Cornerstone Report

Special Report July 18, 2018 By: Jerry E. Tuma, MS, CFP®

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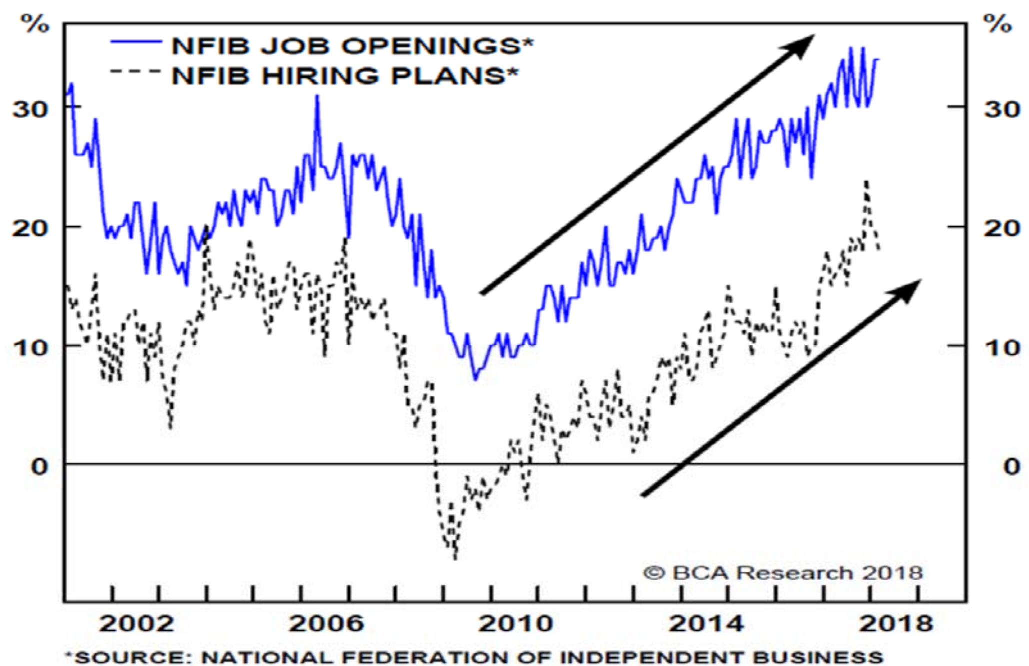
Preparing for the Top - Part I

Thus far in 2018, both headwinds and tailwinds have buffeted the financial markets, yet at this point the overall trend remains up. But, big concerns appear to be headed our way in the 2019-2020 time frame. This currently ranks as the second longest business expansion since WWII, only exceeded by the 1990-2000 dot-com boom.

Economic pluses include jobs, jobs, and more jobs, with unemployment falling to a multiyear low in May at 3.8%, pacing ahead of the Fed's projections. Unemployment could fall all the way to the ***Fed's year-end 2019 target of 3.5% by the end of 2018***! ***The economy is definitely expanding!*** Estimates for economic growth (GDP) for the 2nd quarter 2018 range from 3.5% GDP growth from the New York Fed to 4.5% GDP growth from the Atlanta Fed.



Job openings are being created faster than they can be filled, leading to labor shortages almost everywhere.

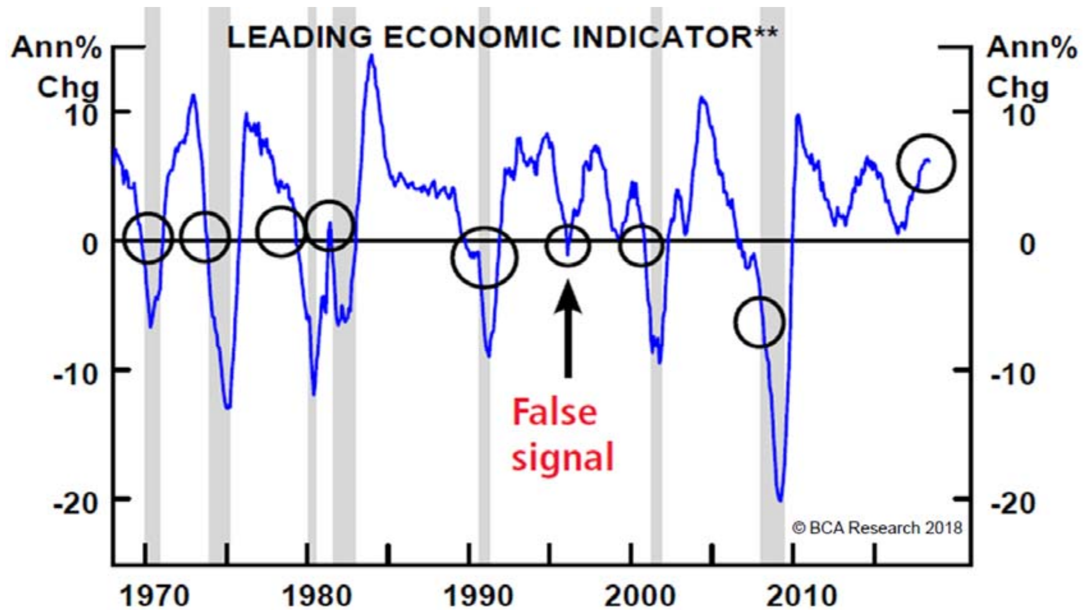
Yet all is far from perfect. Trade wars and threats seem to batter the stock market every few days. President Trump appears resolute in his determination to renegotiate trade deals to be more favorable for American companies and workers. Thus, trade issues have become a potential headwind for the stock market, keeping both media and investors on the edge of their seats.

Topics:

- Small Business Explosion
- Inflationary Spiral Starting?
- Fed Tightening
- Trade Wars
- China Makes the World Go Round

Changing the Way America Thinks About Investing.™

As any investor knows, all recoveries are eventually followed by recessions, and all bull markets are followed by bears. An old Wall Street saying goes – “trees don’t grow to the sky.”



This chart shows the U.S. Index of Leading Economic Indicators. As you can see the index has only experienced one false recession signal, successfully predicting the economy’s direction since the late 1960’s. The index typically peaks six months or more before the economy peaks and recession sets in, and rises before economic recoveries.

Of note is that this indicator, while still positive (above 0 axis) may be topping.

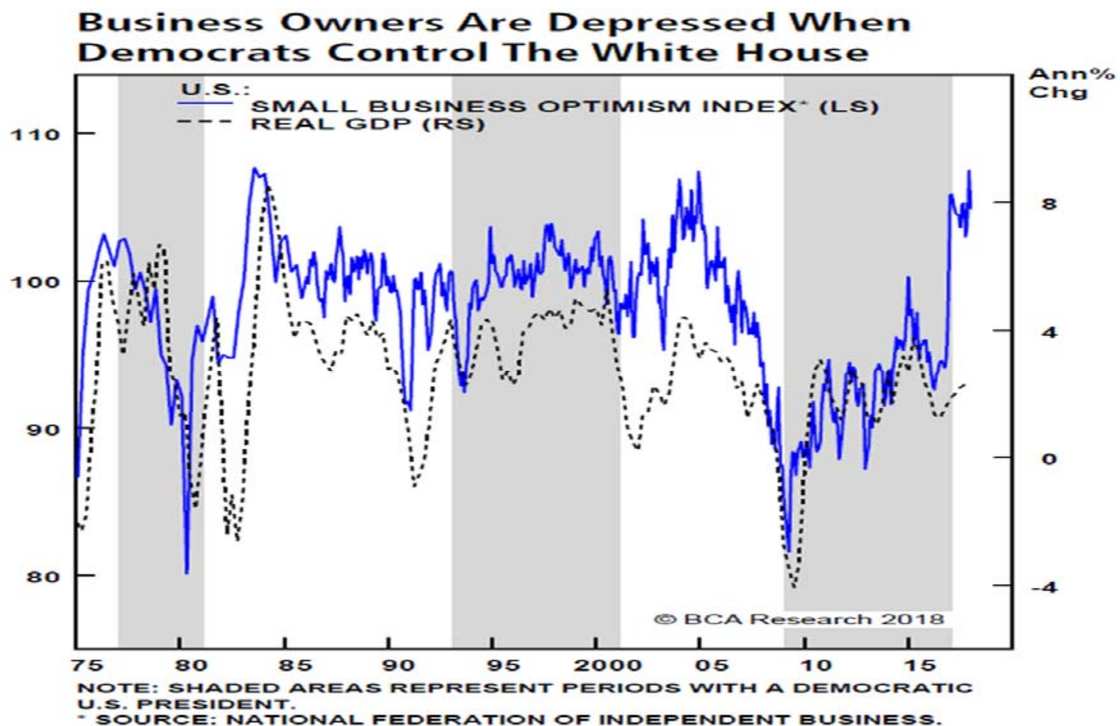
The current question is: Could this expansion ***exceed*** the 1990’s expansion, thereby becoming the longest expansion ever, or will the inevitable force of gravity soon take its toll?

Let’s take a look at both positives and negatives for this current expansion and bull market, to get some clarity concerning how much longer it might last, as we ***Prepare for the Top.***

Small Business Explosion

Positives currently abound in the economy, with accelerating GDP growth and a jobless rate so low that labor shortages are appearing at almost every level of the economy.

Small business optimism has exploded, as the combination of tax reform and Trump's massive deregulatory campaign have small business owners in their most optimistic frame of mind since the Reagan Administration. (Small businesses are typically responsible for between 60-80% of job creation.)



Larger businesses have been expanding as well. Altering the corporate tax code has the potential to be a true game changer long term. Immediate expensing of write-offs for capital expenditures versus depreciating equipment over many years creates huge potential benefits, encouraging quicker decisions and potentially immediate bottom line results. The lowered corporate tax rate and repatriation of U.S. companies cash overseas swings the balance back in favor of U.S. multinationals expanding ***inside*** the U.S, not overseas.

Interest rates, while rising, remain at low levels not seen in decades. The real estate market has largely recovered from the 2008 crash, and stocks remain at or near all-time highs. So, as Mad Magazine's Alfred E. Neuman was fond of saying, "What, me worry?"

Yet worry we must if we intend to capitalize on the bull and avoid riding through another major bear market. The sky may be clear overhead, but storm clouds are on the horizon.

To get a good read on this, we must look further ahead – to 2019 and 2020, starting with inflation.

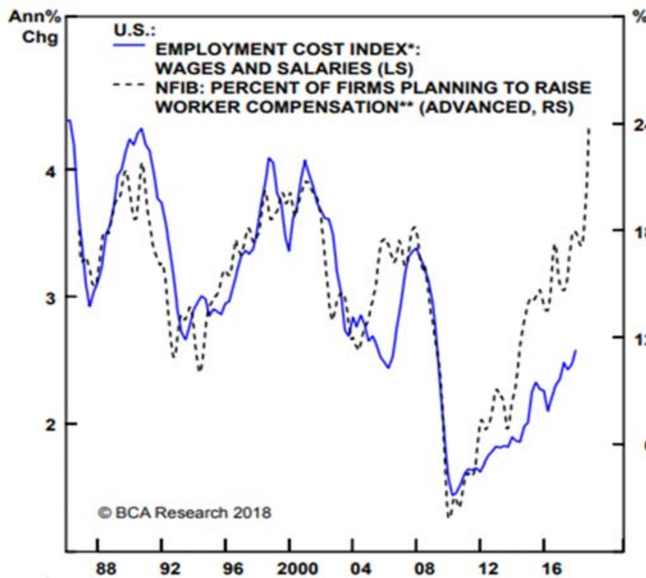
Inflationary Spiral Starting?

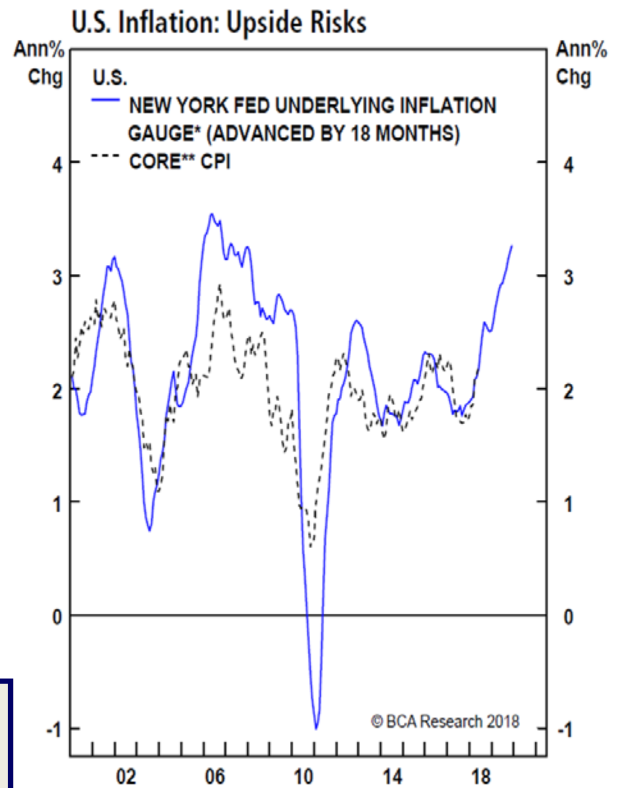
Record low unemployment is great news! However, the negative side effect is that ***true*** labor shortages are showing up almost everywhere. The table to the right shows that all major sectors of the economy (except for information/ technology) are experiencing ***shortages*** of qualified labor. The end result is rising labor costs (wages and benefits) as employers are forced to compete against one another to hire new workers.

INDUSTRIES IDENTIFIED AS HAVING SHORTAGES IN 2018 BEIGE BOOKS	INDUSTRY AVERAGE HOURLY EARNINGS ANNUAL GROWTH ABOVE TOTAL PRIVATE	LABOR MARKET TIGHTNESS AT/ OR ABOVE PRE-CRISIS LEVEL*
CONSTRUCTION	YES	YES
RESIDENTIAL CONSTRUCTION	YES	YES**
MANUFACTURING	YES	YES
TRUCK TRANSPORTATION	NO	YES**
FINANCIAL ACTIVITIES	NO	YES
BANKS	YES	YES**
ACCOUNTING & BOOKKEEPING	YES	YES**
ARCHITECTS & ENGINEERING	YES	YES**
COMPUTERS & SOFTWARE	NO	NO**
NURSING	NO	YES**

* CALCULATED AS THE JOB OPENINGS LEVEL BASED ON THE JOLTS SURVEY DIVIDED BY THE NUMBER OF UNEMPLOYED.
** DUE TO DATA LIMITATIONS RESIDENTIAL CONSTRUCTION IS BASED ON CONSTRUCTION; TRUCK TRANSPORTATION IS BASED ON TRANSPORTATION, WAREHOUSING AND UTILITIES; BANKS IS BASED ON FINANCE & INSURANCE; ARCHITECTS & ENGINEERING AND ACCOUNTING & BOOKKEEPING IS BASED ON PROFESSIONAL & BUSINESS SERVICES; COMPUTER & SOFTWARE IS BASED ON INFORMATION; NURSING IS BASED ON HEALTH CARE & SOCIAL ASSISTANCE. © BCA Research 2018

Historically, inflation ***lags*** economic growth by approximately 18 months. Thus, if what appears to be the latest surge of economic growth manifests in the 2nd quarter of 2018 as expected, ***even more inflationary pressure will likely hit the economy in late 2019,*** on top of already accelerating wages and salaries. (Note: Historically the average corporation spends approximately 70% of its budget on wages and benefits – typically its single largest cost.)





Higher inflation is in the forecast over the next 12-18 months, which is historically what has forced the Federal Reserve to raise interest rates to levels which eventually create a recession, thus ending the recovery.

> Underlying economic growth tends to ***lead*** inflations by about 18 months or so – leading us to conclude that inflation appears to be preparing for a major acceleration in 2019-2020.

Fed Tightening

The table to the right shows previous episodes of Fed tightenings. As you can see, in nine of the previous eleven episodes since 1950, rising rates preceded a recession. We are in the 12th cycle now.

Fed Tightening Cycles*

Date	Recession	Soft Landing
1955-57	X	
1958-60	X	
1963-66		X
1967-70	X	
1973-74	X	
1977-80	X	
1980-81	X	
1987-90	X	
1994-95		X
1999-01	X	
2004-07	X	
2015-??	?	?

* 2 or more consecutive rate hikes

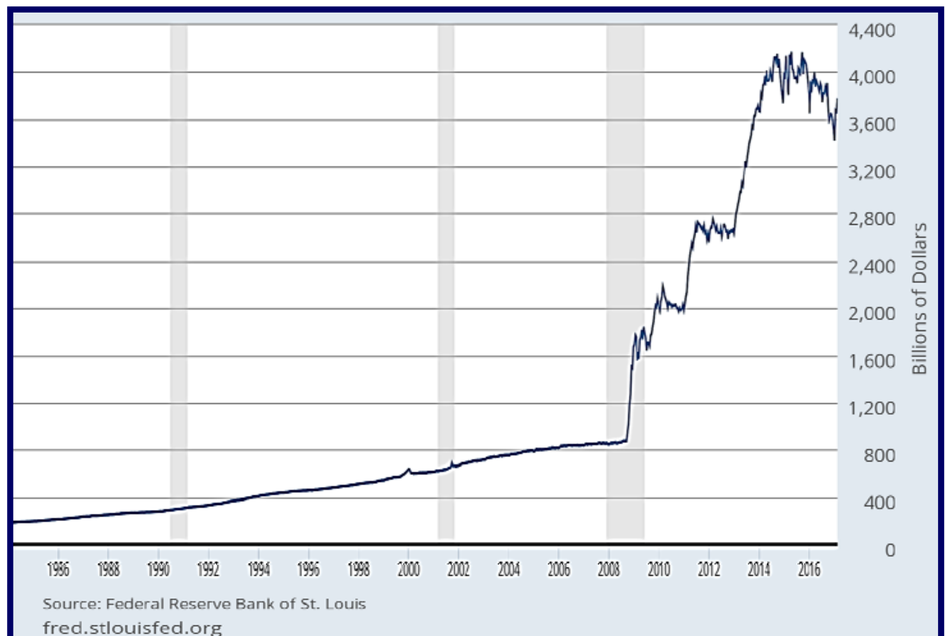
Source: InvesTech 2018

At risk of being a killjoy, let me point out that in the two lone instances when the Fed was able to raise rates without creating recession, we were ***early*** in the cycle, not where we are currently, at the tail end of the 2nd longest expansion. Thus, in those instances the economy still had lots of slack to absorb interest rate increases without tipping into recession. This cycle is different from those two instances, in that wages and labor shortages are already spreading and pushing inflation higher, thus giving the Fed little wiggle room. The old analogy that "the party is going great until the Fed takes the punch bowl away," appears to be taking place.

The Fed has recently announced two more rate hikes for 2018, for a total of four this year versus previous announcements of three rate hikes for 2018. Thus they are ***accelerating*** the speed of their rate hikes, with likely even more inflationary pressure ahead in 2019. Other than the two previously mentioned tightening cycles in 1963 and 1994, all other rate hike cycles have ended with recession and a bear market for stocks. My guess is that this 12th cycle will end that way as well.

Truly Unprecedented

In addition to hiking rates another four or five times in the next 12-18 months, this Fed is about to do something ***truly unprecedented!***

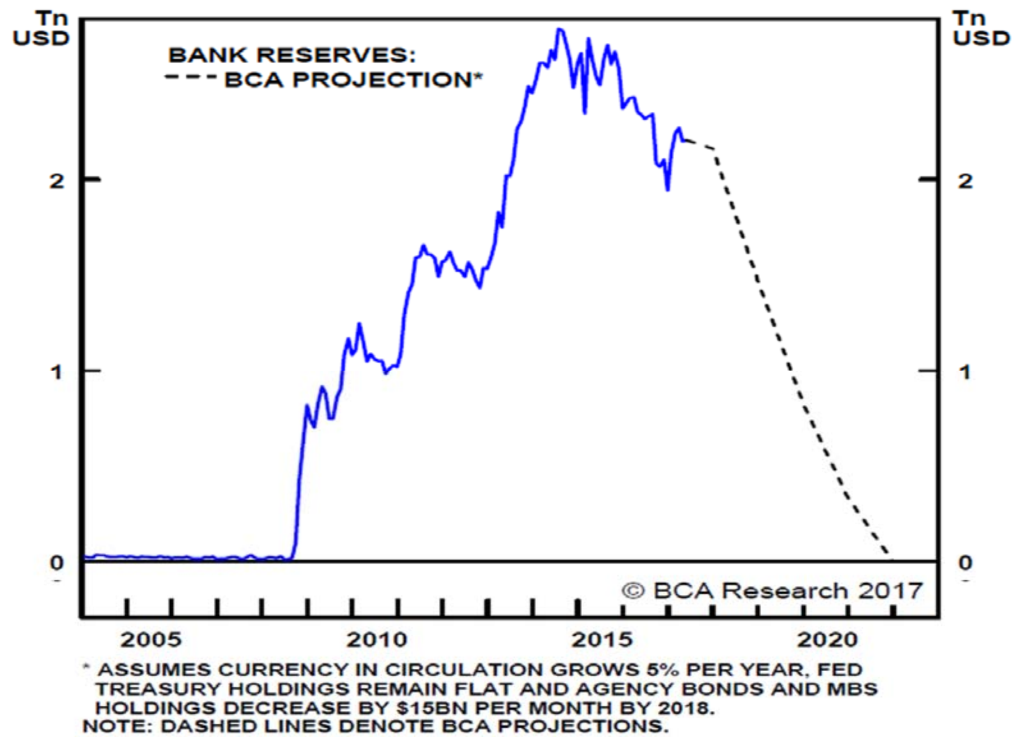


To the right you see the Fed's balance sheet. To fight the Great Recession beginning late 2008 and prevent another Great Depression, Ben Bernanke launched a bold initiative of pouring massive liquidity into the system. In four distinct waves, the Fed engaged in what is referred to as Quantitative Easing (QE), which essentially amounted to the Fed buying some $4.5 trillion or so in U.S. government debt obligations and mortgage backed

securities – all designed to re-liquefy the economy, to stop the credit hemorrhaging in the banking system and to re-inflate both the economy and the markets.

They definitely succeeded in re-inflating the system, which without major intervention may well have headed deep six.

At this point the banking system appears to have pretty well healed, stocks are now at or near all-time highs, and real estate has largely recovered. The ***Fed, in my opinion, succeeded in its goal.*** Unfortunately now, the Fed governors have unbelievably decided to undo much of this – ***by selling off (or allowing to mature) almost their entire balance sheet over the next three to four years.***



This will prove, in my opinion, to be a major mistake. At last count, the world's monetary reserves were estimated at some $24 trillion. Europe's central bank (ECB) has just announced it will stop its asset buying program (QE) before year end 2018, thus removing a major source of liquidity from the world's financial markets. The Fed selling (or letting mature) some 10% +/- of the equivalent of the entire world's monetary base, I believe will cause a major liquidity crunch, starting in 2019 or so.

Fed’s Playbook – (Typical Late Cycle)

Step 1 – Economic growth matures as the business expansion gets long of tooth.

Step 2 - Inflation and wages accelerate.

Step 3 – The Fed raises rates, typically too high for too long.

Step 4 – The economy reaches its growth apex, then rolls over as rate hikes start to bite economic growth.

Step 5 – Recession takes hold, then negative economic forces pick up momentum. Eventually the Fed relents and changes direction by lowering interest rates and pumping the money supply back up, but not until considerable damage has been done to both the economy and stock market.

If you have lived through at least one business cycle, this should all sound familiar.

Yet on top of the “normal” forces which ultimately cause recession and bear markets, this Fed is determined to unwind the largest expansion of the monetary base in American history! Jumpin’ Jehoshaphat! ***While I’m normally not one to use extreme statements, in my opinion this one takes the cake!*** Virtually all stock market participants have widely credited the Fed’s QE program with successfully re-inflating both the economy and stock market. Yet somehow, now everyone seems to think deflating the balloon will cause **NO PROBLEMS??** I don’t think so!

This could end up being one of the largest policy mistakes in history. Likely what will ultimately happen is that economic weakness, a recession and/or a bear market for stocks will force the Fed to reassess its plans (probably by late 2020), but not likely before creating a recession or crisis and probably a major bear market.

Two things to remember:

#1 Don’t Fight the Fed – The Fed’s tightening of the money supply and raising interest rates creates a major headwind against stocks.

#2 Liquidity Trumps Economic Momentum – Long term structural changes to the U.S. economy (tax reform, reduced regulations, etc.) are awesome in my view, and ***could pay dividends literally for decades***. Yet at ***the end of the day liquidity (or lack thereof) almost certainly TRUMPS economic momentum in terms of the current business cycle.*** Economies need funding like fuel for a locomotive. The Fed removing $2.5 trillion+/- in liquidity over the next two years will almost certainly cause big problems, in my opinion.

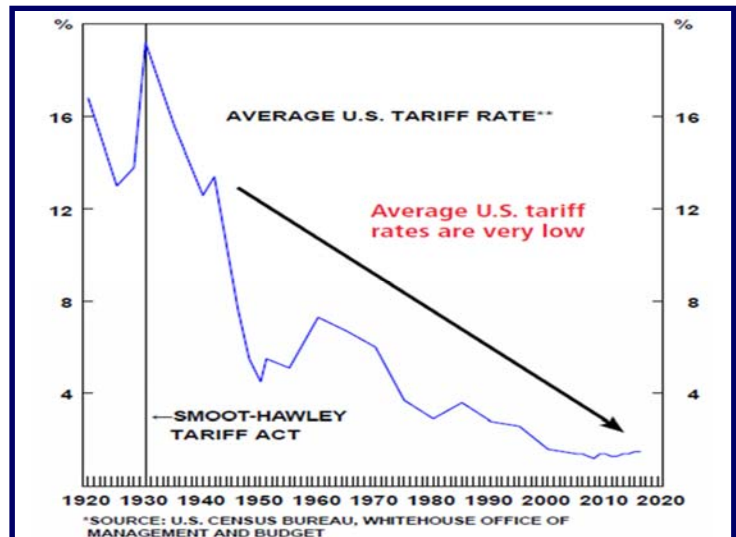
Trade Wars

Probably the biggest single headwind for the stock market right now is the trade wars.

While I agree with President Trump's long term goal of rebalancing trade agreements, so as to ***not*** put our own industries or companies at a significant disadvantage – in the short run it is very upsetting for the financial markets.

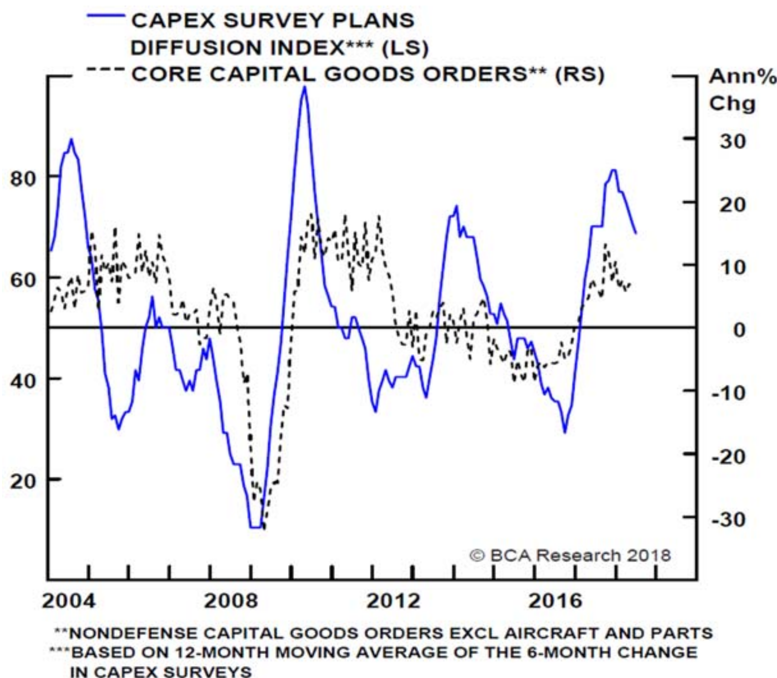
International trade may have very little short term impact upon Main Street, but has an enormous impact upon Wall Street, as the S&P 500 and DJIA are heavily populated with companies where international trade can amount to as much as 50% or more of their annual sales. If trade wars continue to escalate, in the short run this will hurt a lot of our domestic companies and the very workers Trump is trying to protect.

Evidence of trade war escalations taking a bite out of the U.S economy are shown in the next chart, which depicts U.S. companies capital expansion plans (CAPEX).



As you can see from the chart, tariffs are nowhere near what they were in the 1930's when the infamous Smoot-Hawley Act passed. Smoot-Hawley was widely vilified as a major contributing factor to start the Great Depression.

China, parts of Europe and other countries typically charge much higher tariffs on many U.S. goods which are sold in their country, than we charge for their products being sold in the U.S.



Things had just taken off after Trump's election and his pro-business agenda. Deregulation started, then came tax reform, which initially had corporations giddy. But as soon as the trade war started, corporate enthusiasm came to a screeching halt.

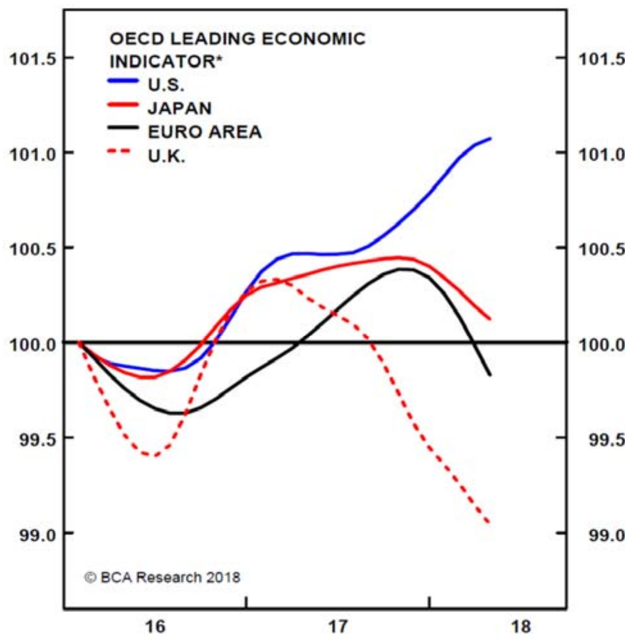
Capital expansion plans (CAPEX), which were headed straight up earlier in 2018, have now topped and are headed back down as CEO's and corporate boards pull in their horns due to the trade war uncertainty.

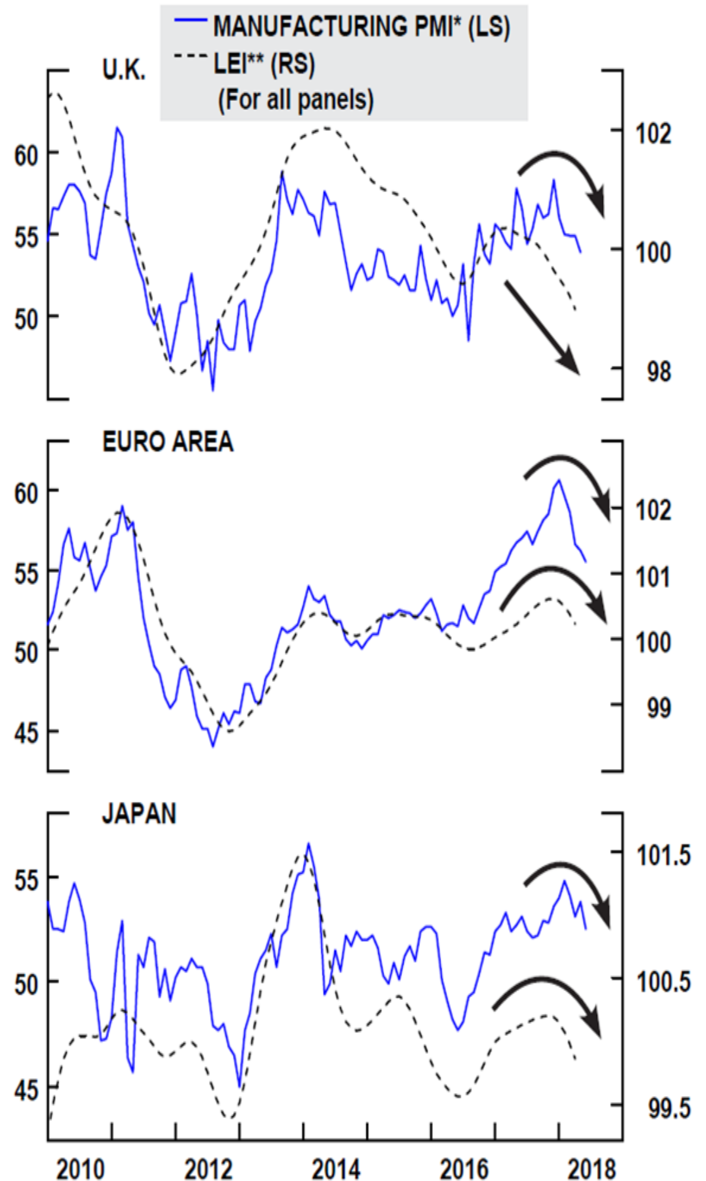
While in the long run I agree with Trump reworking our trade deals, in the short run this is definitely a negative.

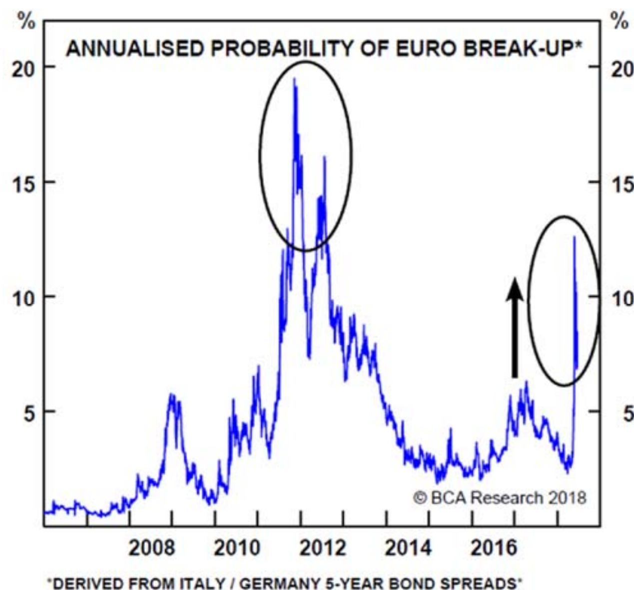
Global Pressures

Outside of the U.S., pretty much every other major economic region has turned down. To the right you see the Purchasing Manufacturing Index (PMI) for the UK, Euro Area and Japan. All have rolled over.

In addition the Leading Indicators of these areas are all pointed down.







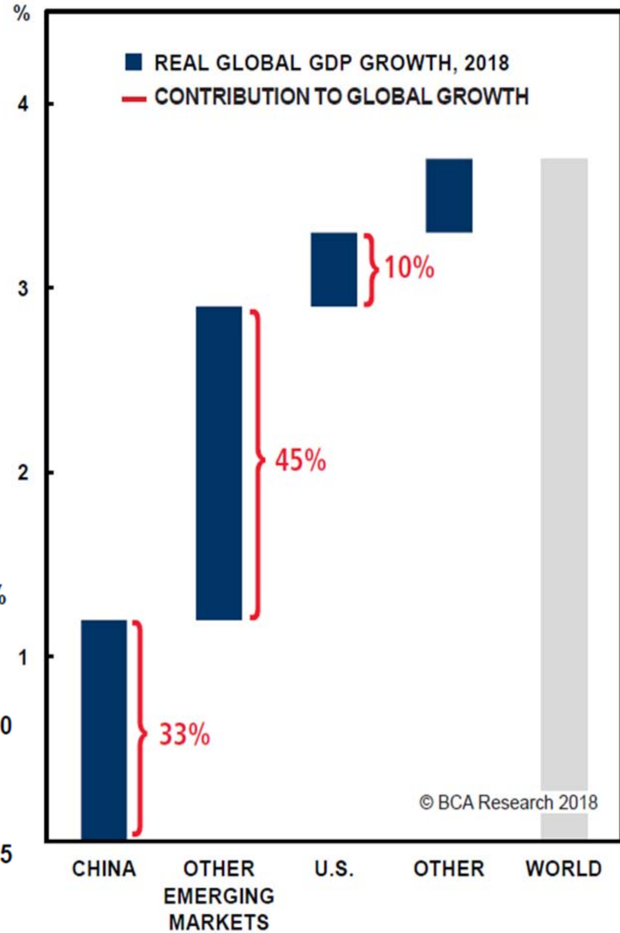
Great Britain faces potentially serious ramifications from Brexit in March 2019, which undoubtedly creates a lot turmoil. Also, the threat of a Euro break up is again rising, most recently due to Italy's problems.

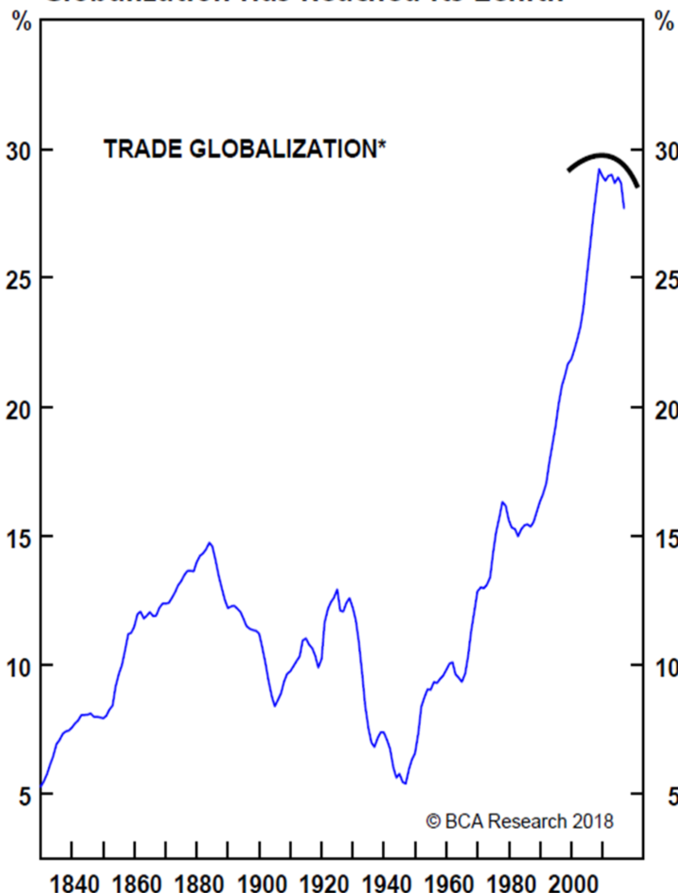
China Makes The World Go Round

But the biggest potential negative upon the global economy revolves around the trade war with China.

As you can see from the enclosed chart, China actually contributes way more in terms of economic growth to the world than the U.S. does.

America is undoubtedly the largest and strongest economy in the world, with far and away the best developed financial systems, but China is the ***growth*** engine of the world, contributing 33% of the world's economic growth by itself, with another 45% due to other emerging economies. ***Only 10% of global growth comes from the U.S.***





Thus, any trade war with China will have not only an outsized impact upon its economy, but a gigantic ripple effect upon other emerging economies, many of which trade with China.

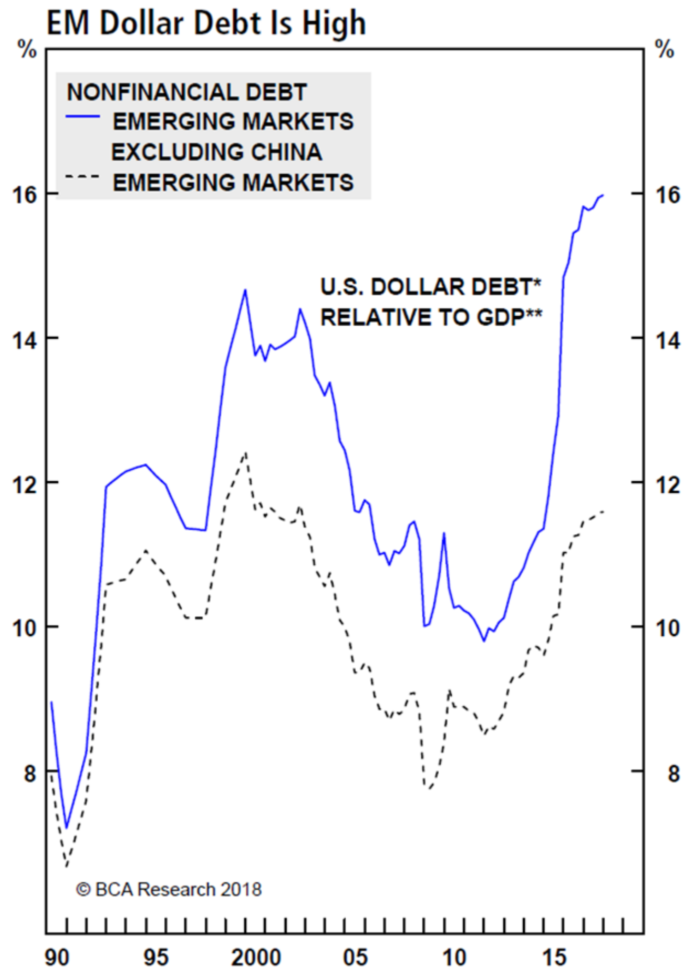
In all, globalization appears to have hit its peak, with likely implications that countries have become more protectionist, that is, more focused upon their own industries and companies versus international trade.

Populist sentiment has shifted voter perception and government's policy initiatives across the globe.

Danger Ahead

To the right you see one of the world's likely trouble spots.

Emerging markets economies, which we have just seen amount to 78% of the world economic growth (33% for China + 45% other Emerging Economies) have borrowed heavily over the last decade, to the point where they have now superseded debt levels last seen in the 1990's during the Asian Financial Crisis.



Most emerging economies (Indonesia, India, Turkey, etc.) have very small and/or immature financial systems. Thus if a corporation in India or Malaysia needed to borrow money to expand, a high percentage of the time the loans will be ***denominated in U.S. dollars.*** (Globally investors use the U.S. dollar as the primary means of exchange.)

So if you are an Asian businessman, for example, who takes out a loan denominated in dollars, and the dollar rises in value versus your country's currency, your loan principal literally rises – the loan value actually becomes ***larger***.

In addition, with the U.S. Fed raising interest rates, not only does the principal of your loan increase as the dollar rises, but the interest rate rises as well. Couple these twin problems with oil prices rising (which hurts non-oil exporting countries), and you have a very large squeeze starting in emerging economies, which are now producing the vast majority of the world's growth but are also heavily in debt. A slowdown, recession or crisis looks to be on the way for emerging economies, which have borrowed too much money.

Summary

All in all, the U.S. second longest economic expansion looks to be in jeopardy sometime in 2019 or 2020. All expansions eventually come to an end, typically because the Federal Reserve raises interest rates too high for too long, and eventually the ship hits the dock.

Ever see those safety films where the car is driving 60 MPH and then hits a concrete block? The car's momentum stops immediately, and the crash dummies get banged up. Remember liquidity trumps economic momentum.

Couple U.S. issues with instability overseas and I think you have all the classic signs of an impending top for the economic expansion, followed by recession, likely coupled with a major bear market for stocks.

While I see great positives developing from trade renegotiations (I hope eventually), the deregulation campaign and tax law changes, none of these revokes the business cycle. Business cycles expand and contract seasonally just like the weather. Summer doesn't last forever (although in Texas it sometimes feels like it). The economy is cyclical, and this cycle is already near the longest in history.

But remember business cycles don't just die of old age, they typically are "assassinated" if you will by the Fed. While the Fed is raising rates slowly – the cumulative impact of rising rates plus selling off large portions of their balance sheets (QT), I believe will bite big in 2019.

In the upcoming Part II we will look more at the markets, but for now remember two things:

#1 Don't Fight the Fed - The Fed is tightening liquidity and raising interest rates.

#2 The Trend is Your Friend. The stock market's trend has been sideways since January (except NASDAQ and small cap stocks). This increasingly looks like a sideways transition pattern, as the market appears to be ***transitioning*** from bull to bear.

Any way you slice it 2019-2020 could be filled with turmoil and pain.

Remember no expansion lasts forever – all bull markets are followed by bears.

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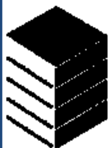

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