GSAM
Grant Street Asset Management, Inc.
INVESTMENT ADVISORS

Thoughts Regarding Economic Data Points and the U.S. Economy January 2019

To provide further insight into how we view the economic environment, we have included some of the data points we track: the Leading Economic Indicators, Global Purchasing Manager Indexes (PMIs) (Chart 1), U.S. corporate revenue growth (Chart 2), and the U.S. Yield Curve Spread (Chart 3). After pausing during 2015, the Leading Economic Indicators (LEI) continue to indicate economic strength, albeit at a slower pace during the most recent quarter. LEI tends to peak well ahead of an economic contraction. Our take: fundamentally we do not believe that the LEI data shows the economy is at an inflection point that indicates recession.

Global Purchasing Manager Indexes, or PMIs, are a survey of purchasing managers regarding current business conditions and changes, whether improving, unchanged or deteriorating. A reading above 50 indicates economic expansion, whereas a reading below 50 indicates economic contraction. The heat map from JP Morgan visualizes the strength and/or weakness across regions based on PMI. PMI data peaked in 2017, however remains above the key level of 50, indicating continued expansion. Our take: global growth is still growing, albeit at a slower pace. Certain regions are still attractive on a valuation basis with underlying economic fundamentals supportive of stocks.

<u>Chart 1: Global Purchasing Manager Indexes (PMIs)</u>

Source: Markit, JP Morgan Asset Management

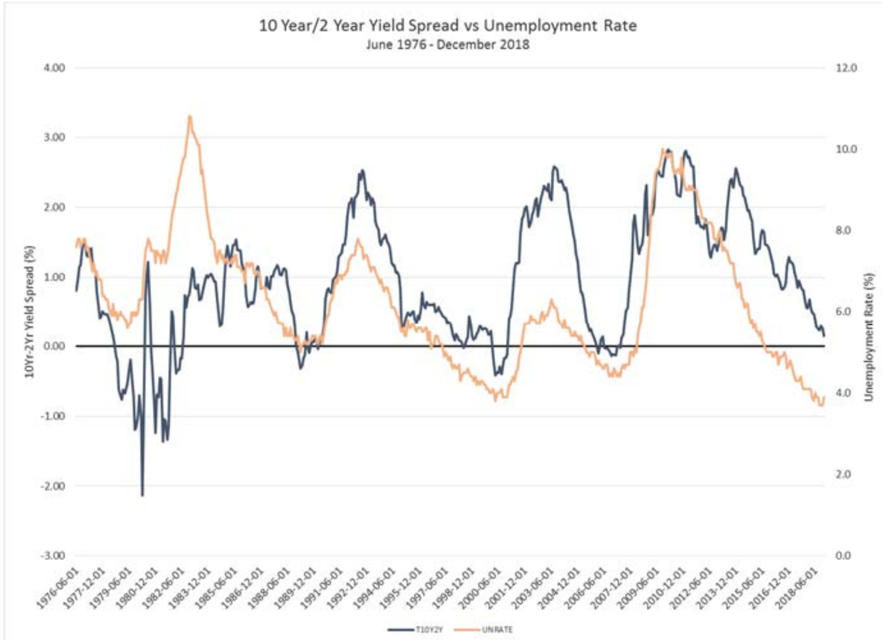
We track the quarterly revenue growth of nearly 2,500 US-based companies. One of the reasons why we more closely follow revenue as opposed to earnings is the fact that earnings can be more easily manipulated (due to accounting rules, tax changes, share repurchases, etc). Reviewing nearly 20 years of quarterly corporate revenue data, on average 35% of US companies report revenue growth of more than 12% year-over-year. As of the most recent reporting quarter, over 37% of companies reported 12% revenue growth; while not as strong as the previous quarter, still above the long-term average and indicates corporate strength. Our take: U.S. companies continue to growth top line revenue above historical levels, which should be supportive of stocks.

Chart 2: US Corporate Revenue Growth

Source: briefing.com, Grant Street Asset Management

The Federal Reserve and its planned monetary policy tightening had markets on edge during the fourth quarter, with Chairman Powell's comments in early October causing concern that the Fed would be overly aggressive and stunt economic growth. Comments questioning Federal Reserve policy from the White House and financial commentators enhanced market concerns. While the Federal Reserve did raise rates at its December meeting, as expected, there exists a significant divergence in Fed member and market expectations for 2019, with the market pricing in zero rate increases for 2019 and even a potential rate decrease in early 2020. At the same time the Fed is raising short-term interest rates, it is also undertaking an even more important policy adjustment: the reduction of the balance sheet. The Fed's balance sheet was built up to over $4 trillion in response to the 2008 financial crisis. As the economy has moved well beyond that period, the need for the balance sheet to be sustained at that high level has diminished. The Federal Reserve is not the only central bank in the midst of tighter monetary policy; the European Central Bank has indicated that it will cease bond purchases as it follows a similar path to Fed tightening policy. Globally, central bank liquidity has turned and a new phase of global monetary policy tightening has emerged. We anticipate that this shift will increase equity and bond market volatility as market participants adjust to this new liquidity paradigm. Our take: in this type of environment, a fixed income allocation should be diversified in regards to interest rate risk and credit risk, as the near-term predictability of yield curve shifts and market sentiment remain uncertain.

Chart 3: US Yield Curve Spread & Unemployment



Source: St. Louis Federal Reserve (FRED), Grant Street Asset Management

While the current economic expansion is approaching record territory as the longest U.S. recovery in history, this does not mean a recession is bound to occur; expansions do not die of old age. According to data compiled by JP Morgan, there are three primary macro environment characteristics of recessions: a commodity spike, an aggressive Federal Reserve, and extreme valuations. In the current market environment, none of those characteristics are present. Commodity prices have actually moderated, the Federal Reserve has been tightening monetary policy (raising rates) but has not done so aggressively, and while equity market valuations were stretched, they were not at extreme levels, and are more attractive today after the fourth quarter sell-off. By JP Morgan's calculations, the valuation of US large cap equities (as measured by the S&P 500) based on forward earnings was less than one standard deviation above the 25-year average valuation. In addition, we closely follow both hard and soft economic data points on an ongoing basis. Hard economic data contains information based on actual data points collected and includes metrics such as hourly average earnings, employment, and corporate revenue. Soft economic data points are based on survey results that inquire about expectations that range from the current period to twelve months and includes metrics such as PMI, ISM Manufacturing and Non-Manufacturing Indexes, and consumer and business sentiment indices. When we collect, review and analyze all of these metrics, we have come to the conclusion that while the economy appears to be decelerating from one of the stronger growth periods since 2008, it still reflects an expansionary economy. Setting investor psychology and headline risk aside to gain clarity on where markets may go moving forward, we do not anticipate a recession in the near term.