2020 Q1

Economic Review and Outlook

The economy grew at an estimated 2.1% real, annualized rate in the fourth quarter, and 2.3% for all of 2019. Consumption, the workhorse of the economy, rose at a mediocre 1.8% pace and housing continued to recover improving by 5.8%. Business investment (-1.5%) and shrinking inventory levels (-1.1%) detracted from growth. Foreign trade added 1.5%, but that "growth" was flattered by an 8.7% decline in imports underscoring weak consumer spending in the quarter. On balance, economic growth was relatively stable in 2019, but consumer demand is showing signs of weakness and continued deterioration in spending would put the longest expansion in U.S. history in jeopardy.

Policy Puzzle

Last year could have been very different if not for an uncharacteristic mid-course change in the Federal Reserve's monetary policy. In 2018, tax cuts and fiscal stimulus propelled the economy to a 3.2% average growth rate over the first three quarters. The Fed's natural reaction to accelerating growth is to raise interest rates to ward off inflation. The Fed had additional impetus to raise rates in an effort to move further away from the zero-boundary line where interest rates were pinned for seven years following the Financial Crisis. Fed Chairman Jerome "Jay" Powell and his committee followed decades of monetary policy orthodoxy and raised interest rates once per quarter throughout the year. As late as December 2018, the Fed's plan called for increasing rates an additional three times in 2019.

Financial markets rendered their opinion on the Fed's outlook swiftly as equity prices and bond yields plummeted in the fourth quarter of 2018, signaling monetary policy was too tight. Key economic data began to wane towards the end of the year as well. Recognizing the error in their ways, Chairman Powell and the Federal Open Market Committee showed uncharacteristic humility. Within a few weeks of signaling a path to higher rates, the Fed pivoted to a "patient" stance. Later in 2019, the Fed would cut interest rates three times as market indicators (i.e., an inverted yield curve) and fundamental data (slowing economic growth) confirmed that the Fed's focus on inflation risked tipping the economy into recession. While we would have liked to see the Fed cut interest rates faster, or by another 0.25% last year, the Fed's actions forestalled a late-2019 or early-2020 recession.

That's the good news. The bad news is that with today's low starting point for interest rates, the potential for negative interest rates in the next U.S. recession is no longer a theoretical consideration – the Fed Funds Target Rate is currently 1.75%, and the Fed has historically cut rates by an average of 5% in recessions. Additionally, the Fed's traditional approach to stimulating economic growth and inflation through monetary policy is ineffective. Indeed, the post-Crisis track record is clear, as the Fed's preferred measure of inflation has averaged only 1.6% (vs. a 2.0% target) since 2011. The question the Federal Reserve is facing is: what can they do differently to move interest rates higher?

We will get an answer to that question later this year. Shortly after assuming the chairman's role in 2018, Powell's Fed initiated a comprehensive monetary policy review. The Fed recognizes that the economy has changed since the Financial Crisis because economic behavior has changed. These developments threaten the relevance of the Federal Reserve at a time when the economy is in danger of following Europe and Japan into the black hole of negative interest rates. The goal of the review is to update the Fed's monetary policy to avoid the negative interest rate trap by changing the way the Fed approaches inflation.

It's encouraging that the Federal Reserve, under Powell's leadership, recognizes the risks of following policy dogma. The fact that Powell is not an economist was cited as one of his strengths when he was appointed Fed Chair. The thinking was that he would bring a more market-based perspective to the institution. His perspective may be challenged, but Powell's willingness to ignore economic tradition is rare among Fed leaders, and somewhat reminiscent of former Chair Alan Greenspan. Greenspan earned the nickname "The Maestro" for overseeing one of the longest economic expansions in history during the 1990s, which included policy decisions that contrasted with traditional economic models. Powell's Fed has a similar opportunity, but the fundamental question is, can they successfully adapt monetary policy to the blurry rules governing today's economic reality?

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

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

MANUFACTURING

We start with manufacturing, as this sector is currently the weakest part of the U.S. economy. Although manufacturing constitutes a smaller part of the economy due to growth in the services sector, manufacturing remains important because so many service-oriented businesses derive revenue from manufacturing clients. Additionally, manufacturing remains one of the highest paying sectors, thus disproportionately impacting consumption, vis a vis employment, relative to its size.

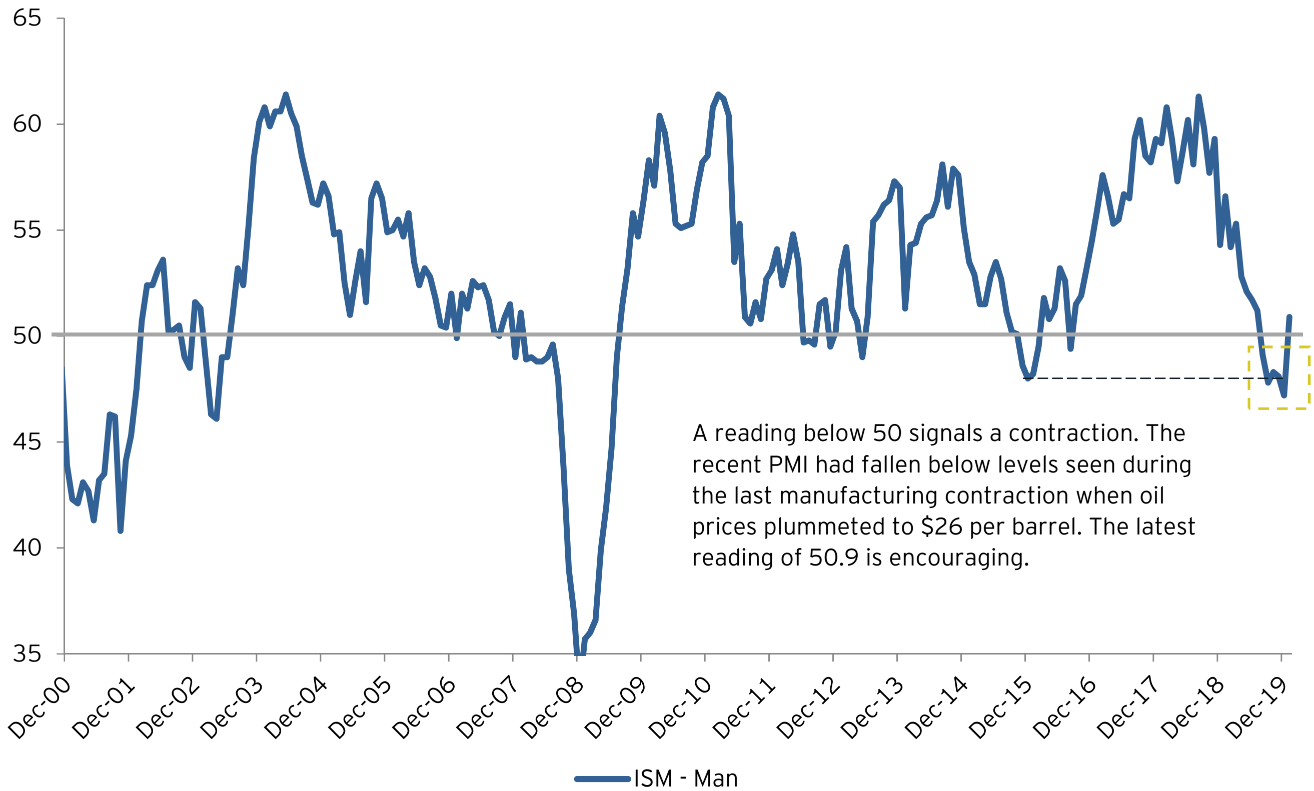
The headwinds responsible for the manufacturing malaise are readily identifiable and intuitive, a group we call "The Big 3":

1. Strong U.S. Dollar – The U.S. Dollar has strengthened considerably since 2014, A strong U.S. Dollar, while benefitting the broader economy, renders domestic manufacturers less competitive globally. The dollar weakened in the back-half of 2019 and a further decline would reverse some of the effects of this headwind.
2. Slowing Global Growth – According to data from The World Bank, Global GDP growth slowed from 4.3% in 2010 to 3.2% in 2019, shrinking the opportunity set for manufacturers worldwide.
3. Nationalistic Trade Policies – While a detente was reached early this year, 2019 was characterized by escalating tariffs and strong rhetoric between leaders in the U.S. and China. Most of those tariffs remain in effect, forcing a reorganization of supply chains and dragging on demand for manufactured goods. In addition to the escalating trade war between China and the U.S., domestic manufacturers are facing other protectionist trade problems with India and Europe.

The poster child for the manufacturing malaise is the ISM Manufacturing - Purchasing Managers Index (PMI).

The Manufacturing PMI is a survey of purchasing managers about whether market conditions are expanding, staying the same, or contracting. A PMI reading above 50 signals expansion, while a reading below 50 is an indication that market conditions are contracting.

ISM Purchasing Managers Index



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

The PMI crossed below 50 in August 2019 and as of November had fallen below the low levels seen during the 2015/2016 manufacturing contraction when oil prices fell from $106 to $26 per barrel. However, the first reading for 2020 surprised to the upside. In January the PMI rebounded to 50.9, which is significant as it is the first time in six months that purchasing managers are striking an optimistic tone suggesting the sector may be in the nascent stages of a recovery.

Outlook: Manufacturing has been in a funk but got off to a good start in 2020 as some of the conditions leading to the recent contraction are abating. On the trade front, the Phase 1 agreement between China and the U.S. suggests no new tariffs will go into effect, and the USMCA trade deal has been ratified. Also, the U.S. Dollar weakened in the back half of 2019 and has continued to do so this year, boosting the competitiveness of domestic manufacturers. It's also worth noting that global growth in 2020 could get a lift from the 2019 liquidity injections by global central banks, that is, if the coronavirus is contained in relatively short order. Data in the coming quarters will provide valuable feedback if the latest data point is the beginning of a growth trend for this important, albeit relatively small, sector.

LABOR MARKET

In contrast to manufacturing, the labor market remains a bright spot, helping support consumption levels that are carrying the economic expansion. During the second half of the year, the official (U-3) unemployment rate fell to a cycle low of only 3.5% in the fourth quarter. The U-6 unemployment rate, a broader measure that includes discouraged workers and part-timers who want full-time work, hit 6.7% – a new low since this data series began in 1994.

Although the labor market is tight, there are still people available to hire. After bottoming in 2015 at about 62%, the Labor Force Participation Rate has improved, rising to 63.2%, but remains well below the pre-Crisis levels of approximately 66%. Moreover, the 25-54 age group participation rate is 80.4% versus its 81.9% March 2000 peak.

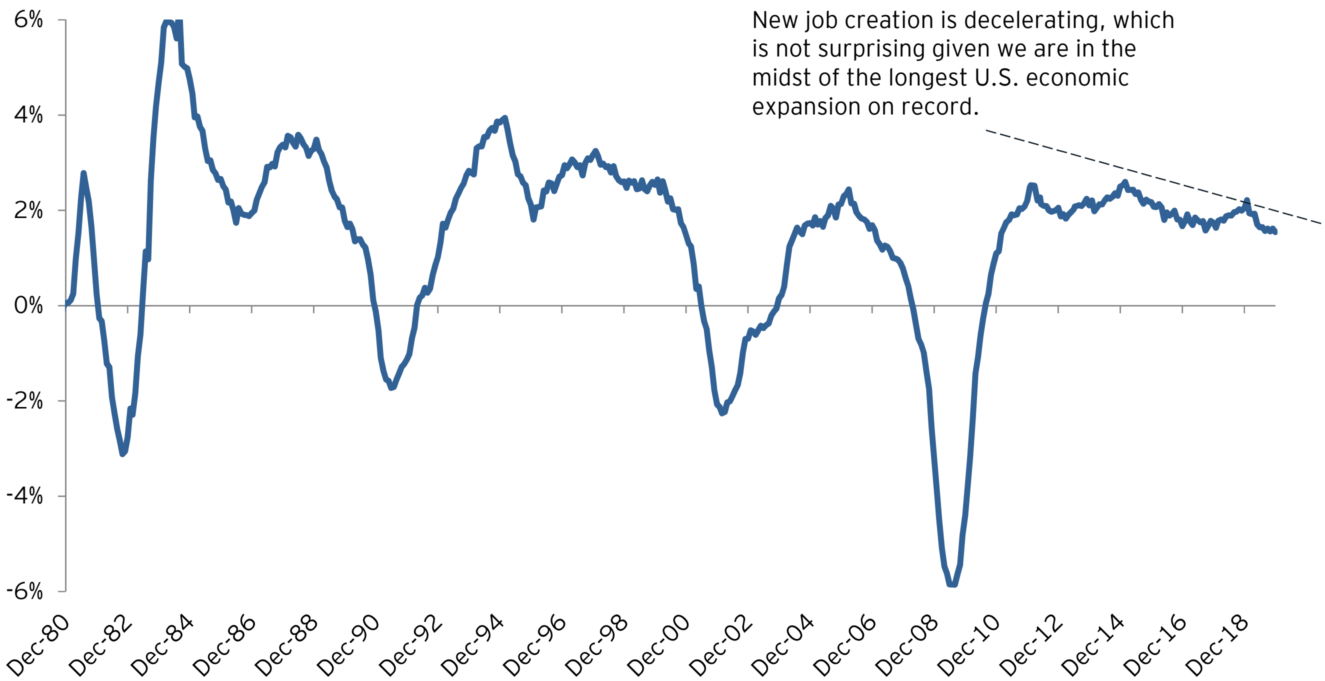
Labor Force Participation Rate

(Chart Inverted)

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

Even as the labor market remains healthy, it's safe to say that the best days of new job creation are behind us. The six-month moving average for monthly new job growth decelerated from 234,000 per month at the start of the year to 189,000 by December, pulling down the year-over-year growth from 2.0% to 1.5%. Slowing job creation ten years into an economic expansion should be expected, and the current monthly hiring rate is more than enough to push the unemployment rate even lower.

Private Non-Farm Payroll Growth
(Year-Over-Year)

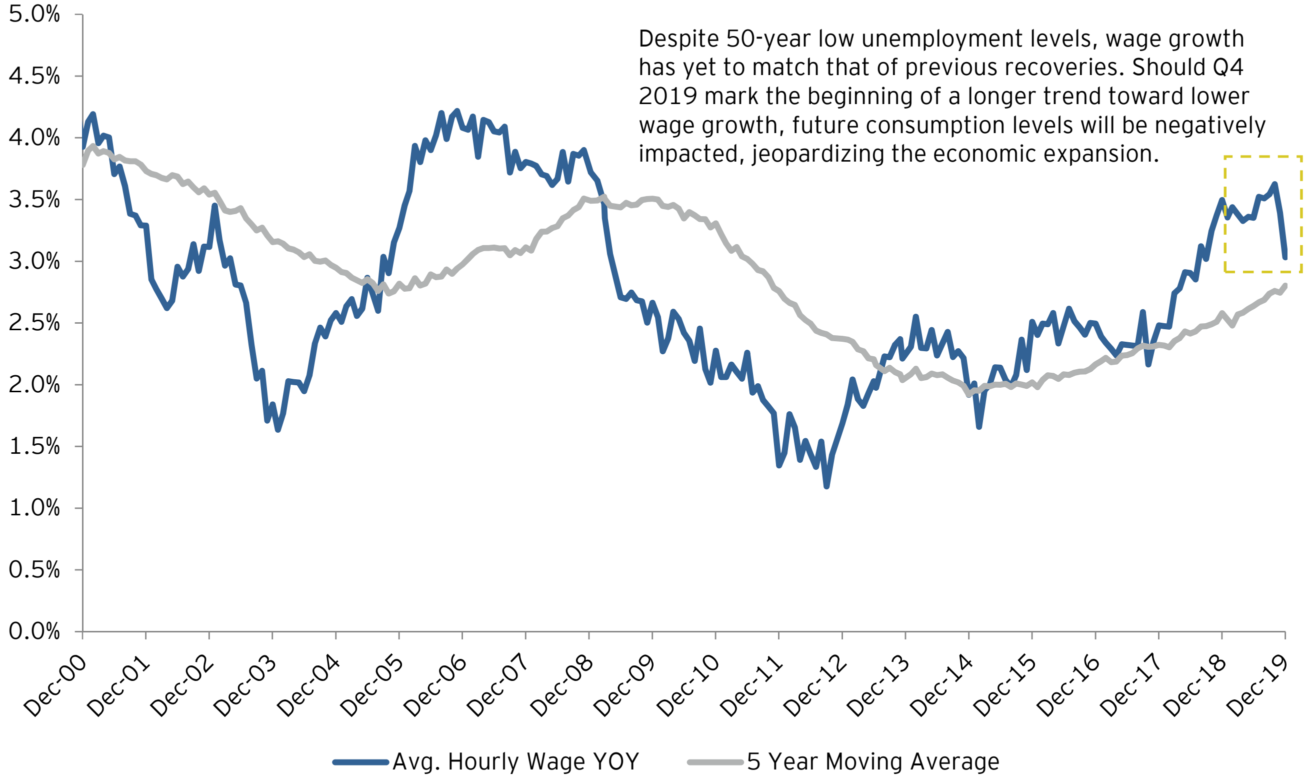


Sources: Bureau of Labor Statistics, Foleynomics, and Covenant Investment Research.

One of the puzzling characteristics of this extended recovery is the relatively weak wage growth accompanying historically low unemployment rates. Time and again, economists have forecast accelerating wage growth in this cycle, only to be disappointed. One explanation may be that there is more slack in the labor pool than believed, with the low Labor Force Participation rate serving as a good example. In previous economic recoveries, nominal wage growth reached levels exceeding 4%, but thus far in this cycle, it has not breached 3.6%. A second factor relates to the mix of jobs added, which has skewed towards lower paying non-manufacturing jobs in recent months.

Wage growth, along with total employment, is especially crucial in a consumer-driven economy like the U.S. Rising wages enable consumers to spend more money, increasing the overall economic output for the economy. Unfortunately, wage growth has been relatively subdued during this recovery, capping consumption. Wages began to accelerate in 2018 as fiscal stimulus temporarily boosted economic activity and hiring, but as the chart below highlights, wage growth turned down in the fourth quarter.

Nominal Hourly Wage Growth YOY



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

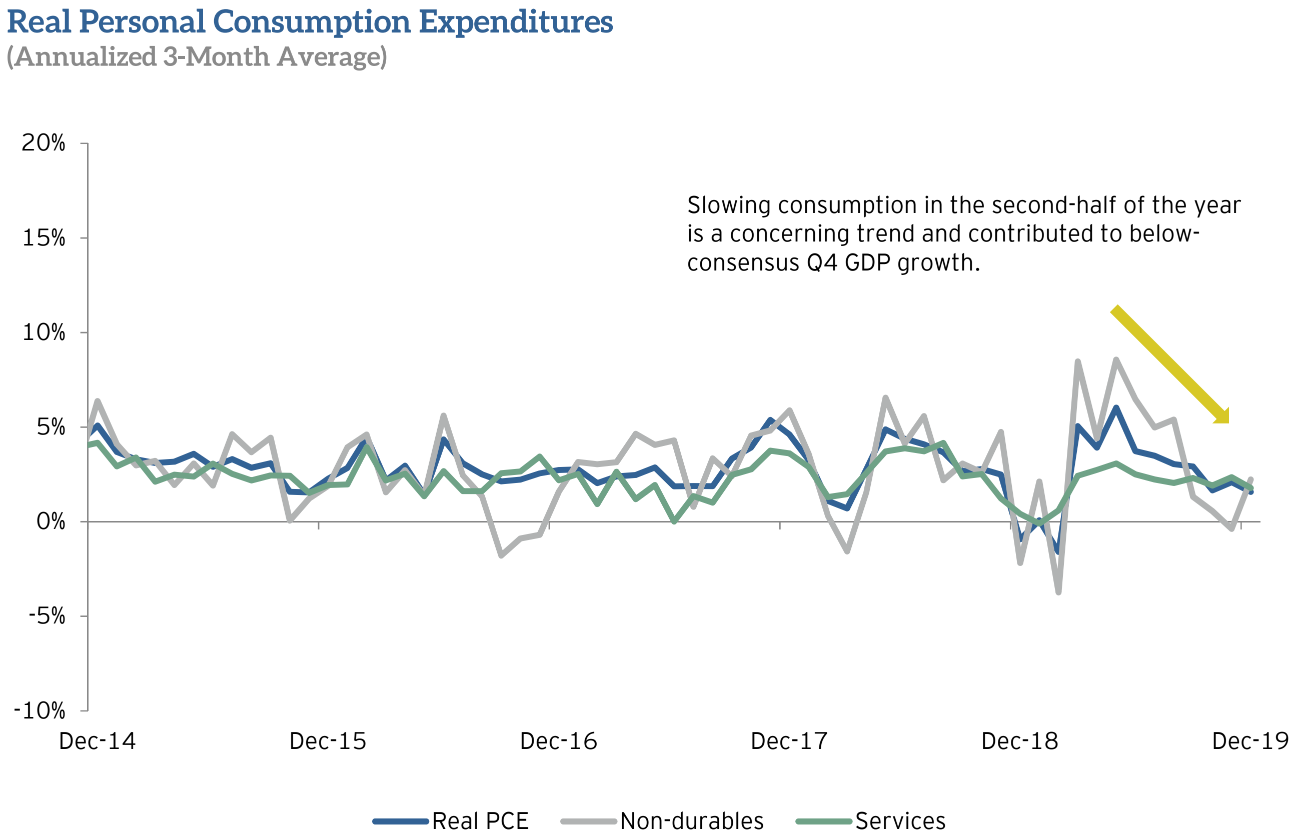
Additionally, hours worked have declined from a year ago resulting in tepid weekly earnings growth. Like any economic data series, wage growth does not move in a straight line. The current recovery includes at least three cycles of rising and falling wages. However, if the downward trend in wages and hours continues, lower consumption is sure to follow. And for an economy that is only expanding around 2% per year and ultra-sensitive to consumption levels, this trend is on our radar.

Outlook: A deceleration in the pace of hiring does not surprise more than ten years into the economic expansion. 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. We expect continued strength in the labor market and lower unemployment ahead, despite a slower hiring pace. However, the Q4 downturn in hourly wages and hours is a trend worth watching.

CONSUMER SPENDING & CONFIDENCE

Consumer spending was reasonably steady through the middle of 2019 but decelerated in the fourth quarter – a trend worth watching. If consumption growth holds at these levels, a recession is unlikely, but further deterioration, especially in spending on services, would be problematic.

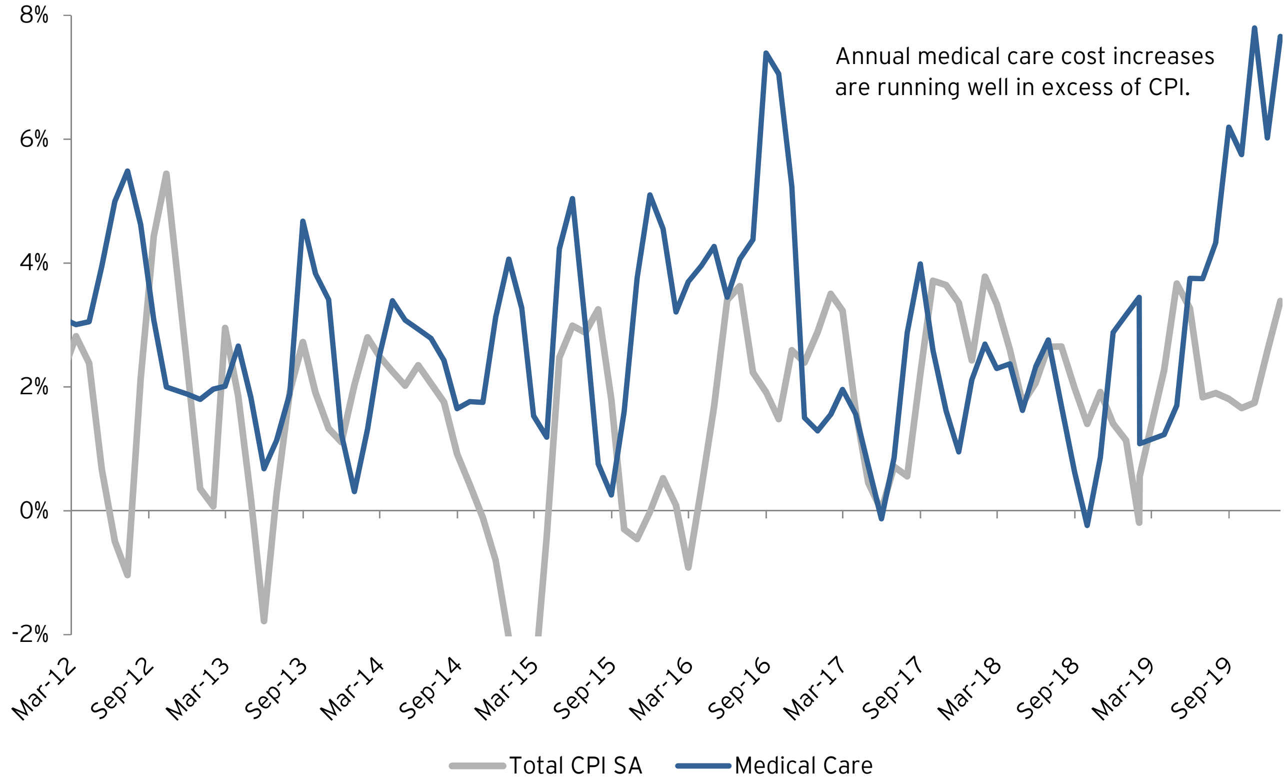
In reviewing Q4 data, weak Q4 retail sales were offset by strength in services spending. Total real personal goods consumption grew at just 1.2% annualized in Q4. Consumer services spending, which comprises about 45% of total GDP, grew at a 2% rate. Total consumer spending expanded at 1.8%.



Sources: Bureau of Economic Analysis, Foleynomics.

The relatively steady growth of services spending compared to weak retail sales growth may be telling us something both about inflation and consumer confidence. First, with regard to inflation, aggregate inflationary pressure is low. Still, inflationary pressures are well above the official inflation rate (the Consumer Price Index) in individual pockets like medical care (see chart) and education. It stands to reason that spending on these types of services may be displacing a portion of retail sales. For example, spending on restaurants and bars is a good barometer of consumer health, and the Q4 spending growth rate was -2.2%.

Total CPI and Medical Care Inflation
(3-Month Annualized)



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

Second, Disposable Personal Income rose at a faster pace than Personal Consumption Expenditures in the fourth quarter, implying a higher savings rate. Saving more of one's income is good on a personal level and can improve long-term consumption potential, but higher savings in the aggregate negatively impacts current consumption levels. Perhaps the higher savings rate is in response to consumers' relatively low confidence in the future, which is at an okay level but well below consumers' confidence in current conditions. While a poor timing tool, wide divergences between confidence in current conditions vs. future expectations have presaged each of the recent recessions.

Consumer Confidence
(Current Conditions vs. Future Expectations)

Sources: Conference Board and Foleynomics.

Outlook: Consumption of discretionary retail purchases slowed in the fourth quarter. Services spending, which consists of substantially necessary expenditures, continued at a healthy pace, buoying overall consumption levels and helped keep the economy on a 2%'ish growth track. If services spending continues to track around 2%, it will be tough for the economy to end up in a recession simply because services expenditures comprise nearly half of U.S. GDP.

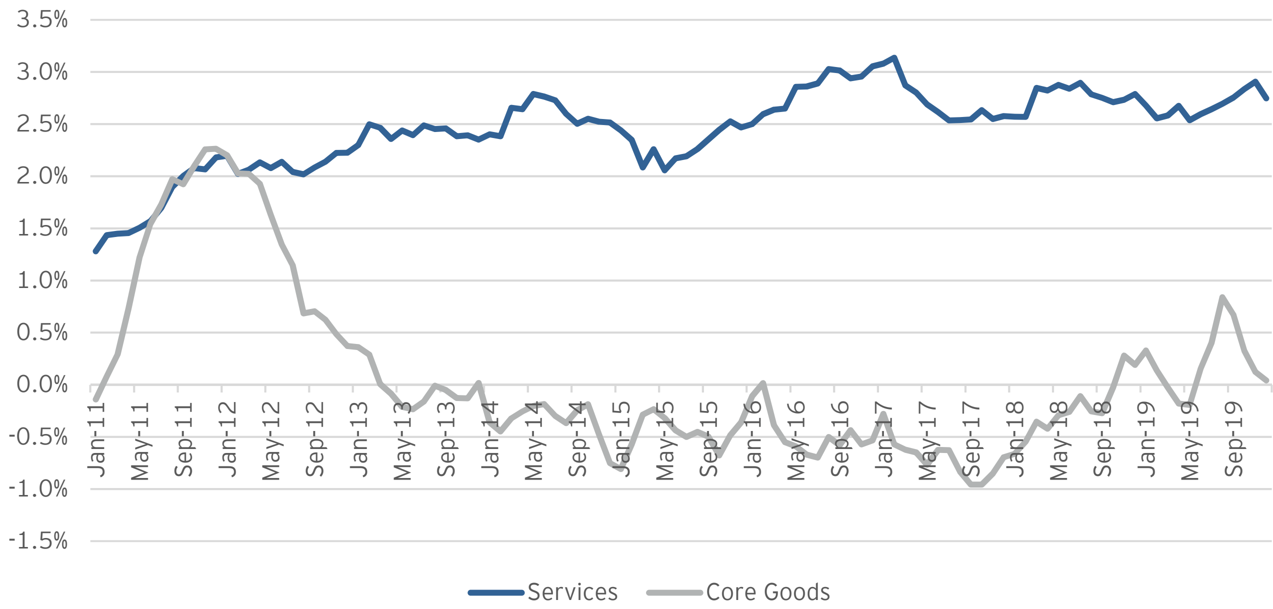
INFLATION

In the aggregate, inflationary pressure in the economy is weak. As of the latest reading, the Fed's preferred measure of inflation, the Core Personal Consumption Expenditures (PCE) Index is running a cool 1.3% year-over-year, well below the Fed's target 2.0% rate.

However, as mentioned in the Consumption section above, the economy is not devoid of inflationary pressures. Indeed, there is a binary division in the rate of price increases for purchased services (relatively high) and for core goods (flat, if not deflating). For example, below is a summary of the three-month annualized price changes for several core goods categories. Lower costs for these categories of goods are beneficial to the consumer but holding back total economic inflation.

- Apparel -4.9%
- Recreation commodities -0.4% (e.g., toys, audio, and video equipment)
- Communication commodities -12.2% (e.g., computers and information technology products).

Inflation Bifurcation
(Year-Over-Year)



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

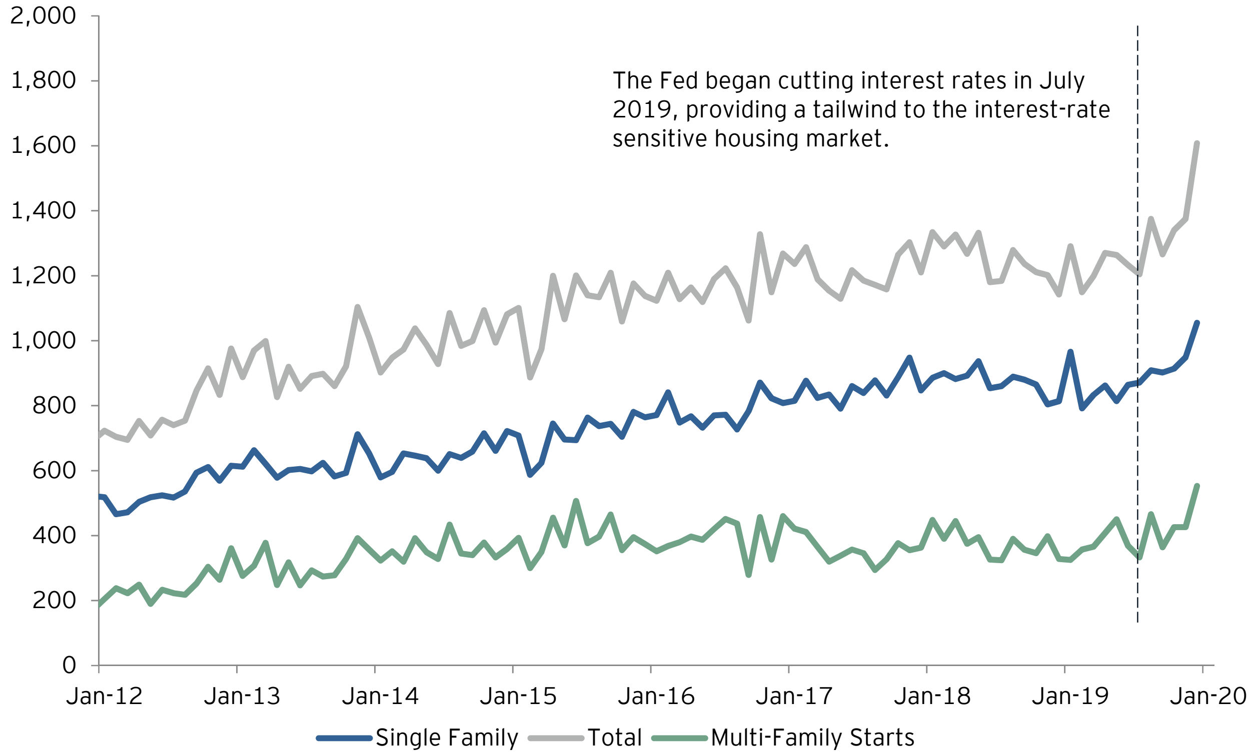
Outlook: Higher Inflation that forces the Fed's hand to raise interest rates will return to the economy someday, but it's unlikely to occur in 2020. Expect an uptick in year-over-year inflation readings in the Spring, as the lookback period will include weak levels from last year. Yet, the data suggests the uptick will be a head fake, and average inflation for 2020 will be below the Fed's 2% target.

CONSTRUCTION & HOUSING

Of any sector in the economy, housing has the highest sensitivity to interest rates. Hence, the Fed's efforts to normalize monetary policy (i.e., raise rates) dragged on the sector, leading to six consecutive quarters of negative GDP growth. However, with the Fed rate cuts working their way through the economy, housing finally began to show signs of improvement in late 2019:

- The six-month moving average of new single-family home sales improved from 599,000 at the start of the year to 709,000 in December.
- New single-family starts accelerated from 1.3 million in January to 1.6 million by the end of 2019. Multifamily starts strengthened from 325,000 to 553,000 during this same timeframe.

New Housing Starts
(Annualized)



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

Outlook: Outside of manufacturing, the housing sector was one of the more disappointing areas of the economy over the last couple of years, so it's good to see nascent signs of a recovery. Moreover, leading indicators like single-family construction permits (+11% year-over-year) and growth in new mortgage purchase applications suggest this sector is reasserting itself as a reliable contributor to GDP growth.

Conclusion

We are entering a new decade in the midst of an old economic expansion. The length of the expansion, the longest on record for the U.S., does not suggest a recession is imminent, but it does imply that GDP growth will struggle to exceed 2% consistently. This "Good, but not great" growth theme we've been writing about for the last several years is the result of constraints within the economy. For example, after an extended period of economic growth, the available labor pool is not as large as it was at the beginning of the recovery, making it more difficult for companies to add workers. This supply constraint is even more challenging for the U.S., which is contending with Baby Boomer retirees, low birth rates, and strict immigration policies. A slowing pace of new hires results in reduced output (a.k.a. GDP), all else being equal. Aggregate demand also remains weak for a variety of reasons including the aforementioned aging demographics and low population growth plus high levels of indebtedness across the economy.

The economy is still capable of growing at around 2% per year but is increasingly reliant on the consumer to carry it. Hence, high employment levels and decent wage growth are critically important to the longevity of this extended business cycle. Even at a 2% growth rate, the economy is more vulnerable to exogenous shocks, whether they come from geopolitical events or natural disasters in the form of a global pandemic.

Against this backdrop, 2020 may be the Fed's most critical test since the Financial Crisis. They're faced with both sustaining the expansion and preparing for how they will approach the next recession with little room to lower interest rates before encountering the zero-boundary line. Hence, findings from the Fed's comprehensive monetary policy review, due later this year, will be watched closely. The hope is that the world's brightest economists and Chairman Powell can translate the findings from the review into a modified approach for monetary policy that syncs with the post-Crisis economic environment to generate higher inflation. Higher inflation would allow for higher interest rates, giving the Fed more ammunition to combat future downturns with the most potent weapon in any central banker's toolbox – cutting interest rates. The key is to get interest rates higher from where they are now without pushing the economy into a recession. And for that reason, paradoxically, the Fed is more likely to cut rates than raise them this year. Lower rates sooner could extend the expansion and create the higher inflation the Fed needs to raise rates later without killing the expansion.

- The Covenant Investment Team

Disclosures