Ivory's Economic Outlook

SPRING 2019 • IVORY JOHNSON; CFP®, CHFC; FOUNDER; DELANCEY WEALTH MANAGEMENT, LLC

"I'm from Texas, and one of the reasons I like Texas is because there's no one in control."
Willie Nelson

In the aftermath of winning the silver medal in the 4x400 relay at the Junior Olympics national track meet, my then 10-year-old son decided he would play tackle football. For what it's worth, his 4x100 team also placed 4th, which is to say he has a good set of wheels. The problem was he had no business on a football field – he wasn't very good.

Despite his subpar gridiron acumen, by the end of the season he was convinced he should have been the starting wide receiver. As a staunch opponent of helicopter parenting, I told him he was the worst kid on the team. Then I asked if his teammates could run as fast as he could or if they had played violin at the White House like he did several months earlier.

This dose of reality served him well when he helped his team win back to back conference championships in track and field for a high school whose athletic program boasted the fastest 100-meter runner in the country and the first player drafted in the 2017 NBA draft. Even when he didn't make first chair violin until his senior year, he just worked harder and handled his business.

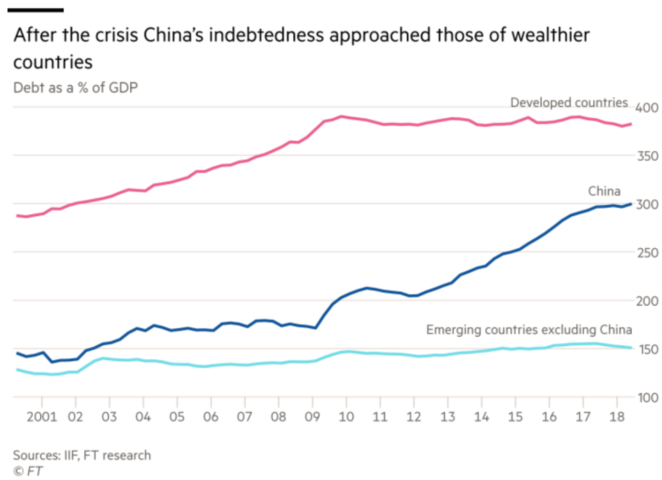
It's never as good (or bad) as you think it is. Likewise, the markets do not move in a linear fashion in either direction. For a variety of reasons, however, many investors confuse setbacks with something far more sinister and look for convenient excuses to explain away business cycles.

Sure, the markets are on a tear in 2019 and balances are higher, but the same could have been said last year around this time, right before the bottom fell out. I'm not complaining, I'm just conscious of the fact that earnings growth has been declining on a rate of change basis for a full year and the market is pretty much where it was at the beginning of October last year.

To be clear, corporate earnings beat expectations, but they're certainly not beating gravity. Earnings grew on a year over year basis by 24 percent in the 3rd quarter of last year, 14 percent in the 4th quarter, 1.6 percent in the 1st quarter of '19 and they're estimated to rise .9 percent in the second quarter of this year[i].

The subjectivity of math notwithstanding, we're told that the trade war is the culprit in the age of "it's somebody else's fault". And why not? It's almost a weekly occurrence that tariffs are set, then delayed due to scheduled talks with important people that seem to anger government officials from both sides until they agree to do something that they predictably renege on as leaked to the press by one of the parties and trade talks are once again rescheduled.

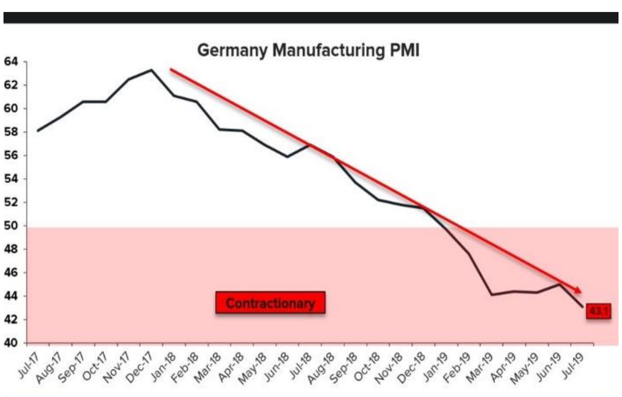
Negotiations with China resemble a high school romance that ends every Monday and gets renewed by Friday after lunch. Everybody eventually becomes hip to the routine, but that still won't stop the entire school from talking about the teenage lovebirds after class.



All of this serves as a backdrop for an 8th place trophy. Rather than acknowledging an economic slowdown, which for the record is not the same thing as a recession, the deceleration of earnings is said to be a consequence of a trade war. That might sound reasonable, but it's also what happens when the global economy takes a breather.

China is currently growing at the slowest pace in 27 years[ii] and this after China's gross debt exploded from 171 to 299 percent of GDP since 2008[iii]. Euro zone economic growth halved in the April-June period[iv], which explains why $13 trillion of their sovereign bonds are offering negative yields[v], which means you have to pay them for the privilege of lending them money.

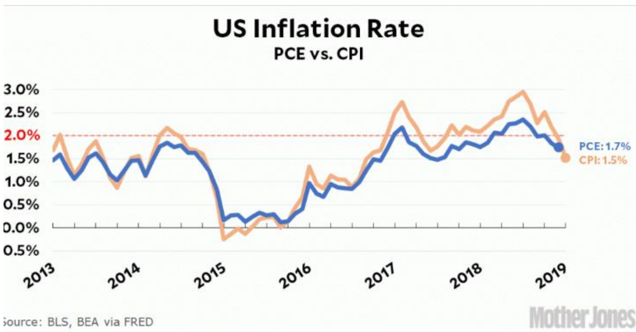
The Book "Switch" describes how teenagers who successfully fight cancer through chemotherapy are not out of the woods because they are required to take antibiotics and low dose chemo pills for two years after they leave the hospital. Unfortunately, the side effects include nausea and skin breakouts, something no teen wants to deal with.



The problem is missing 20 percent of the doses increases the odds of getting cancer again by 200 percent. In response, HopeLab, a social innovation lab focused on designing science-based technologies to improve the health and well-being of teens and young adults, created a video game called Re-Mission where the teens raced through blood streams zapping tumor cells with chemo-rays. The results showed that dosage intake increased by 20 percent.

What was interesting is the amount of time the kids played the game had no bearing on their compliance with the chemo regiment. It turns out that the problem wasn't knowledge, but emotion. These teenagers just had their lives turned upside down and they wanted it back. They didn't want to be the sick kid anymore – they wanted to regain control.

Whenever the business cycle ends, the Federal Reserve offers investors a video game with low interest rates zapping volatility. Helicopter central banking may be all the rage, but it didn't stop GDP from decelerating to a 2.1 percent growth rate[vi] in the 2nd quarter and headline inflation growth slowing to 1.5%[vii] versus the 1.8% predicted in March. Mind you, this is just a continuation of a downward trend that began last September that creates a whole new dilemma because nobody knows what will happen if they don't cut rates enough to compensate for the deteriorating economic data.



This trend isn't a red flag, the great plague is not on the horizon, it's just a data point that refutes the narrative that a trade dispute is the overwhelming factor in recent volatility. There's little wonder why inflation is muted – prices aren't going to skyrocket when U.S. consumer discretionary earnings slows to -1.34% year-over-year.

When I first learned how to drive one of my friends noticed that the meter attendants had to ensure that the machine worked before they could write a parking ticket. Armed with this valuable information we began inserting a quarter in the meter without turning the dial. While the meter would show that it was expired, as soon as they verified the integrity of the device by turning the dial, the quarter would drop and there would be time left for us to remain parked. We had identified a loophole; they couldn't write us a ticket if our meter still had time.

The meters eventually became digital and now I use an app in DC that charges me a service fee for the convenience. Everything eventually comes full circle and sometimes it's expensive. Over the last 12 months companies have spent 104 percent of free cash-flow on stock buybacks that are on pace for $1 trillion in in 2019[viii], a 26 percent increase over last year. The Federal Reserve can control interest rates, but they have no domain over the rate of stock buybacks when slowing corporate sales eventually mitigates the amount of buybacks companies can engage in.

One could argue that companies will continue to borrow the money to buy more of their own shares, although corporate debt is nearing half of U.S. GDP[ix] and there's already $4 trillion in BBB rated and below corporate bonds on their balance sheets, a third of which is junk status[x]. To put that into perspective, there were $1.5 trillion in subprime loans in 2007[xi].

If I seem on the verge of being dismissive, it's not that I'm unconcerned. Rather, these conditions were noticeable last year and whatever I would do in response already got done. When corporate earnings peak, the following year's data will be compared to the best of times and that's difficult to beat, whether it's GDP or earnings growth. Without growth, interest rates decline and then the Fed lowers rates further.

That's why we have owned bonds, utilities and real estate investment trusts for the last year, with the latter two the only sectors to have recorded stronger quarter-over-quarter growth[xii] . These asset classes pay dividends and investors will prefer a dividend in the hand over future growth in a bush. It looks bad when we get a bounce, but when everything is said and done this approach has worked out just fine.

Gold has a place right now because our global competitors have decelerating economic growth of their own. Now everyone is in a race to devalue their currency to increase exports. Gold, being a store of value, has benefited from currency not backed by anything of value being created out of thin air across the world.

I get it, trade wars create policy uncertainty that reduces corporate expenditures as they wait and see what will happen to their costs of doing business. The point I'm trying to make is that there's way more to it than that. What we're seeing is a collaboration of troubling data that has been brewing across global markets for several quarters.

My friend who figured out the parking meter loophole grew up to be a very successful attorney. He originally wanted to be a police officer and scored high on the written NYPD exam, but when they asked what he would do if somebody spit on him during the psychological exam he gave an honest answer and was removed from consideration.

It's anyone's guess what happens now, but it helps to know all of the intervening variables. From the looks of things interest rates aren't going up any time soon and the market will continue to be choppy. In the meantime, we'll wait for the market to turn the dial on the parking meter so that quarter can drop and give us more time.

No sense risking a parking ticket now.

[i] Halfway through earnings season, it looks like we are going to dodge the feared profit recession; CNBC; 7/30/19
[ii] China's economic growth slumps to lowest in 27 years as the trade war hits; CNN; 7/15/19
[iii] China's debt threat: time to rein in the lending boom, Financial Times, 7/25/18
[iv] Euro zone second-quarter growth halves, inflation slows despite jobless at 11-year low, CNBC; 7/31/19
[v] Value of debt with negative-yields hits $13 trillion; MarketWatch; 6/21/19
[vi] Economic Growth Slowed to 2.1% in Second Quarter; Wall Street Journal; 8/6/19
[vii] Fed lowers its inflation expectations for 2019, keeps growth outlook the same; CNBC; 6/19/19
[viii] Companies are ramping up share buybacks, and they're increasingly using debt to do so; CNBC 7/29/19
[ix] What Ballooning Corporate Debt Means for Investors, Forbes, 4/8/19
[x] There Have Never Been So Many Bonds That Are Almost Junk, Wall Street Journal; 8/6/19
[xi] The United States of Subprime, Wall Street Journal; 10/11/07
[xii] Corporate America is narrowly avoiding an earnings recession, but signs of weakness are lurking within the data; MarketInsider; 5/29/19