

August 12, 2016

## ROSE-COLORED? OR RIGHT-COLORED?

- US consumers are spending, and doing so without depleting their savings.
- Household formation is on track for further growth, thus providing a boost to the housing market.
- Inventories have depleted to a level where manufacturing has stabilized.

Every time the stock market corrects there is media rhetoric that permeates the minds of investors. The popular rhetoric is a means to sell the fear of a declaration in the form of a question, “Is this the start of a recession?”

Typically what we find ourselves doing is reacting to the media when investors ask us our stance on that question. And I don’t like that, because the stock market has predicted nine out of the last two recessions. In other words, the market goes down and people expect what has happened recently to continue happening, and that it is somehow more meaningful than the time before. So when we calmly explain that the market will bounce back, we look like Pollyannas. Even when we end up being right, at that moment it looks a little bit too much like our glasses are far too rose-colored.

The stock market goes down five percent, on average, three-and-a-half times per calendar year. And it goes down ten percent about once per year. Add in seasonality (summer doldrums) and a coming Presidential election, ***it wouldn’t be surprising to see something in between happening (a 6-9% correction) over the coming weeks or months.*** So, with the US equity markets at all-time highs we thought it would be a good idea to preemptively talk about the economy and why we believe that ***any coming correction will likely be short-lived,*** but still scary. (We’re still overweight the US in our equity exposure and still are out of Europe; but emerging markets are beginning to look more attractive for the most aggressive of investors),

That being said, let’s address a couple important issues. First, the US will have a recession again. To steal a popular phrase from the Federal Reserve, our expectation of when that will happen is going to be data dependent. The data (which we will discuss) is not there now to support an argument for an impending recession. But if information changes, we may need to change our minds. Just because we don’t see a recession coming now doesn’t mean there won’t be one as soon as, say, 2017, or later.

Second, ***employment growth is going to drop. For the better part of the last year we have been forecasting the US will reach full employment by the summer of 2016.*** Well, the broadest unemployment rate hit 4.7% in May, and has leveled off at 4.9% for the last two months. There is a lot of debate as to what rate of unemployment “full employment” is. From



Investopedia, full employment is defined as “an economic situation in which all available labor resources are being used in the most efficient way possible. Full employment embodies the highest amount of skilled and unskilled labor that can be employed within an economy at any given time. Any remaining unemployment is considered to be frictional, structural or voluntary.”

But let's not use this article to debate what that number is (though few would argue that it's not far from today's levels, and that's the point). Instead, let's just recognize that labor growth has been robust, but as we attain full employment fewer jobs will be created. And when that happens, even sans a stock market pullback, the question “Is this the start of a recession?” will still likely ring out.

I just want to address this quickly then move on to the pure positives instead of the mixed positives. And there are mixed positives when the unemployment rate stabilizes at full employment. Although at full employment the unemployment rate may not improve and the number of new job growth may slow, those numbers do not reflect what has been happening. Namely, **wage growth has been increasing** (a net gain for the economy as corporations may have to pay more, but the percentage of income that tends to get spent by workers is typically greater, allowing for a multiplier effect). Also, **at full employment, hours worked tend to increase** (so even if it is only the same number of people working, they are working more). Again, in the spirit of preemptive explanation, it was worth mentioning that **we'll see employment growth moderate at some point and that you shouldn't (yet) be alarmed**.

## Consumers

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**During the first half of the year, real consumer spending grew by three percent, on top of similar growth last year.** Vehicle sales are near record highs, and home sales are the strongest they have been since the housing bubble burst. But the best news is that the spending has not hurt the balance sheets of consumers. We don't intend to get too detailed as to who is doing the spending versus who is not (that often looks different at different ages), **but in the aggregate the savings rate has remained near an impressive six percent.**

**When that recession does come, consumers' balance sheets will be strong and will keep any recession shallower than it might otherwise have been.** But even before a recession comes, as we mentioned above, we anticipate slowing job growth. Because of rising wages and ample savings, consumers should be able to continue spending even as the job market tightens. Household debt relative to discretionary income is as low as it has ever been. And because the



Brexit vote shocked debt markets, early sources suggest another mortgage refinancing wave has started as rates dipped.

## Housing

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Housing demand is the summation of household formation (there are different definitions for this, but think along the lines of two people in an apartment decide to have a kid, so they move into a house), and (to a lesser degree), replacing obsolete homes and second homes. There are a lot of different models that can be run, but without trying to argue the pros and cons of each, it seems as if ***the trend of housing demand is about 1.7 million units per year. However, new housing construction is running at only about 1.25 million units per year. This should be a driving force for the US economy.***

Helping to push that trend housing demand growth is extremely low rental vacancies, which are pushing up rental rates. The high rents are an incentive for renters to become home owners. The bad news is that high rents will pinch the incomes of lower- and middle-income renter households. The positive economic offset is that this will lift the wealth of middle- and higher-income households that own these properties.

## Inventories

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We'll keep this part short and simple. ***US inventory accumulation peaked during the first half of 2015*** at an annualized rate of close to \$100 billion. That is about double the accumulation needed in an economy that has been trending as it has. That's just too much. For the remainder of 2015 and into 2016, producers pulled back in responses to corporations trying to get their inventories under control. At the same time oil prices were plummeting, thus halting energy-related activity. These factors combined explain a lot of the slowdown in corporate profits and economic growth in the past year.

***Now that the worst of the oil decline is (seemingly) behind us, and that inventories have mostly been worked off to sufficiently low enough levels to argue for a stabilization in manufacturing*** (the Institute of Supply Management survey tells us that manufacturing is again on the upswing); at the very least headwinds have been removed. This was a global problem that has been improved upon outside the US, allowing a less obstructed path to global and domestic growth.



### **Bottom Line:**

It's when, not if, the next recession will happen. As of right now, the economic indicators arguing for a recession are absent. That doesn't rule out a recession in 2017, or some other time frame. But it does argue ***that whatever Summer / pre-election drawdown in prices that might occur in the stock market is likely to be limited to the ordinary, and regular (though unpredictable in timing) variety of 5-10%. Any changes to portfolios around that time (or even before) are more likely to be adding to more growth-oriented investments than moving toward more conservative positions***



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