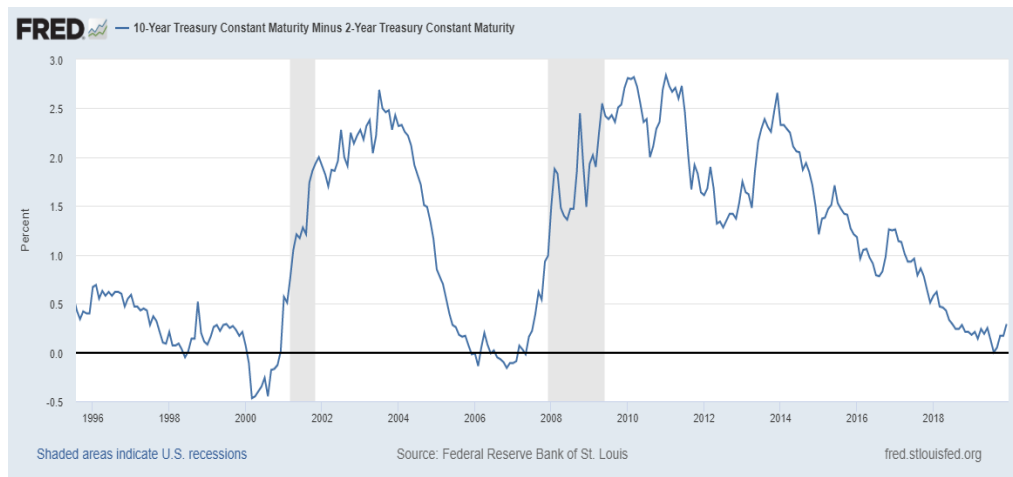
The move this year was nothing more than the Treasury market adjusting to the reality of the economic situation. In 2018, it looked like the economy was finally shifting to a higher growth path. This year disabused the market of that notion. The trend for US growth is around 2%. And that won't change until we see better productivity growth.





## Yield Curve

The 10-year/2-year yield curve inverted briefly in late summer causing an outbreak of recession angst. We didn't get too excited about it because we didn't see confirming signals from other markets. The recent steepening has caused similar concern as the curve usually steepens prior to recession. Wrong again. This isn't the steepening you're looking for.



## Credit Spreads

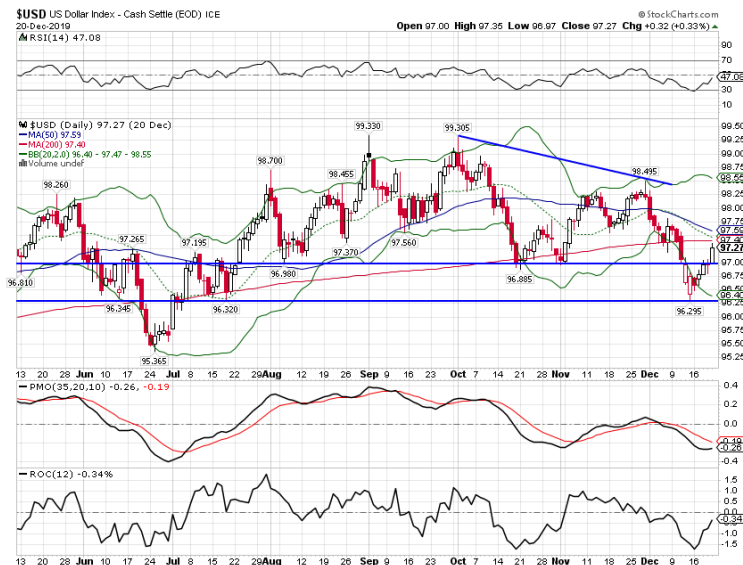
Credit spreads widened late last year, but it wasn't even close to what we saw in 2015/16 and a blip compared to 2008. Spreads spent most of 2019 working back toward the lows of the cycle. The consensus is that the next crisis will emerge from the corporate debt sector. That could be true, but there is no stress in the junk bond market right now.





## US Dollar

The dollar index has seen some recent weakness, coinciding with the inflection point in early September, mentioned above, in bond yields. Dollar strength is negative for global growth because it reflects lack of dollar funding outside the US.



Longer term, the dollar index has been fairly steady for the last 4 years, but has trended higher since the end of the 2008 crisis. We're in the middle of the range since 2015 but closer to the highs for this cycle.



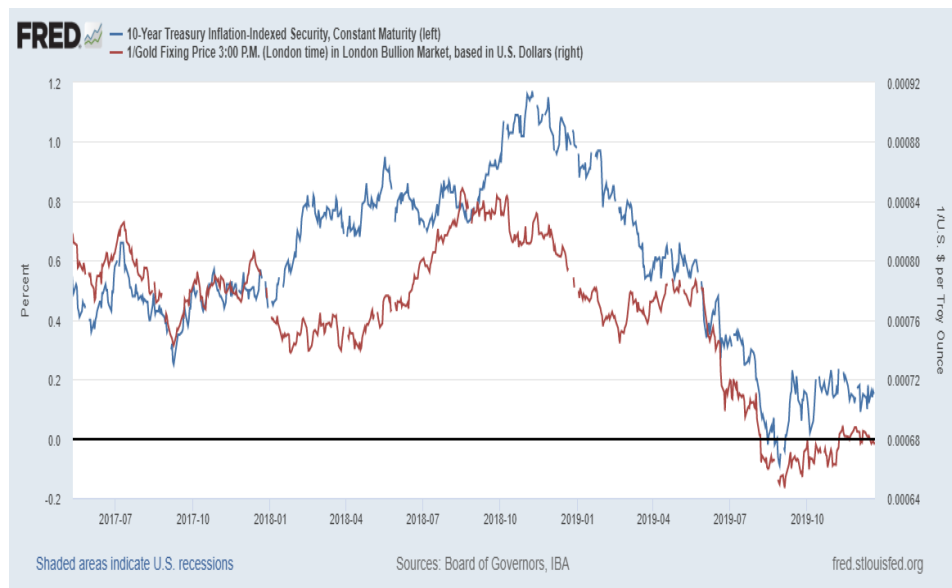


## Gold

Gold had a big move starting in early summer. Most people tend to think of gold as inversely correlated with the dollar but it is actually more about growth expectations.



Gold moves with real interest rates. This is the inverse of gold (1/gold price) versus the 10-year TIPS yield. Falling TIPS yields, as mentioned above, reflect falling real growth expectations. If real yields are zero or very low, the opportunity cost of owning gold goes down making it more attractive.







## Commodities

Commodities were volatile in 2019 and generally tracked growth expectations. Overall, commodities rose nearly 17% on the year.



The copper/gold ratio turned higher in early September as growth expectations started to recover.



We monitor the macro-economic environment to identify changes in the growth rate (up or down) and the onset of recession. *Growth rate up-and-down cycles* within the larger business cycle offer us opportunities to make tactical changes to our portfolios. These changes are generally within asset classes. We might favor general commodities over gold in a *growth rate-up* cycle or extend bond duration during a *growth rate-down* cycle. Imminent recession dictates a larger change, to the strategic allocation itself, a change to the overall risk orientation of the portfolio. An investor with a 30% baseline bond allocation might shift to 40% bonds if recession is deemed imminent.

**Right now, the market is anticipating another growth rate-up cycle in this long expansion and we have made some tactical changes within asset classes to reflect that. We have made no changes to our strategic allocations.**

We, at Alhambra, would like to thank all our readers and clients for making 2019 a record year for us. We end the year with our assets under management at an all-time high. We are very thankful for our long-term clients and the new ones who joined us in 2019. We wish all our clients and readers a healthy, happy and prosperous new year!



## How We Can Help

Do you have a strategic investment plan? Are you wondering how recession will affect your portfolio? If you haven't reviewed your investment plan recently – or you don't have one – we think we can help.

**Give us a call today at 1-888-777-0970**  
and we'd be happy to arrange for one of our

investment professionals to discuss your situation with you – completely complementary. Let's start the conversation today.



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