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Weekly Economic Update

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What a difference a year makes – and what a difference a week makes. One year ago, optimism was booming. The US economy was set to explode on the passage of an unexpectedly low 21% corporate tax rate -- plus repatriation. Macron was at his peak, quickly filling the international void whenever Trump stepped back. He was to pair with Merkel in a new French-German led Euro Area reset. UK Prime Minister May was still promoting pro-UK Brexit terms. And Xi Jinping had just been appointed President for life. Today, pessimism rules with equity markets down around the world, a trade war simmers, weaker domestic economies feed nationalism, and world leaders are on the back foot. Yet, after bottoming on Christmas Eve, the equity markets have rallied during the twelve days of Christmas as Federal Reserve Chair Powell was more dovish, Trump and Chinese sources touted progress on the trade negotiations, and China shoveled a new round of coal into their guttering economic fire.

Last year, we argued that the late cycle tax cut and spending hikes would fuel booming growth, but that it would be a sugar high as rising interest rates, wages and energy prices narrowed margins. By mid-year, we suggested a significant equity market correction and an economic slowdown in 2019. In our favorite Labor Day letter, we warned of a financial correction deeper than any in the cycle so far (which meant at least 15%) -- and after the initial 10% dip suggested a 25% sell off, but only a slowdown to under 1%, not a recession in the real economy. Now that equities have bounced off bear market levels, we still expect a retest in early 2019, and hold to the view that the damage done by the unexpected weakness in asset values will cool – but not recess – the US economy near midyear.

Bottom line, the twin policies of tighter monetary policy and punitive tariffs, which blunted the impact of tax cuts and spending hikes, are now being reconsidered. Globally in 2019, as in China already during 2018, the policy mix should shift back toward stimulus. This bodes well for equities by year end and the real economy in 2020 – if policymakers don't regress from this week's promises. We believe the strong employment report was in the rear view mirror, but another rate hike is still possible and a flaring of trade bravado may come if asset values and the economy revive too quickly from their current funk. Still, our core view is that near term caution will lead to fresh optimism by year end.

Interestingly, the first line of our first letter in 2018 was "The disappointing December employment report failed to confirm the optimism in the equity market after the passage of the tax cuts." We could just reverse the wording this year after the spectacularly strong jobs report Friday. Still, now as then, each individual jobs report must be view as just one element of the preponderance of all economic data. First and foremost, our view is that this report was unambiguously strong. It confirmed job strength seen in the ADP report and in some other December data, like the Chicago PMI. Unfortunately, this survey reflects employment growth as it was during the month ended the week containing December 12th. The equity sell off was not even worrisome at that point, as the S&P500 having recovered to 2790 on December 3rd. Investors will be much more interested in earnings reports and forward guidance, which start being released January 14th – with Apple's warning a harbinger of what may come. As clarity increases on who is worried about trade versus the Fed – or other issues like weak European growth, currency movements or the plunge in oil prices – we expect a trading range will develop for asset values and the economy will slow as we wait to see where policy settles.

The most optimistic sign for the global economy in 2019 is that the Chinese are not waiting. Rather they are accelerating a stimulus program that started around mid-year and has been growing in increasingly larger increments as they fail to see their economy rebound and the longer term risks from the trade war offsets their domestic efforts. We had estimated previous infrastructure spending, cuts in taxes and tariffs, and other new subsidies at a hefty 2%+ of GDP before this week's moves. Starting January 1, China has announced a fourth round of cuts in reserve requirements (by 1% for all banks) which should free about $110 billion in fresh credit after allowing for other restrictions, or about 0.8% of GDP. They also allowed state and local lenders to pull forward roughly $220 billion in credit that would have become available after the March Party meeting. This adjustment will remain for the next three years. Finally, new tax deductions for children's and continuing education, mortgage interest or rent, and serious health expenditures plus elder care are targeted at boosting middle class consumption. All told, stimulus is now nearer 4% of GDP. In our view it is probably excessive, but this is a traditional problem in Chinese policy making as excesses on tightening and easing add to the natural boom-bust pattern of a manufacturing based economy. Bottom line, China should be recovering nicely by late 2019 and roaring into 2020. Most of the world is just catching up to the fact that China is sputtering, rather than focusing on the inevitable consequences of so much stimulus. As noted earlier, China's future is about the 97% not directed at US exports, not the 3% hit by the trade war.

The Chinese consumer stimulus is particularly well designed – being as Bruce Lee might say "the art of having tariffs without really having tariffs." As in America, the vast bulk of consumption is done by those in higher tax brackets. Taxes range from 3% to 45% in China with the middle class at 20% and up (higher than on comparable US incomes even allowing for living standards). The new deductions reflect areas where the middle class spending is growing fastest. These are also almost entirely domestic industries – as compared to cars, vacations, and other luxury spending, which have a high import content. The mortgage interest deduction is more a tax cut than a spending stimulus as access to credit will remain tight, making increased consumption difficult. Investors are also aware a long discussed property tax is likely coming in 2020 – after the current stimulus has perked up the economy again. Bottom line, while tariffs were lowered recently on many imports (even for US goods, though they still face the 25% penalty), these tax deductions cut affected prices by 20% to 45%.

Domestically, the strong employment report indicates both a strong fourth quarter and pressure on margins. The 312,000 new jobs in December was as much an outlier as the 119,000 in September. They mark the extremes of the 115,000 range in the survey's 90% confidence level. The four month average of 220,000 matches the average for the year. Interestingly, it is manufacturing that exhibited the most strength at year end – along with leisure & hospitality. Education retreated recently after a strong summer reflecting the fact that teachers were not let go this year for fear they would not come back. Bottom line, a 2% growth rate in hours worked during another roughly 3% quarter leaves productivity anemic at around 1%. With wages rising at a 3.4% annual rate in the second half of 2018, they are now well above inflation plus productivity – pressuring margins for the weakest firms.

The employment report is at best a coincident indicator, while the equities markets are leading indicators of profit margins and volume – both now under pressure. The reasonable expectation now is that firms will cool their hiring in anticipation of others cooling their hiring. There is no longer a need to hire before your competitor, when the reality is some may soon be out of business. Less energetic hiring will ease wage acceleration. Slower growth in consumer spending power will hit both volume growth and inflation. Less inflation will keep hiring and wages spiraling down until there is enough productivity growth for unit labor costs to fall. Productivity growth is always strongest when firms are laying off, as the least productive go first. This widens margins enough to offset weaker growth (or recession). Ultimately, the survivors buy out weaker firms or just take their customers, shifting the economy into stronger hands that will take risks, forming the start of the new cycle.

The stock market just marked the need for a Fed pause and a trade truce – but it will be months before the economy sees those policies put in place. After three very strong summers, we expect seasonals will help make 2019 look pretty soft – but, again, no recession. Guideposts for the all clear include the Fed skipping the March tightening (now well over 50%, though one year rates trade above both six month and two year notes, so some temporary tightening is still priced in), a rise in the unemployment rate of at least 0.5%, any bipartisanship vis a vis the economy from Washington, and any agreement to begrudgingly get along with China – until both economies start to recover. If we are right and China is growing robustly sooner than the US (with 4% of GDP stimulus already stoking their boiler), Sino-US head butting will reappear before the 2020 election and 2021 Party centennial.

In any case, we see a very flat recovery in the real economy, as in 2001-2003 and 2010-2016. While Chinese growth was the feature of the last two cycles, that will be far more difficult ahead. Any replacement – ASEAN, India, Mexico, or Eastern Europe – will be far smaller and less homogenous, so risk takers will be both more wary and less reinforcing. Cycles come and go and this one is looking for a bottom. That generally does not take more than a year (even in 2008) so we are shifting to a more optimistic tone. My only regret is that sadly my first and greatest mentor, my father, passed away this weekend just shy of his 92nd birthday, and I will no longer benefit from his sage insights.