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2019 Mid-Year

Economic Review and Outlook

In the second quarter, only two sectors of the economy contributed positive growth, and deteriorating trends suggest our "Good but not great" growth outlook for the economy will come under pressure in coming quarters. Slowing growth is one reason the Federal Reserve has shifted toward easier monetary policy, but importantly, U.S. central bankers are also responding more reasonably to slowing global macroeconomic conditions and persistently low inflation. With the Fed actively easing, our baseline forecast does not include an imminent recession, but the call is increasingly difficult to make as slower growth produces a fragile economy more susceptible to shocks.

2019 Mid-Year Review

In the second quarter, the economy expanded at an above-consensus annualized real rate of 2.1%, predictably slowing from the unsustainable pace of 3.1% Q1. Consumption (+4.3%) and government spending (+5.0%) were above expectations but were the only two components that contributed to positive growth in Q2. All other components, including Residential Investment, Net Exports, Business Investment, and Inventories dragged on economic output.

Importantly, the Q2 GDP report included revisions to economic data going back over the last five years, resulting in a markdown of Q4 2018 growth by a full percentage point to only 1.1%. In hindsight, the economy was slowing faster than thought at the end of 2018 when the Federal Reserve was hiking interest rates (the Fed raised rates on December 18th) and still forecasting continued monetary policy tightening throughout 2019.

Against this backdrop, in the first half of this year, the Fed made one of the fastest and most dramatic monetary policy changes in Federal Reserve history:

- January - Just weeks after the Fed raised interest rates and signaled it would raise rates three times in 2019, Fed Chair Powell said the Fed could be "patient."
- March - The Fed's interest rate forecast (aka, the "dot plot") confirmed Powell's message that the Fed was on hold.
- June - The Fed went a step further and signaled they would begin easing monetary policy with rate cuts.
- July - The Fed cut interest rates by 0.25%.
- August - The Fed ended Quantitative Tightening ("QT") two months early by reinvesting interest and proceeds from maturing bonds to maintain the size of their balance sheet at about $3.8 trillion. Based on the Fed's internal estimate, shrinking the balance sheet from $4.5 trillion equated to nearly a full percentage point of annualized tightening. Ending QT will remove the effects this liquidity drain had on the U.S. and global economies during the last nineteen months.

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However, in a world awash in debt ($15 trillion of which has a negative yield), the ultimate impact of these actions is unknown. Since the Bank of Japan, the European Central Bank, and the Federal Reserve simultaneously embraced Quantitative Easing following the Financial Crisis, central bankers have been operating in uncharted territory. Historical correlations between monetary policy stimulus and economic activity are stretched, and the law of diminishing returns has asserted itself as each dollar of stimulus is generating less growth.

Nevertheless, Chairman Powell explained the first rate cut in more than ten years as a "mid-cycle course correction," channeling the mid-1990's Federal Reserve's monetary policy actions. In the mid-1990s Fed Chair Alan Greenspan earned his nickname "The Maestro" for quickly (by central bank standards) tacking from rate hikes to rate cuts that allowed the economy to reaccelerate and prolonged the expansion through the turn of the millennium.

The question is not whether one rate cut is enough – it almost assuredly is not. The more relevant question is whether the Fed acted quickly enough to avoid a recession considering, what Morgan Stanley has coined, "slowbalization": low and negative interest rates globally, a slowing global economy, persistently low inflation, and a trade war with China that has, to this point, shown no signs of convincing progress.

In reviewing the economic data from the first half of the year, we conclude that activity levels are generally consistent with our "Good but not great" growth theme of the economy expanding at 2.0%. However, deteriorating data trends suggest increasing downside risks, which the Fed surely recognized in deciding to shift to a more accommodative monetary policy.

In the pages that follow, we review recent economic data and offer our outlook on key sectors of the economy:

- Labor Market
- Consumer Spending & Confidence
- Inflation
- Manufacturing
- Construction & Housing

LABOR MARKET

The current market for labor is about as strong as they come, yet there are some early indications of trend deterioration. The good news is that over the last twelve months, businesses added 2.2 million jobs, keeping the headline (U-3) unemployment rate in July near cycle lows of 3.7%. Moreover, the broader U-6 measure of unemployment (which includes discouraged workers and part-timers who want full-time work) continued to grind lower, reaching 7.0% in July – a level last seen in 2000. With higher overall employment (or lower unemployment, if you prefer), there are fewer available workers, and small business surveys indicate difficulty in finding qualified labor.

In light of the labor scarcity, business owners and managers are increasing compensation to attract and retain talent. Wage growth has not reached a level that will stimulate pronounced inflation, but after failing to break above 2.5% since the Financial Crisis convincingly, it's good to see the American worker getting a raise.

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Annual Nominal Hourly Wage Growth

Sources: Bureau of Economic Analysis, Foleynomics, and Covenant Investment Research.

Moreover, inflation-adjusted aggregate wages are the highest in five years, expanding more than 3.8% on a year-over-year basis. Inflation-adjusted (or "real") aggregate wages are influential to consumption levels because the calculation includes hourly wages paid, hours worked in the week, and total workers. In other words, it is the total inflation-adjusted income earned by the U.S. labor force and therefore has a direct relationship with consumer spending.

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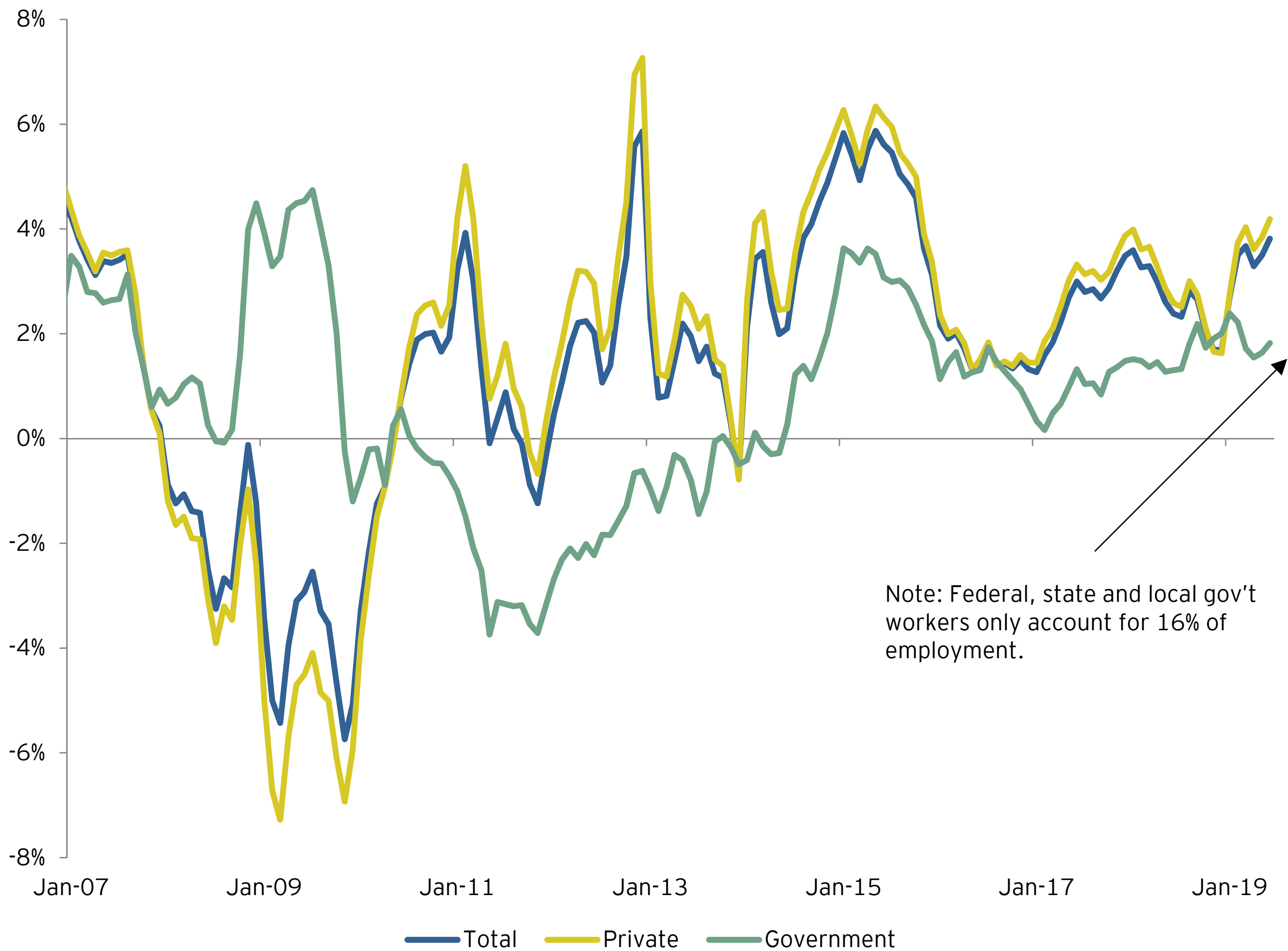
Annual Real Aggregate Wage & Salary Growth



Sources: Bureau of Economic Analysis, Foleynomics, and Covenant Investment Research.

Lower unemployment and higher wages sound good, what's the rub? The rub is not the current levels of employment or wages, but rather that several employment-related data series are plateauing or rolling over:

- Non-Farm Monthly Payrolls: The monthly payroll number is inherently volatile, but the six-month moving average peaked at 233,000 in late 2018. The current level is 141,000 and likely heading lower.
- Labor Force: The year-over-year growth rate of the labor force has slowed to approximately 0.7%. Slowing labor force growth implies fewer available workers in the future, which translates into lower economic output absent an increase in productivity.
- The July labor report showed a steep decline in aggregate hours worked, a sub-component of aggregate wages discussed above. Aggregate hours worked is like GDP for the labor force, and the last time it slowed to this level was in 2016 when the broader economy expanded at a tepid 2% rate. Reduced hours can be a precursor to higher unemployment and lower personal income.
- ISM Surveys: The ISM Non-Manufacturing Employment Index peaked in September 2018. While it's understandable that the ISM Manufacturing Employment Index is weak given the headwinds U.S. manufacturers are facing, a deterioration of Services Sector employment is more concerning. Services

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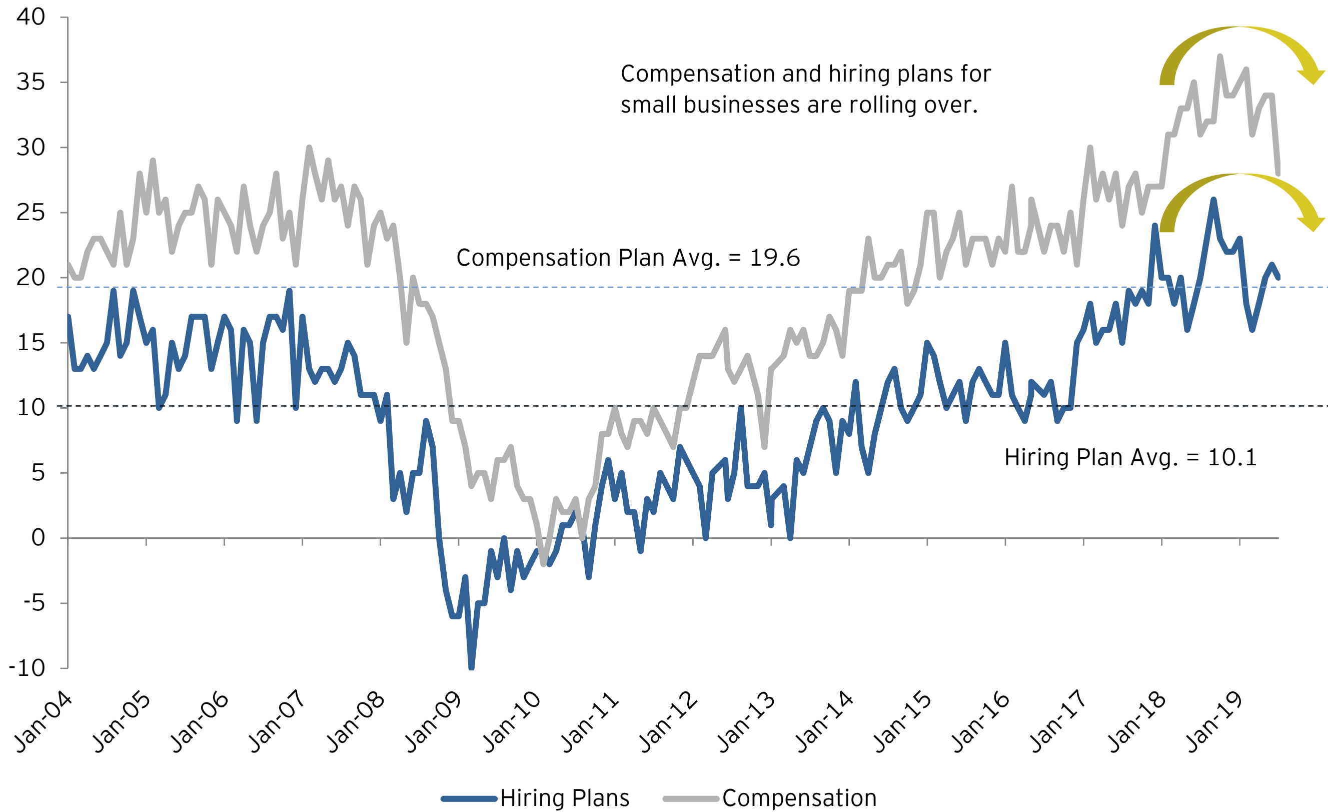
comprise the majority of total employment, and an extended downturn would have a decidedly negative impact on the labor market.

- Small Business Survey: The survey of small business owners' plans for hiring and compensation peaked in late 2018. Whereas large companies can afford to maintain relatively stable labor forces, small businesses are more susceptible to changes in the economy. Hence, small business hiring often serves as a harbinger of future hiring trends.



Sources: National Federation of Independent Business, Foleynomics, and Covenant Investment Research.

Outlook: Ten years into the economic expansion, decelerating labor market strength is to be expected. One reason is that people with skills are already employed, making qualified applicants a scarce commodity. Moreover, the labor force is expanding slowly due to structural issues, including retiring Baby Boomers, restrictive immigration policies, lower birth rates, and a social safety net that sometimes disincentivizes people from finding work. Slower labor force growth also provides fewer workers to hire. All things considered, the levels of the data do not give us pause, but change happens at the margin. And at this point, there are several data trends worth watching closely to determine if the labor market is settling into a new equilibrium, or if something more pernicious is afoot.

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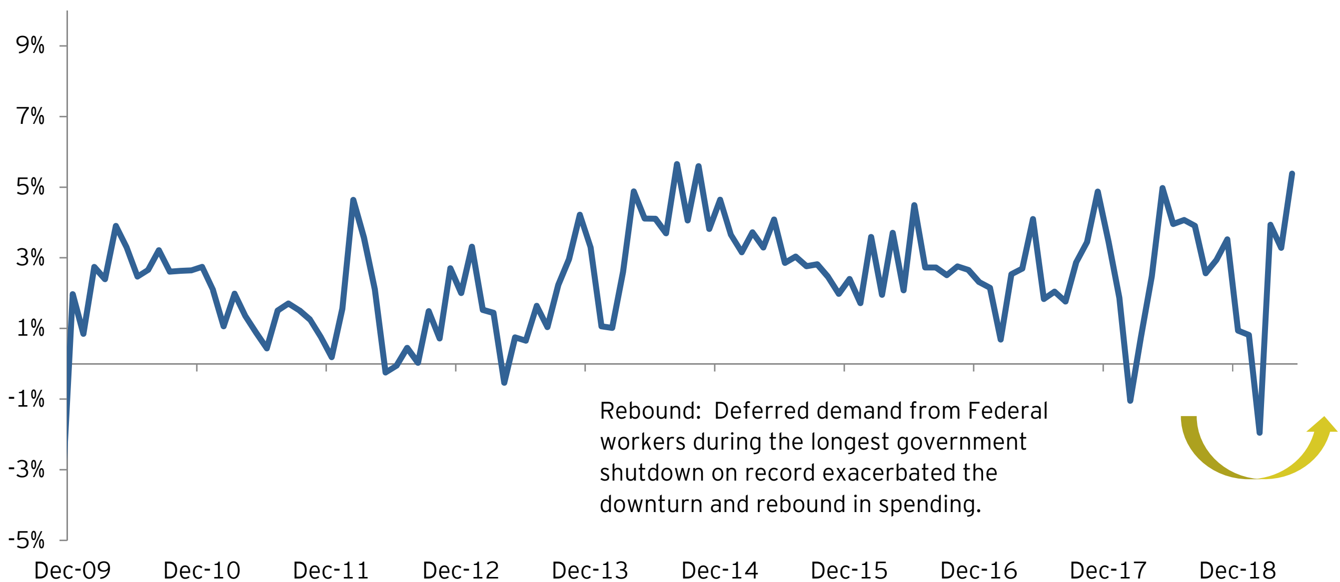
CONSUMER SPENDING & CONFIDENCE

After downright weak consumption activity in Q4 2018 and Q1 2019, spending rebounded nicely in the second quarter. The 35-day government shutdown (the longest on record) negatively impacted consumption levels before and after the turn of the year and then deferred demand from affected federal workers and contractors boosted consumption in March, April, and May. Lower inflation also contributed to the rise in Real Consumption Expenditures.



Sources: Bureau of Economic Analysis, Foleynomics, and Covenant Investment Research.

With the noise of the government shutdown falling out of the data, we expect the Real Personal Consumption Expenditures level to revert to the trend annualized growth rate of 2.5% - 3.0% in the second half of the year due to the relatively healthy status of the U.S. consumer:

- Consumer confidence - Confidence is near cycle highs. Importantly, the most recent survey showed an increase in future expectations, a segment of the confidence survey that has been lagging and a potential sign of slowing future consumption that we highlighted in our last Semi-Annual Economic Review and Outlook.
- Consumers are not overspending - Consumption growth is below personal income levels, leading to an elevated savings rate. Thus far in 2019, the savings rate (as a percent of Disposable Personal Income) has been running above 8% as compared to the long-term 7.7% average. Higher savings rates represent deferred consumption that may be realized in the future.
- Household Balance Sheets - Rising consumer debt is a well-reported topic, and while it's true that consumer debt as a percentage of Disposable Income is modestly higher than before the Financial Crisis, the picture (as shown in the chart on the next page) is very different when excluding student debt. Although student debt is real debt, more than 50% of the $1.6 Trillion in student debt is in non-payment status (e.g., in-school deferrals, forbearance, or forgiven status). Hence, the impact on consumption patterns is lower than would otherwise be indicated.

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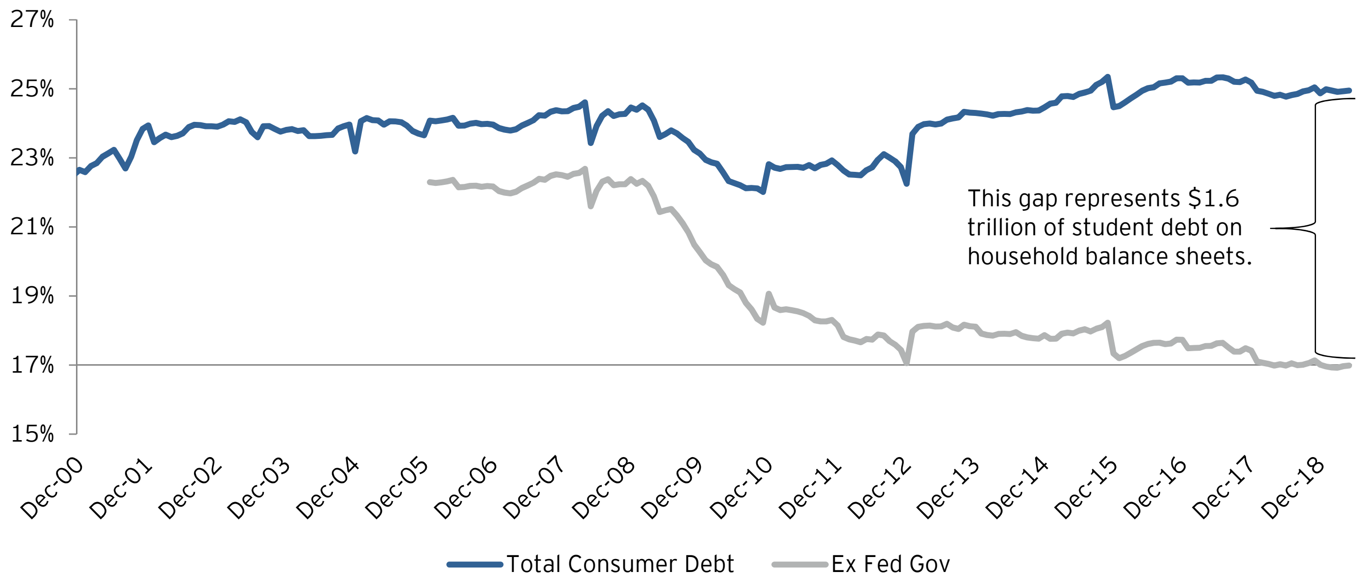
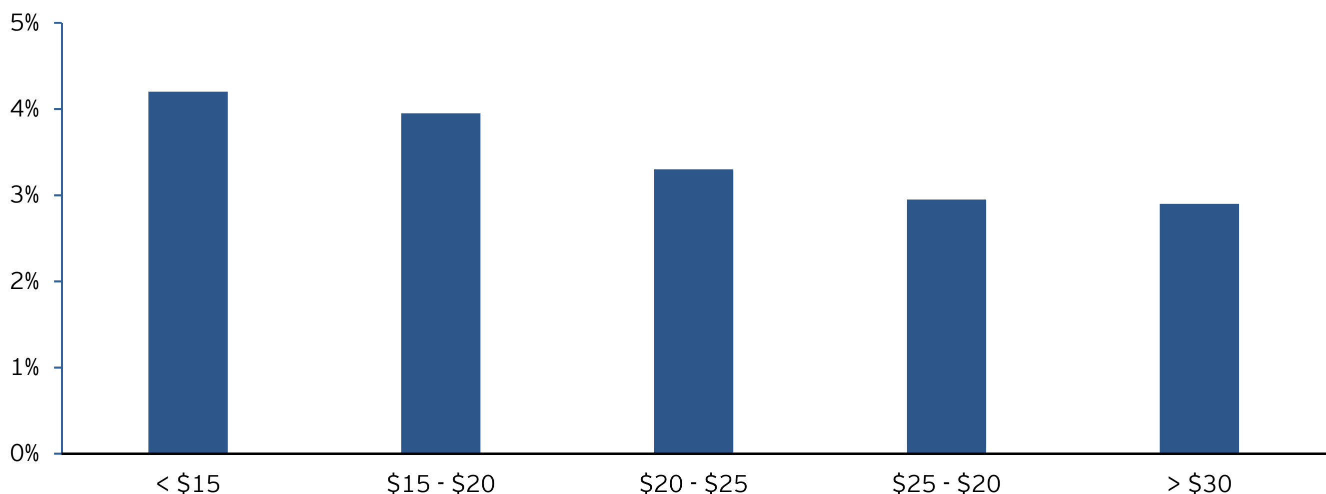
Consumer Debt / Personal Disposable Income



Sources: Bureau of Economic Analysis, Foleynomics, and Covenant Investment Research.

- Low unemployment combined with rising wages - As mentioned in the previous section, wages are rising. Importantly, wage growth has increased at the lower end of the compensation spectrum (see chart below). Laborers at lower pay scales tend to spend the majority of their income, so increased compensation for these workers generally ties directly to increased consumption.

U.S. Average Hourly Earnings Growth by Income Group



Sources: BCA Research.

Outlook: Representing nearly 70% of U.S. GDP, growth in consumption levels is critical to keeping the economic expansion on track. Assuming confidence is not knocked off course by the rhetoric surrounding international trade or political vitriol, the consumer is positioned to keep the economy on its "Good, but not great" growth trajectory.

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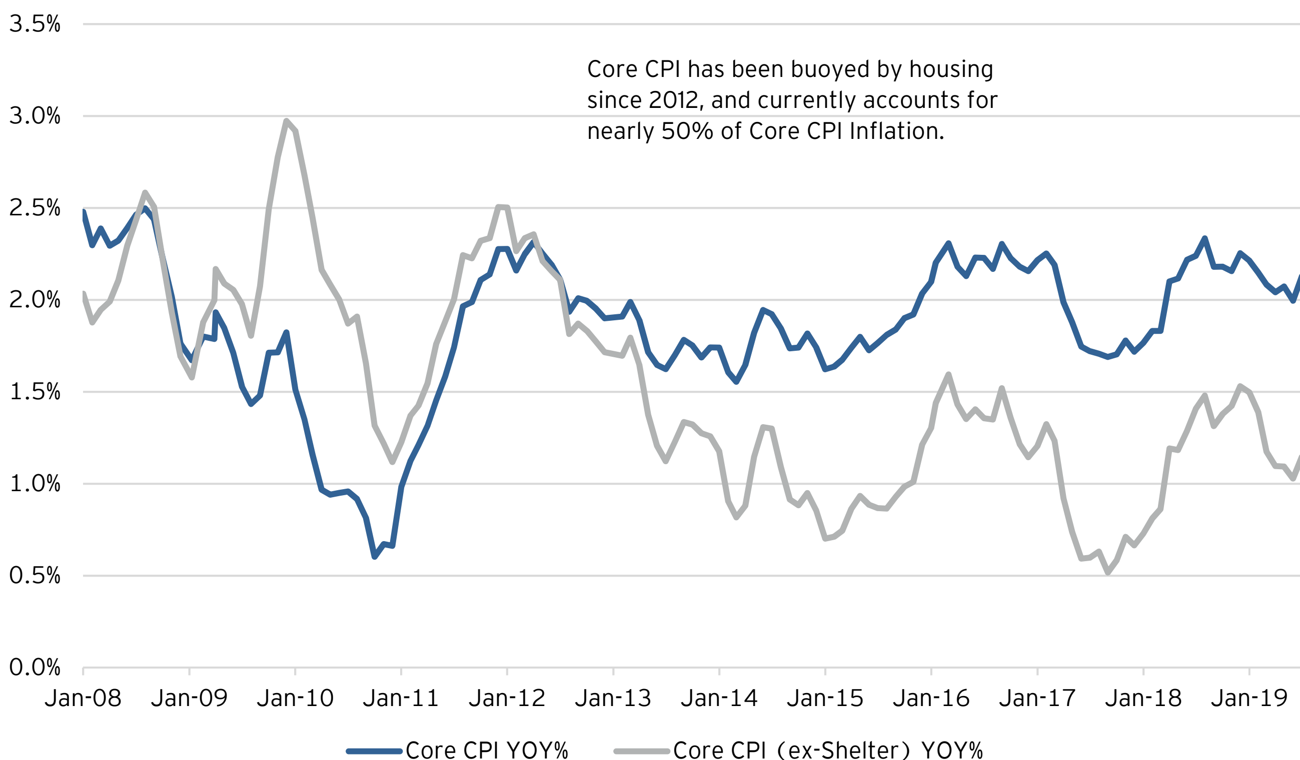
INFLATION

"Waiting for Godot" is the comment most frequently mentioned around Covenant's Investment Committee when discussing inflation. Back in 2018, we began to see inflation data firming in the economy, but a series of interest rate hikes from the Fed squelched progress. Even though the Fed's last interest rate hike was in December, inflation has continued to decline, highlighting the lagged effect of monetary policy on the economy. Indeed, since the start of 2019, the Fed's favored measure of inflation the Core Personal Consumption Expenditure Price Index ("Core CPE") declined from 1.95% to 1.60%.

The Core Consumer Price Index ("Core CPI"), a more commonly quoted measure of inflation, has been running slightly above the Core CPE, but the reason is primarily related to the higher weight assigned to housing costs in Core CPI. As detailed in the chart below, housing has accounted for a significant portion of inflation since early 2015.



Sources: Bureau of Labor Statistics, Foleynomics, and Covenant Investment Research.

Moreover, inflation does not appear to be in the offing any time soon. Further up the value chain, Producer Price Index ("PPI") inflation began trending higher in early 2016, but the trend reversed at the beginning of this year. Indeed, the Goods component of Core PPI is nearly in a state of deflation, and it's only the firmness in Services inflation that is stabilizing Core PPI. But, here too, the trend inflected and reversed lower earlier this year.

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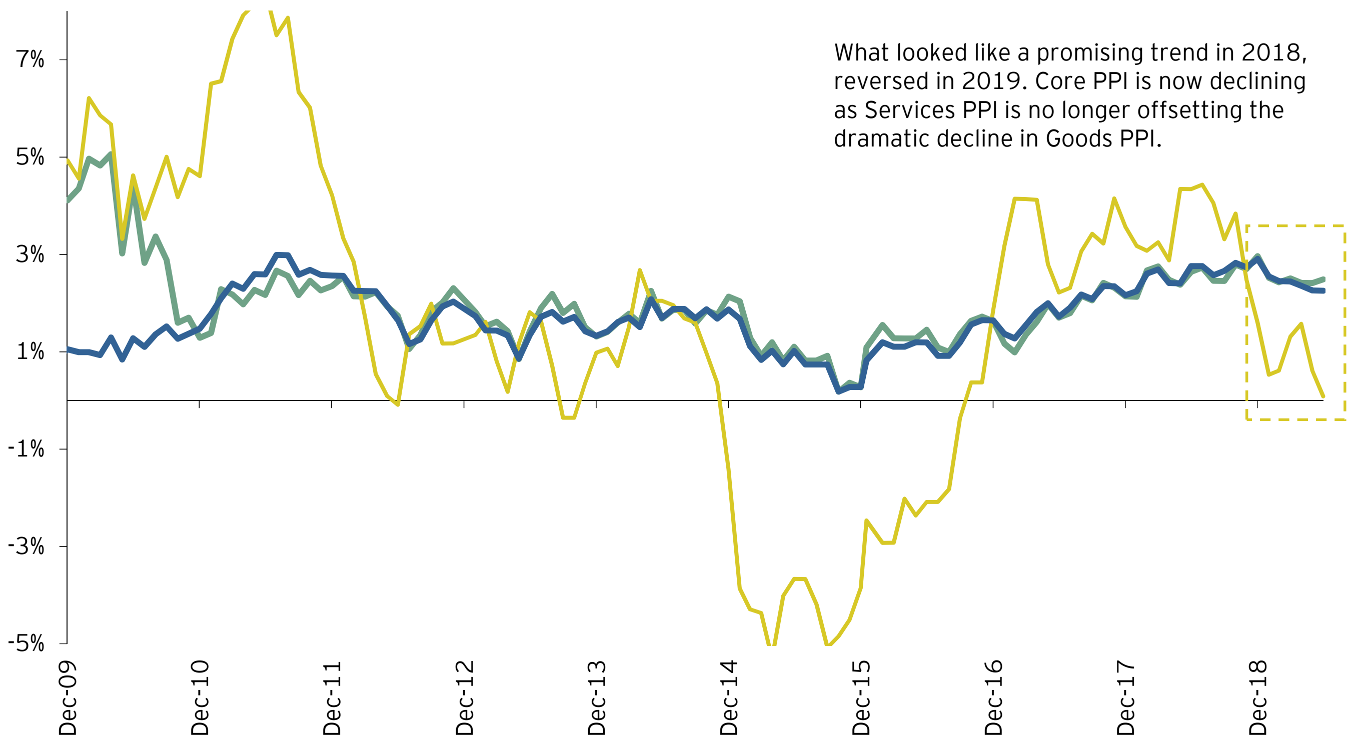
Core PPI (Blue) – Services PPI (Green) – Goods PPI (Yellow)



Sources: Bureau of Economic Analysis, Foleynomics, and Covenant Investment Research.

Outlook: Dating back to the previous Chair Janet Yellen, the Federal Reserve's narrative has been that "transitory factors" have prevented inflation from reaching their 2% target. Based on minutes from the Fed's meeting in June, that is no longer the case, which makes sense because is it really plausible that "transitory" factors can hold inflation below target for ten years?

Even before dropping the "transitory" language, the Fed had been exploring alternative explanations for persistently low inflation and how to best address the problem. Although the Federal Reserve has long held an inflation target of 2%, the Fed's monetary policy decisions since the Financial Crisis have been more consistent with treating 2% as a ceiling – a threshold they do not want to exceed. That approach is currently being questioned within the Federal Reserve, and they are discussing an alternative methodology that seeks to average 2% inflation over time. Under this new strategy, following prolonged periods of low inflation, the Fed will allow inflation to run over 2% to bring the longer-term average into line with the 2% target. Whether they adopt the new philosophy or not, the rate cut in July was a step in the right direction to offset the mistaken hike in December.

MANUFACTURING

The Manufacturing sector is, in a word, weak. Buffeted by the "Big 3" headwinds, the industry is on the verge of, or already, contracting. The "Big 3" headwinds are:

1. Strong U.S. Dollar – The U.S. Dollar has strengthened considerably since 2014, and the Fed's trade-weighted-dollar index is up approximately 3.9% year-to-date. A strong U.S. Dollar, while benefitting the broader economy, makes domestic manufacturers less competitive globally.

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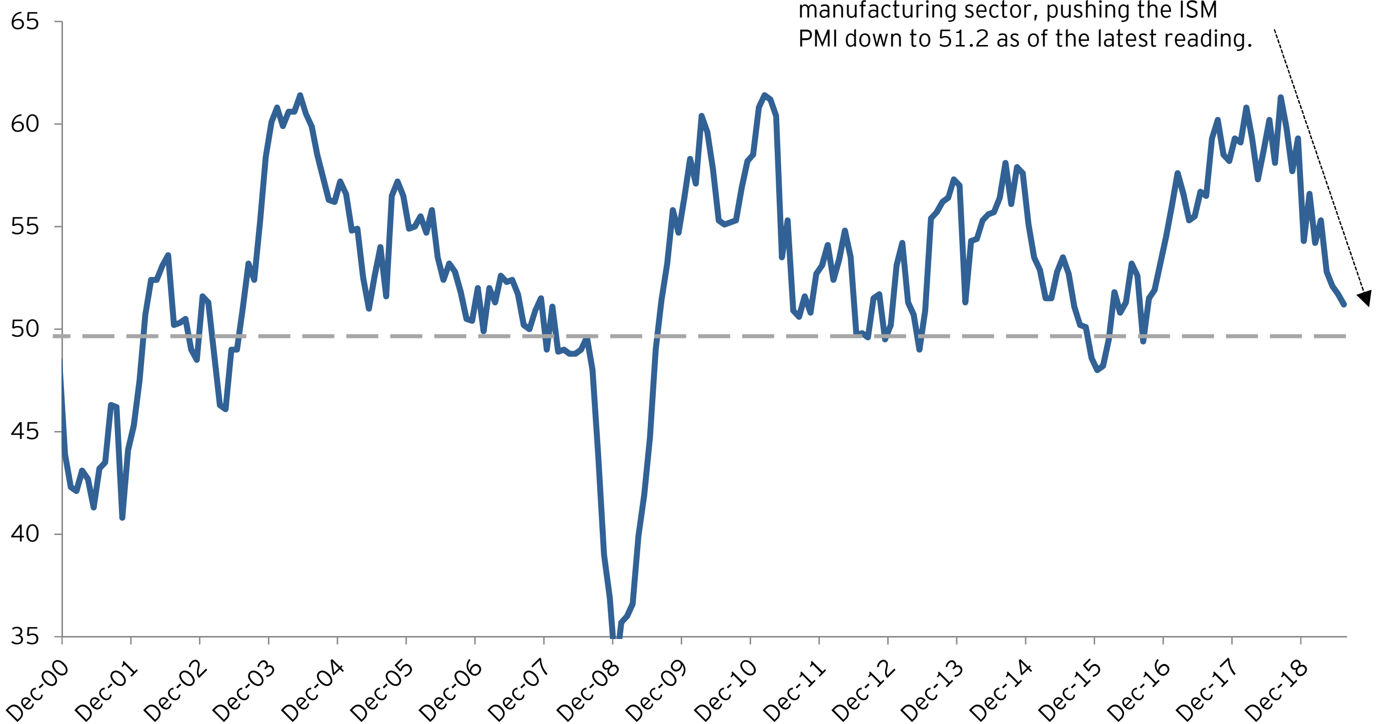
2. Slowing Global Growth – According to data from The World Bank, Global GDP growth slowed from 4.3% in 2010 to 3.0% in 2018, shrinking the opportunity set for manufacturers worldwide.
3. Nationalistic Trade Policies – In addition to the escalating trade war between China and the U.S., domestic manufacturers are facing other protectionist trade problems. For example, in June, India placed tariffs on 28 U.S. goods, including chemical products, and the European Union imposed import duties of 25% on $2.8 billion of imports, such as Harley-Davidson motorcycles, steel, and aluminum.

The Big 3 are causing widespread weakness in the sector, including:

- Core Capital Expenditure Orders (excluding defense and airlines) are ~flat year-over-year.
- Intermodal rail traffic is down ≈5% year-to-date. Intermodal rail traffic is the movement of goods shipped in containers involving multiple types of transportation (e.g., ships, trucks, and railroads), which is a common form of transportation for manufactured products.
- The closely-watched ISM Manufacturing Purchasing Manufacturers Index is in a significant downward trend, declining from 60.8 in August 2018 to only 51.2 as of July 2019. A reading below 50 implies a contraction.



Sources: Institute for Supply Management, Foleynomics, and Covenant Investment Research.

Outlook: There are few bright spots in the manufacturing sector, but auto sales (up ≈2% year-over-year) and factory shipments (up ≈4% year-over-year) are two of them. Yet, the outlook for the manufacturing sector is worrisome. If any of the Big 3 headwinds were to relent, the current malaise of the manufacturing sector could improve and recover just as it did in the 2015/2016 downturn. However, at this time, the manufacturing sector is vulnerable to a contraction.

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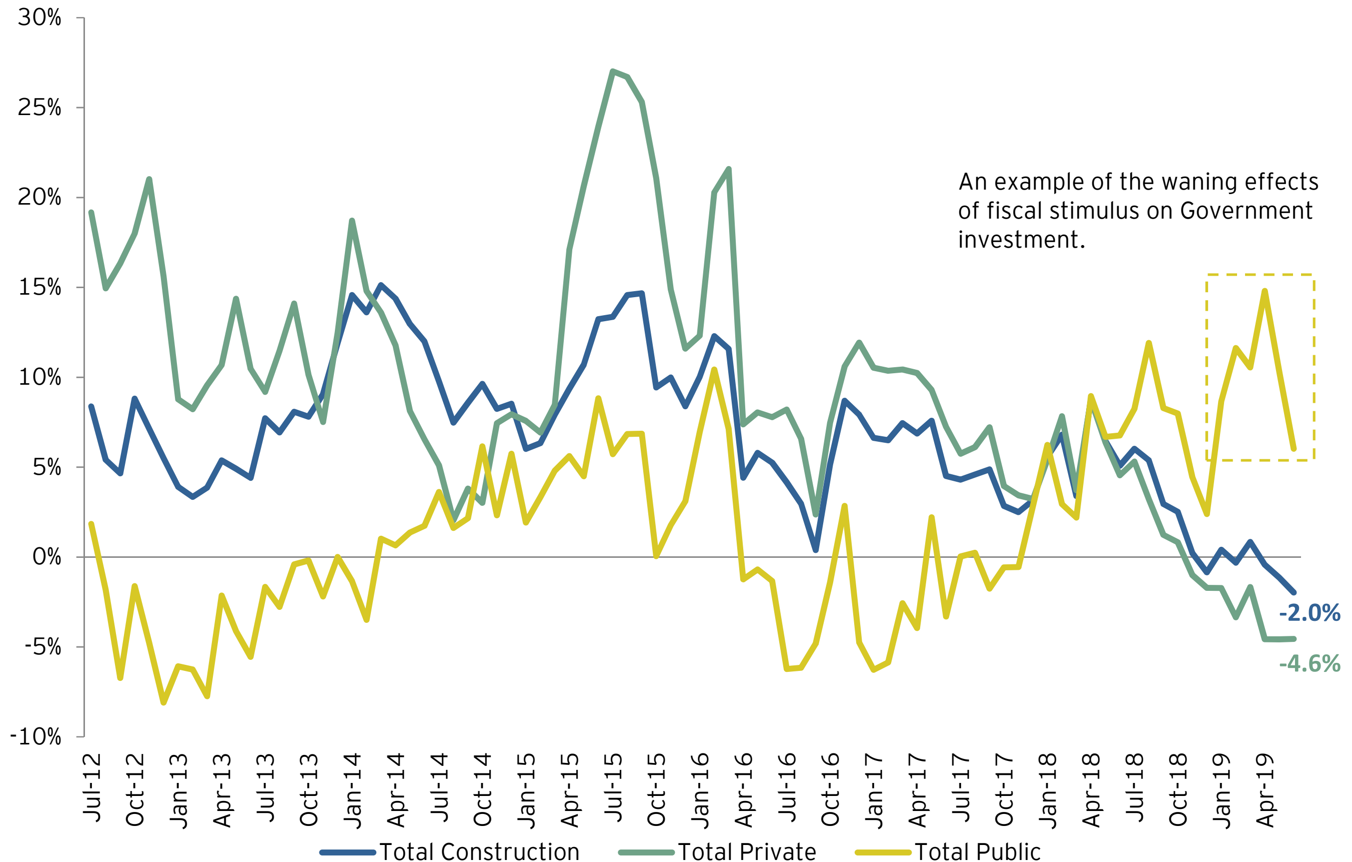
CONSTRUCTION & HOUSING

Unfortunately, the troubling trends in construction we highlighted in the Q1 Economic Review and Outlook remain intact. Total construction, which was treading water at the end of 2018, deteriorated further in the first half of 2019 and fell 2% year-over-year. A continued slide in Private construction spending (-4.6%) and the throttling back of fiscal-stimulus-fueled government investment tell the tale. Negative growth in total construction was last seen following the Financial Crisis and, before that, after the Dot-com bust.

Nominal Year-Over-Year Construction Spending



Sources: Census Bureau, Foleynomics, and Covenant Investment Research.

Residential investment is also in the doldrums, recording its sixth consecutive quarter of negative growth. Through June, new single-family home sales rose just 2% year-over-year, and existing home sales decreased by approximately 4%. Rising mortgage applications aided by lower rates may offer some eventual support.

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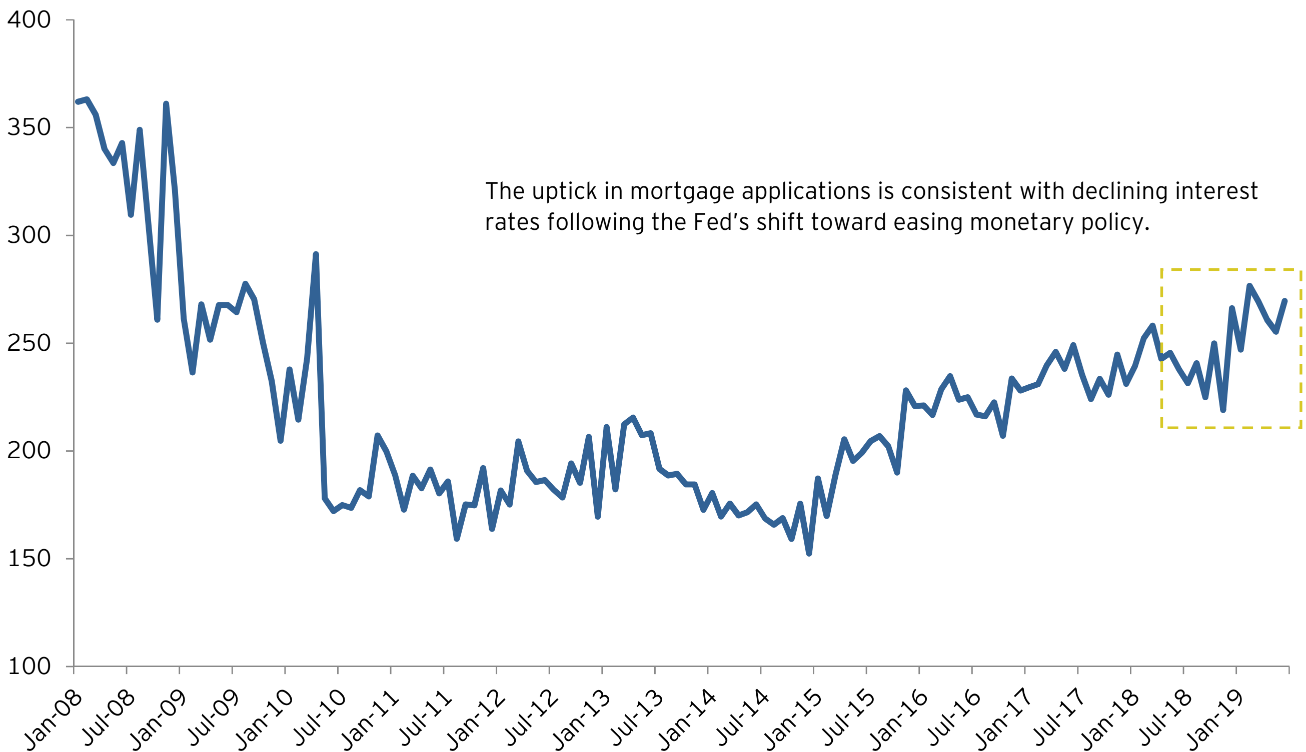

Sources: Mortgage Bankers Purchase Application Index, Foleynomics, and Covenant Investment Research.

Outlook: The waning effects of fiscal stimulus will continue to drag on construction growth, and unlike other sectors of the economy, both the current level of activity and spending trends are negative. In housing, however, overall levels are OK, but many of the trends bear watching. The shift by the Fed toward easing monetary policy combined with moderating home prices and wage growth, provide some reasons for optimism that the housing sector is stabilizing and will emerge from its growth contraction later in 2019.

Conclusion

The data irrefutably shows economic growth is slowing. But again, this is not a surprise, as tax cuts, pre-tariff inventory stocking, and fiscal stimulus boosted 2018 economic growth to an unsustainable level. As the effects of those stimulants wane, economic activity will naturally slow to the potential output of the economy, which after ten years of expansion, the Congressional Budget Office currently estimates to be about 2%. That is also our baseline forecast.

Downside scenarios include even slower growth as, while insulated, the U.S. economy is not immune to the gravitational pull of the slowing global economy. Additionally, trade uncertainty has the potential to erode business and consumer confidence, disrupting potential investment and spending, which are critical inputs to economic growth.

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Recognizing these risks, the Federal Reserve performed a rare 180-degree turn in the first half of the year, joining the European Central Bank and Bank of Japan in attempting to stimulate the economy via monetary policy. The Fed's actions to cut interest rates and halt Quantitative Tightening have global implications:

- Cutting interest rates provides cover to countries overseas, otherwise concerned about capital flight, to cut interest rates to stimulate their economies.
- Reinvesting maturing bonds on their balance sheet relieves the pressure on the U.S. Dollar supply, improving global liquidity.

Both of these actions are stimulative domestically and globally.

Now that the Federal Reserve is responding more sensibly to slowing global macroeconomic conditions and persistently low inflation, the odds are that the current slowdown is reminiscent of 2015. In that year, the economy slowed from 3.2% in the first quarter to only 0.1% in Q4, before bouncing back to the 2% post-Financial Crisis growth trend the following year. Our forecast is not that the economy will precisely follow that path, but instead that we are reverting to trend growth that will overshoot and undershoot from time to time but gravitate toward 2%.

In sum, overall levels of activity support continued "Good but not great" growth of around 2%, but there are worrisome trends implying downside risks to this forecast have increased.

- The Covenant Investment Team

Disclosures

The principal sources used in the preparation of this Report include: Bloomberg L.P., Foleynomics, Congressional Budgetary Office, Wells Fargo Securities, and Covenant Multifamily Offices, LLC ("Covenant"). Some data included in this report including government reports and other data has been taken from secondary sources and were not derived from the primary sources. Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Covenant), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Covenant. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Covenant is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the Covenant's current written disclosure statement discussing our advisory services and fees is available upon request. If you are an Covenant client, please remember to contact Covenant, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services.

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