Diversion, Inversion, Submersion, Coercion... Oh My!

August 14, 2019

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Risk assets continue to exhibit heightened volatility with the S&P 500 on pace to decline over ~3% – the third consecutive day with a 1% move and the sixth day in the 10 trading days thus far in August. Our recent *Weekly Headings* cautioned investors about the potential for some seasonal weakness in the equity market (August-September has historically been the weakest two-month period of the year), especially since the S&P 500 entered August near record highs. In our last *Thoughts on the Market (Head Fake or Head Shake? 8/7/2019),* we were more sanguine about the 'noise' surrounding an escalation of tariffs with China because we assumed President Trump would not want to place undue pressure on the economy in the run-up to the holiday shopping season, which would ultimately dampen his prospects of re-election. On cue, yesterday, the president announced a delay of the 10% tariffs slated to take effect September 1 (to December 15) and exempted other products based on health, safety, and national security issues. Ultimately, this trade concern proved to be another diversion (e.g., a head fake) as yesterday saw the S&P 500 strongly rally following the tariff delay.

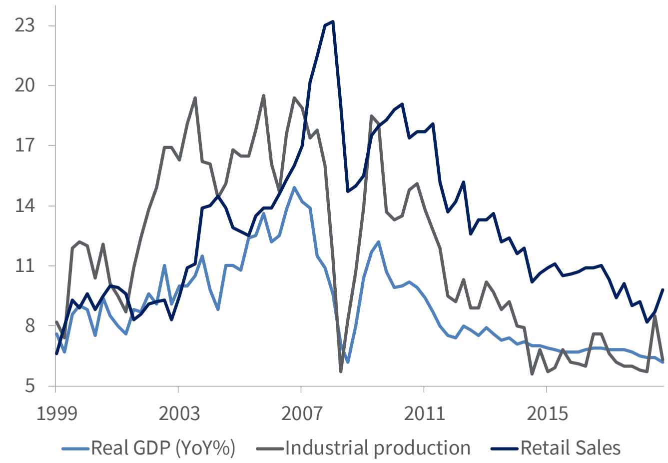
Today, however, is another day and admittedly, fundamental risks are mounting. Globally, signs of economic weakness continue to grow. Some of these include:

• Chinese industrial output growth weakened to 4.8%, the lowest level on record since 2002 (6.3%), and real GDP slowed to its lowest level (6.2%) since the Great Recession. Additionally, retail sales growth declined to 7.6% year-over-year (YoY) due to trade tensions affecting exports.

• Germany's industrial production slumped further to 101.4, and GDP turned negative again (-0.3%) after posting a barely positive figure in the first quarter (0.02%). Germany's economic sentiment index (ZEW) dropped to -44.1, its lowest in seven years.

• European GDP slowed to 0.2% from 0.4%, while economic sentiment in the euro zone declined to 102, its lowest level since 2014. Additionally, the IHS Markit Eurozone Manufacturing PMI declined to its lowest level (46.48) since inception in 2012. As a result, the market is now pricing in at least 20 basis points (bps) of interest rate cuts by the European Central Bank (ECB).

Chinese Economic Data



US and UK 10year - 2year Yield Curve

Adding to these concerns are today's inversion of the US and UK 10-year to 2-year yield curves. The US curve inverted for the first time since 2007. The fear is that the last five times the US yield curve inverted, it preceded an eventual recession. However, we emphasize that there is a significant delay (~22 months) between the time of inversion and the actual beginning of the recession. So, as we have often stated, the inversion starts the 'shot clock' and not the 'panic button'. Could this inversion potentially signal the next recession? It is possible. While there is no foolproof crystal ball, the almost two-year lead time the inversion typically suggests would put the next recession after the 2020 presidential election. History suggests that would not be unusual as nine of the fourteen US recessions have occurred in the year after a presidential election (six when the opposing party wins and three when the incumbent wins).

The biggest question is how can we remain positive on the equity market in the face of this inversion and discussions of a potential recession intensifying? A few reasons we remain constructive on the equity market include:

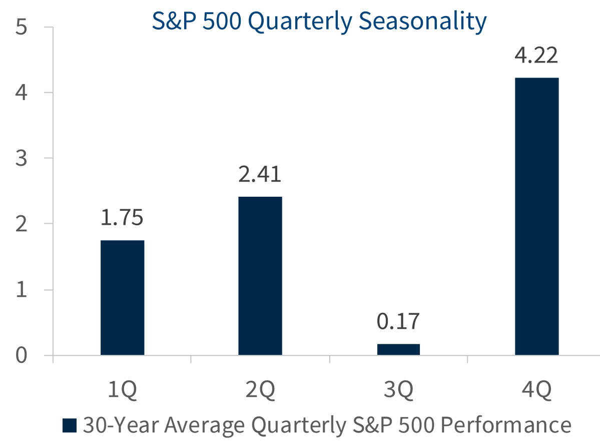
Time | Historically, after the inversion, the equity market has gone on to rally an additional 12% in the ensuing 12 months and is positive 80% of the time.

Fed | The longest lead time between inversion and recession was the 2001 recession. That elongated lead time was the result of the Fed taking out three 'insurance' rate cuts in 1998 to prolong the expansion. In this cycle, whether because of further coercion from the president or not, we believe the Fed will implement at least one more 'insurance' cut before the end of the year. Incidentally, the S&P 500 went on to rally another 19% in the 12 months following the inversion and the Fed 'insurance' cuts in 1998.

Submersion | Currently, the amount of negative-yielding debt has grown to approximately $16 trillion. In Europe, for example, the entire German yield curve is negative and is at the lowest level on record. With negative total returns indisputable if you hold these bonds to maturity, other assets, such as equities, become more attractive on a relative basis.

Valuations | On a comparative basis, equities are becoming more attractive versus bonds. With sovereign yields near record lows, the S&P 500 dividend yield is now above the 10-year Treasury yield by the widest margin since November 2016 and is in the ~90th percentile over a 15-year period. It is also worth noting that 57% of S&P 500 companies currently have a higher dividend yield than the 10-year Treasury.

Seasonality | Historically, after a weak third quarter, the fourth quarter tends to be the strongest of the year. In addition, when looking at the presidential cycle, the fourth year of a presidential term tends to remain strong, exhibiting, on average, the second strongest year of performance.



Bottom Line:

In the near term, volatility will remain heightened as market participants digest the uncertainties surrounding trade tensions and the slowdown of global economic momentum (particularly as we remain ~6% off all-time highs). However, the combination of limited risk of a recession over the next 12 months and Treasury yields remaining depressed should provide a relatively constructive environment for equities. In addition, positive earnings growth in both 2019 and 2020, ongoing shareholder friendly actions (e.g., buybacks and dividend increases), and a more dovish Fed (the futures market is currently pricing in a 91% probability of two or more rate cuts and a 55% probability of three or more rate cuts by year end) should support an upward trajectory of equity prices. With the equity market experiencing heightened volatility, we would consider adding equity exposure at the 2,850 level and then become incrementally more positive should the market move toward its 200-day moving average (currently around the 2,790-2,800 level), as this has been a key level of support over recent years. With dispersion and selectivity becoming increasingly important, we prefer the US equity market over international markets and favor the Info Tech, Consumer Discretionary, Communication Services, and Health Care sectors.

S&P 500 Performance Following Previous 10year - 2year Inversion

Inversion Date	+1mon	+3mon	+6mon	+9mon	+12mon	+18mon	+24mon
8/17/1978	-0.2%	-9.4%	-5.4%	-4.2%	3.9%	10.7%	20.6%
9/11/1980	3.7%	1.4%	3.4%	6.1%	-3.2%	-13.0%	-3.7%
12/14/1988	3.1%	7.2%	17.6%	24.6%	27.5%	31.8%	18.7%
5/26/1998	3.6%	-0.9%	8.5%	13.2%	19.3%	29.5%	26.0%
12/27/2005	2.2%	3.6%	-1.4%	6.4%	13.6%	19.9%	17.5%
Average	**2.5%**	**0.4%**	**4.6%**	**9.2%**	**12.2%**	**15.8%**	**15.8%**
% of Time Positive	80%	60%	60%	80%	80%	80%	80%

Michael Gibbs, Managing Director of Equity Portfolio & Technical Strategy, **Joey Madere**, CFA, Senior Portfolio Analyst, Equity Portfolio & Technical Strategy

The inversion between the 2-year/10-year yield spread has roiled equity markets. Given that this metric has historically predicted coming recessions, the weakness is not completely unexpected with equities already in a pull-back period.

Even if the current inversion is signaling economic weakness (or recession) in the future, the historical lead time is generally rather long (12-15 months). Currently, with the jobs market and services side of the US economy both healthy, a recession is a low probability. If initial claims begin to climb and leading indicators slip below zero year-over-year (YoY) growth, the risk will increase, but we have not yet reached that point. Leading indicator YoY growth is coming down and is just under 2%, but it moved to nearly the same level during the manufacturing recession in the 2015-2016 time frame. Initial claims are not trending higher. Yield curve inversions also have mixed success at calling equity market peaks. Half of the last 10 inversions came near a market peak or early in a bear market, while the other half came prior to a continued climb in equities.

While we shy away from saying 'this time is different,' the influence of low global yields spurred by central banks around the world (e.g., the European Central Bank keeping yields across Europe in negative territory) bears mentioning. Additionally, the Federal Reserve (Fed) is well aware of yield curve inversions. Members of the FOMC have commented on the curve over the past year. We feel the "Fed Put" is still viable, and the yield curve inversion (assuming the 2-year to 10-year spread inverts again and remains inverted) is a potential catalyst for a more aggressive policy response from the Fed.

Equities remain in an air pocket and the weakness (choppy trading) is likely to continue. Given the bounce off the recent low (August 5) has been technically mixed, the move lower today on heavy down volume raises the odds the lows are yet to be seen for this down move. Given that the market closed at the session low, this raises the odds of additional weakness.

In the coming days, a move below the August 5 close of 2,844 and the 200-DMA (2,795) raises the odds the S&P 500 undercuts the June low (2,728). Odds are elevated that the support levels are breached with the S&P 500 turning back from the 50-DMA resistance level. Other indices are weaker than the S&P 500, with the equal weight S&P 500 Index sitting on the 200-DMA and the Russell 2000 less than 0.50% from the June low. If these indices undercut these supports, odds increase that the S&P 500 will as well.

Nonetheless, we maintain our opinion that equities are not on the cusp of being instantly swept into a decline similar to the 19.5% swoon seen last fall, given that economic conditions (jobs and services) are fine, the Fed is easing, and interest rates are lower now than they were then. Our favored area of support is somewhere near or just below the June low of 2,728. If the S&P 500 slices through that level, then we favor the 15x next 12-month price-to-earnings (P/E) multiple (near 2,600) as a favored valuation support.

The historical track record of inversions warrant investor attention, and typically reflects less supportive financial conditions in the event of an economic shock. However, they can come with very large lead times and should not induce a knee-jerk reaction by investors. The global economy is clearly slowing, especially on the manufacturing side, but it ultimately takes unemployment to reach recession. For now, the jobs market and consumer remain solid in the US. Also, the Fed has stated its intent to support the economy, and has recently cut rates.

Scott Brown, PhD, Chief Economist, Investment Strategy

The slope of the yield curve, the difference between long- and short-term interest rates, is widely considered to be the best single indicator of recessions. Most economists focus on the spread between the 10-year Treasury yield and the 3-month Treasury bill yield (or the 10-year yield less the federal funds rate), but some investors look to the 10-year to 2-year spread. The 10-year to 2-year spread has recently (and briefly) inverted (dropped below zero), but the 10-year to 3-month spread has been negative since May.

A simple yield curve model of recessions (based on the 10-year to 3-month spread) would put the odds of entering a downturn in the next 12 months at nearly 40%. Bear in mind that the odds had only risen to 50% ahead of the 2007-2009 recession. We've only had 11 recessions since WWII. That's a low sample size. So, the projected odds may not be all that accurate. Furthermore, the model may understate the risks of recession when the overall level of interest rates is low. On the other hand, US bond yields may be artificially depressed by extremely low long-term interest rates abroad, which has led some to conclude that 'this time is different' (a phrase which shows up every time the yield curve inverts).

Why is the yield curve a good predictor of recessions? An inverted curve means that investors expect short-term interest rates to fall. The Federal Reserve (Fed) is expected to lower rates because the economy is slowing (this is also evident in the federal funds futures market). Recession expectations can be self-fulfilling. Consumers hold off on big ticket purchases, such as a house or motor vehicle. Businesses put aside expansion plans, reducing capital expenditures. A flat or inverted yield curve also reduces the incentive for banks to lend (lack of loan growth equates to lack of economic growth).

Currently, consumers are likely to keep on spending, supporting overall growth. However, there is a risk that more cautious business attitudes will lead to less hiring and increased layoffs. The Challenger Job-Cut Report showed a 36% increase in announced corporate layoff intentions in the first seven months of this year. The total is still low by historical standards, but this could be an early signal of a softening in labor market conditions. Job growth has slowed this year, but remains well above the pace needed to absorb new entrants into the labor market.

Trade policy uncertainty and slower global growth have made businesses more cautious in recent months. The May 10 increase in tariffs (to 25% from 10%) boosted input costs for US firms, further disrupting supply chains and dampening manufacturing activity. While some of the September 1 tariffs (10%, mostly on consumer goods) have been delayed, the uncertainty remains. The US economy is more self-contained than other advanced economies, but exports into an expanding global economy have been an important source of profit for US firms.

As we have seen repeatedly, stock market participants have reacted sharply to shifts in trade policy perceptions and have been hypersensitive to minor changes in the monetary policy outlook. The Fed is expected to respond to increased downside risks by lowering short-term interest rates at the policy meeting in mid-September. Chair Powell will speak at the Kansas City Fed's monetary policy symposium August 22-24.

Ed Mills, Washington Policy Analyst, Equity Research

The Office of the US Trade Representative (USTR) will delay a planned 10% tariff on a significant portion of consumer goods until December 15, but will implement tariffs on a broad list of goods starting September 1 in a move that provides some negotiating room for the remainder of 2019. Initial publicly-available analysis indicates that the 21-page list released by USTR (including electronics, clothing, and other goods that typically see a seasonal uptick in purchases around the holidays) is of greater value than the 122-pages of items subject to tariffs on September 1.

Although prospects for continued US-China talks increase in the near term, it is likely we are not yet moving closer to a long-term deal and we expect back-and-forth brinksmanship with periods of escalation to continue.

Longer term, we view Tuesday's developments as further evidence that the Trump administration remains sensitive to the strength of the market as it relates to trade talks. We expect this dynamic to persist, especially as we get closer to the 2020 elections. Periods of incremental escalation are likely to persist, but are also likely to be strategically mitigated to lessen the impact on the market and consumers. Staggered tariff implementation serves to mitigate the consumer impact ahead of the holiday shopping season and increases the chances that negotiators follow through with planned in-person talks in Washington in September, barring significant negative developments with regard to ongoing unrest in Hong Kong.

The Hong Kong protests and a potential response by China is a significant near-term threat to US-China talks as larger geopolitical questions become increasingly intertwined with the trade negotiations. China has repeatedly sent signals that it views developments in Hong Kong as an internal matter, and that any action by the US in support of the protestors would be viewed as meddling in China's internal affairs - a consistent red line that has derailed progress on the trade front in the past.Longer term, we view Tuesday's developments as further evidence that the Trump administration remains sensitive to the strength of the market as it relates to trade talks. We expect this dynamic to persist, especially as we get closer to the 2020 elections. Periods of incremental escalation are likely to persist, but are also likely to be strategically mitigated to lessen the impact on the market and consumers. Staggered tariff implementation serves to mitigate the consumer impact ahead of the holiday shopping season and increases the chances that negotiators follow through with planned in-person talks in Washington in September, barring significant negative developments with regard to ongoing unrest in Hong Kong.

Pavel Molchanov, Senior Vice President, Energy Analyst, Equity Research

Given the backdrop of increasingly negative macroeconomic headlines, the Raymond James Energy Group often hears the question: could global oil demand actually fall? The answer is that falling demand is exceedingly unlikely. The last time global demand growth turned negative was during the financial crisis of 2008 and 2009 when it declined by 0.5% in both years. Before that, we have to go all the way back to the Asian currency crisis of 1998 to see a demand decline. During 'normal' recessions or economic slowdowns - for example, the aftermath of the tech bubble bursting in 2000 or the European currency troubles of 2011-2012 - global demand continued to grow, just at a slower pace. Looking at the past four decades, average demand growth has been 1.4%, whereas we are forecasting around 1% in both 2019 and 2020.

Doug Drabik, Managing Director, Fixed Income Research

We believe the story remains relatively unchanged, with an increase in global and domestic indicators building a stronger case for strained economic growth around the world. Many countries, including the US, are sitting at or near historic low rates across the yield curve. Much of Europe and Asia continue to push the accelerator by easing monetary policy in an attempt to jump start their economies. The Fed finds itself in a predicament in trying to weigh average economic conditions in the US against a global economy that is faltering. The demand for less risky assets has elevated bond prices, resulting in an unprecedented $15.8 trillion of negative-yielding debt now issued worldwide. US rates are falling regardless of Fed interaction as 'risk-off' sentiment moves through the market.

Today's volatility has moved the 2-year to 10-year Treasury spread in and out of inversion. Keep in mind that the 3-month bill to the 10-year Treasury spread has been inverted for around 93 days. Many experts look to these spreads as indicators of an economic cycle's end or the start of a recession in the near future. It is not uncommon for different curves to invert at different times. When looking back at the last five recessions, yield curves inverted anywhere from three to five months apart (with the average being ~3+ months). If the 2-year to 10-year were to close inverted today, it would be lagging the inversion of the 3-month to 10-year curve by roughly three months. Depending on which spread you choose to view (and adding the average length of time from inversion to recession), it would indicate a recession sometime between May and November of 2020. Using the historical minimum and maximum periods of time from inversion to recession, it would suggest a potential recession as early as January 2020 or as late as March 2021. Of course, prior occurrences are never guarantees of what lies ahead.

Chris Bailey, European Strategist, Raymond James Investment Services

The current weakening in global economic growth levels has certainly contributed to the cautious backdrop which has unsettled US financial markets. Today's contributions include an abundance of data coming out of China (of which all components are clearly weaker). Year-over-year industrial production statistics for July (5.8% growth) is the lowest reading since February 2002. The China Statistical Bureau views this as a slowdown from unsustainably-high numbers noting that "consumption still has big potential" and "stimulus policies are gradually showing their effects." Meanwhile, the German economy joined the UK economy in posting a modest decline in second quarter economic growth as the impact of Brexit stockpiling and the tougher global export backdrop impacted the two countries. Upcoming meetings of leading regional politicians later this month will add colour to these pan-European debates on Brexit and related issues.

Clearly, fear is high as shown most notably in yesterday's well-publicised monthly Fund Manager Survey which gave cash the largest overweight among polled fund managers (while equities had the largest underweight), signaling a material amount of pessimism being factored in. Further bilateral US-China trade progress would be helpful as would some progress in issues keeping the pan-European economies below potential (such as Brexit). Comments in recent days by German Chancellor Merkel finally acknowledged the need for further efforts to stimulate her local economy, will likely be supplemented by European Central Bank actions in September along with ongoing efforts by the Chinese. The magic ingredient missing internationally continues to be a level of confidence that encourages consumer spending and entrepreneurial verve.

Source for charts: FactSet

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