

April 2019

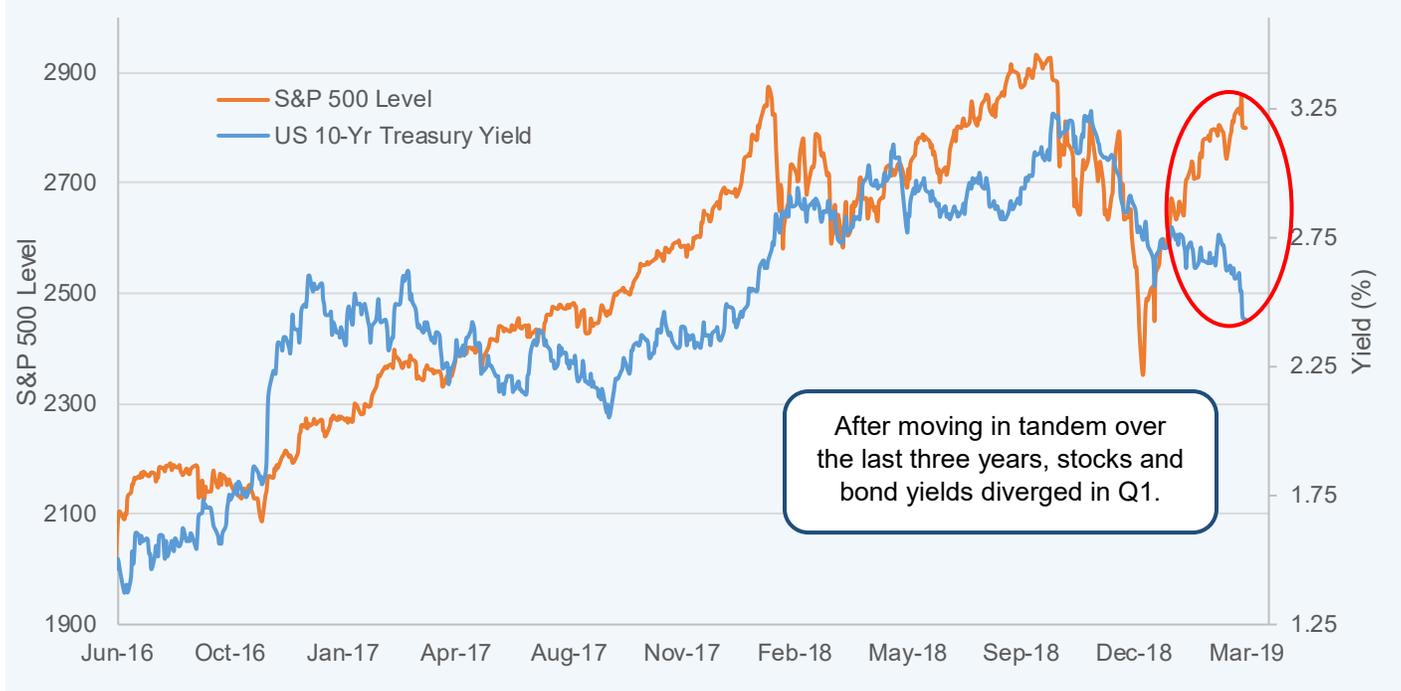
Rain or Shine?

Evaluating the State of the Global Economy

Imagine you are going to the ballgame with your friends and you ask them if it is supposed to rain? Your more pessimistic friend tells you to bring your heaviest rain jacket because it is going to pour. However, your second friend is much more of an optimist and says that it may sprinkle but you will be fine. Who do you believe?

This is a similar situation to conflicting advice that stocks and bonds provided to investors in Q1. On one hand, global stocks (MSCI All Country World Index) were +12% in the first three months of 2019 and recovered almost all their losses from last quarter's sell-off. This price action would appear to be in line with your more optimistic friend. On the other hand, global bond yields continued to decline in Q1, suggesting stormier times ahead.

Figure 1: Stocks and Bond Yields Diverged in Q1



Stock prices and bond yields tend to tell the same story when it comes to future economic growth expectations. When growth expectations are rising, stocks tend to appreciate in anticipation of higher earnings and bond yields tend to rise as a reflection of higher inflation expectations and potentially more restrictive central bank policies. This has generally been the relationship between the S&P 500 Index and the US 10-Yr treasury yield over the last few years as you can see in **Figure 1**. Since treasury yields and the S&P 500 bottomed in the summer of 2016 after the surprise Brexit vote, both have moved in relative lockstep. From July 2016 to September 2018, they rose higher on the back of stronger synchronized global growth expectations. After peaking in September 2018, they both tumbled lower in Q4 as global growth expectations began to slip.

However, since the New Year, stocks and bonds have been on divergent paths. Stocks have risen and recouped most of their Q4 losses. This would suggest perhaps brighter expectations for future growth. Conversely, bond yields have continued to decline – suggesting a bleaker future. So, which one is telling the truth? Are we on the precipice of a storm or just experiencing a light shower?

Evidence for a Storm: Why a recession could be on the horizon

A recession is defined as a period of economic decline in which gross domestic product (GDP) falls for at least two successive quarters. Currently, global GDP prints and future estimates are still safely above contractionary levels. However, the trend over the last few years has been downward and there are a few major geopolitical events that could increase the risk to the downside. The most notable being the United Kingdom leaving the European Union without a new deal later this spring (i.e. a hard “Brexit”) or the US and China stepping away from the negotiating table and further escalating their ongoing trade dispute.

Figure 2 shows recent GDP growth and future projections from the International Monetary Fund for major countries and economic blocs. Growth in the Eurozone has been the most anemic and an unorganized Brexit could push the region back into a recessionary environment. Growth in China and emerging markets is projected to remain relatively robust, although the 6.2% projection for China could move lower if the communist state’s fiscal stimulus package fails to negate the negative effects of US tariffs. The stalwart of the most recent expansion has been the US economy, which is still expected to grow at a healthy clip going forward. However, last year’s tax cuts have so far failed to ignite the economy to superior growth targets and a growing fiscal deficit could be a headwind for the economy ahead.

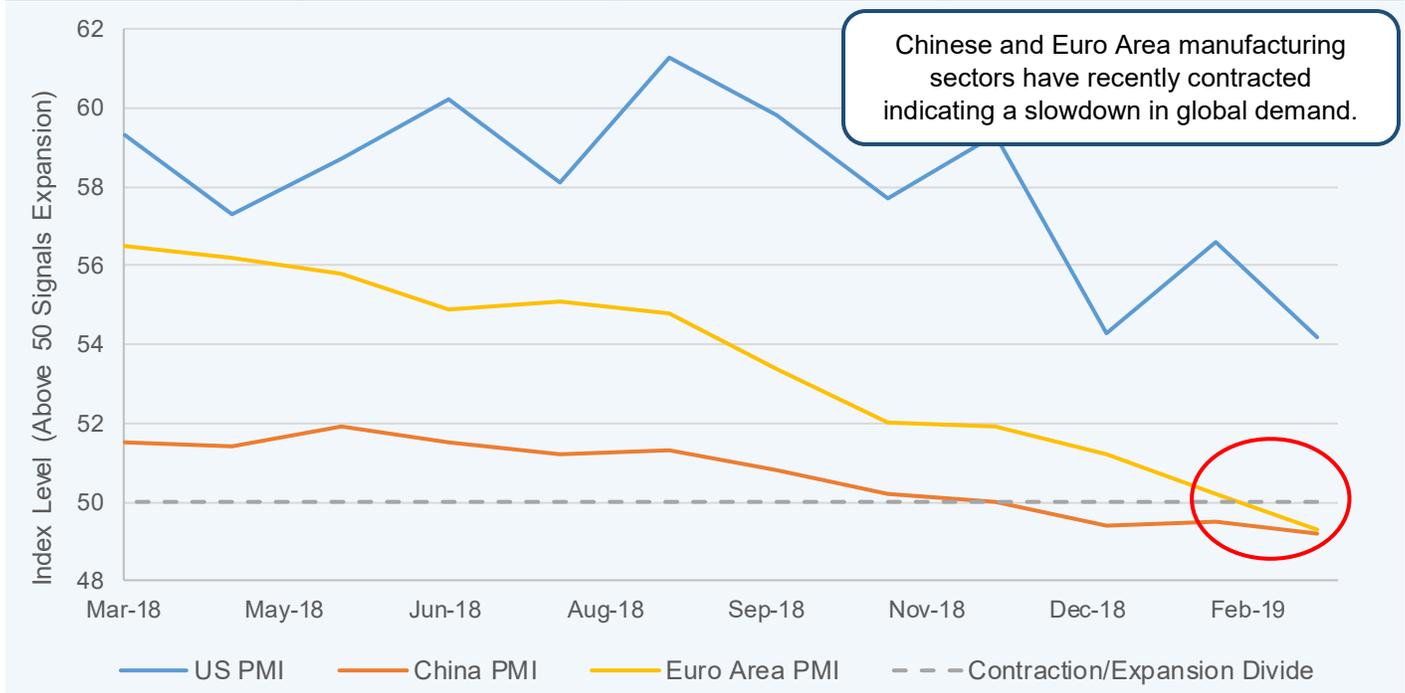
Figure 2: GDP Growth is Decelerating Across the Globe

Region GDP Growth	2017	2018est.	2019est.	2019 change from Q3 18 est.	Risk Factors
World Output	3.8	3.7	3.5	-0.2	Trade tensions, high levels of debt, UK withdrawal from EU
Advanced Economies	2.4	2.3	2.0	-0.1	Slowing trade growth, escalation of trade tensions
United States	2.2	2.9	2.5	0.0	Tighter financial conditions
Euro Area	2.4	1.8	1.6	-0.3	Potential hard Brexit, decelerating industrial production
Germany	2.5	1.5	1.3	-0.6	Weak industrial production due to revised auto emission standards
France	2.3	1.5	1.5	-0.1	Negative impact from ongoing street protests
Italy	1.6	1.0	0.6	-0.4	Weak domestic demand and higher borrowing costs
Emerging Markets	4.7	4.6	4.5	-0.2	Slower growth in China, recessions in Turkey/Argentina
China	6.9	6.6	6.2	0.0	Fiscal stimulus does not offset the impact of US tariffs

Besides GDP projections, there are numerous other leading economic indicators that are suggesting that global growth will continue to slow. Some of which include:

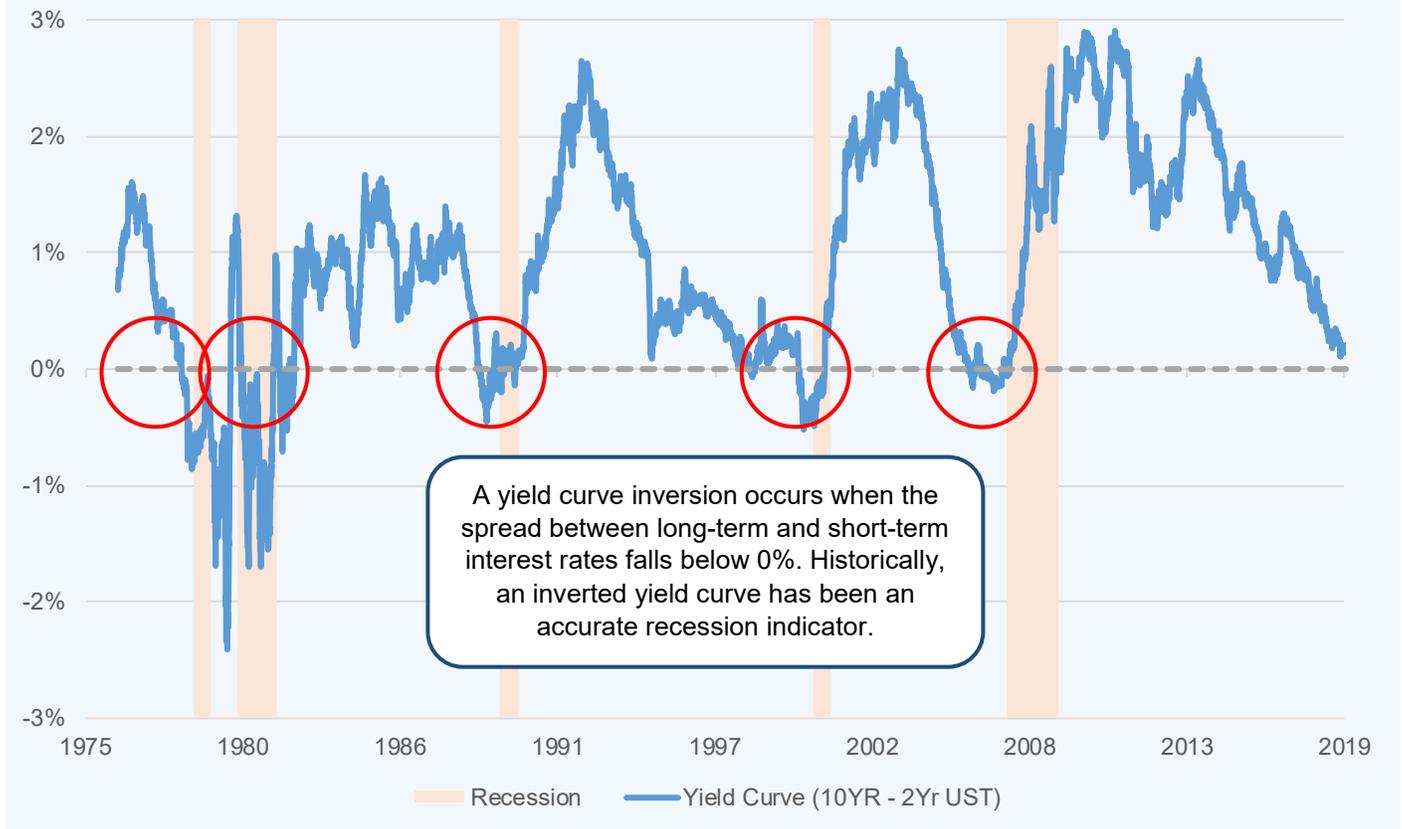
- **Manufacturing indexes** in many leading economic areas, such as the US, Eurozone, and China have been on the decline as shown in **Figure 3**. These indexes reflect strength in the manufacturing sector, which is a key economic indicator because manufacturers must respond quickly to changes in demand – either by ramping up or scaling back operations. A level above 50 indicates an expansion of production whereas a level below 50 indicates a contraction. The further away from the 50 level, the more the extreme expansion or contraction. While the US manufacturing level (blue line) remains firmly in expansion mode, both the Eurozone and Chinese sectors have recently contracted suggesting that there is softening demand for finished products in these regions.

Figure 3: Manufacturing Indexes are Trending Downwards



- Corporate earnings growth** has also been a concern for investors as of late. After robust growth in 2018 due to lower corporate tax rates, earnings growth will return to a more normalized pace in 2019. For Q1 2019, the S&P 500 Index is projected to experience a -3.7% decline in earnings. If -3.7% is the actual decline for the quarter, it will mark the first year-over-year decline in earnings for the index since Q2 2016. For the full year though, earnings growth is still in line to hit 4%, which is a far reach from last year's 21% expansion but still relatively healthy.
- Perhaps the most ominous leading economic indicator in Q1 was the **inversion of the yield curve** in March. The yield curve has inverted prior to all nine U.S. recessions since 1955. Furthermore, there has only been one instance when an inversion wasn't followed by an official recession within two years or less. That is a pretty accurate indicator. Don't panic though, as there is on average a twelve-month lag between when the curve first inverts and when the recession begins. The reason that the yield curve has been a harbinger for recessions is that the curve is the spread between long-term interest rates and short-term interest rates. When the curve inverts, it means that short-term interest rates are higher than long-term interest rates. This is bad news for banks because their borrowing costs are primarily tied to the short end while they make money lending on the longer end. When the curve inverts, they have less incentive to lend, which slows the growth of the economy as liquidity dries up.

Figure 4: The Yield Curve has Inverted Prior to the Last Five Recessions



Evidence for a Light Shower: Why a recession is not on the horizon

While there is little doubt that growth is slowing, it may be transitory. There are many instances where global growth has slowed but not declined into a recession. For example, growth decelerated in 2015 and 2016, only to resume its upward pace again in 2017 and 2018. There are many positive signs that we may be in the midst of a similar situation and perhaps the worst is behind us.

Central Banks are Taking Action - Maybe the most important factor in recent stock market rally has been the action of the US Federal Reserve. Prior to Q4's sell-off, the Fed was adamant that they would continue to raise rates and tighten financial conditions well into 2020. This was a large driver of the Q4 market swoon as stocks feared the Fed would tighten financial conditions to a point where the economy would churn to halt. Since then however, the Fed has completely reversed its position and in the most recent meeting, they announced that they would not raise rates in 2019. Since lower rates tend to spur lending and economic activity, the Fed's more accommodative stance should give the economy more room to run.

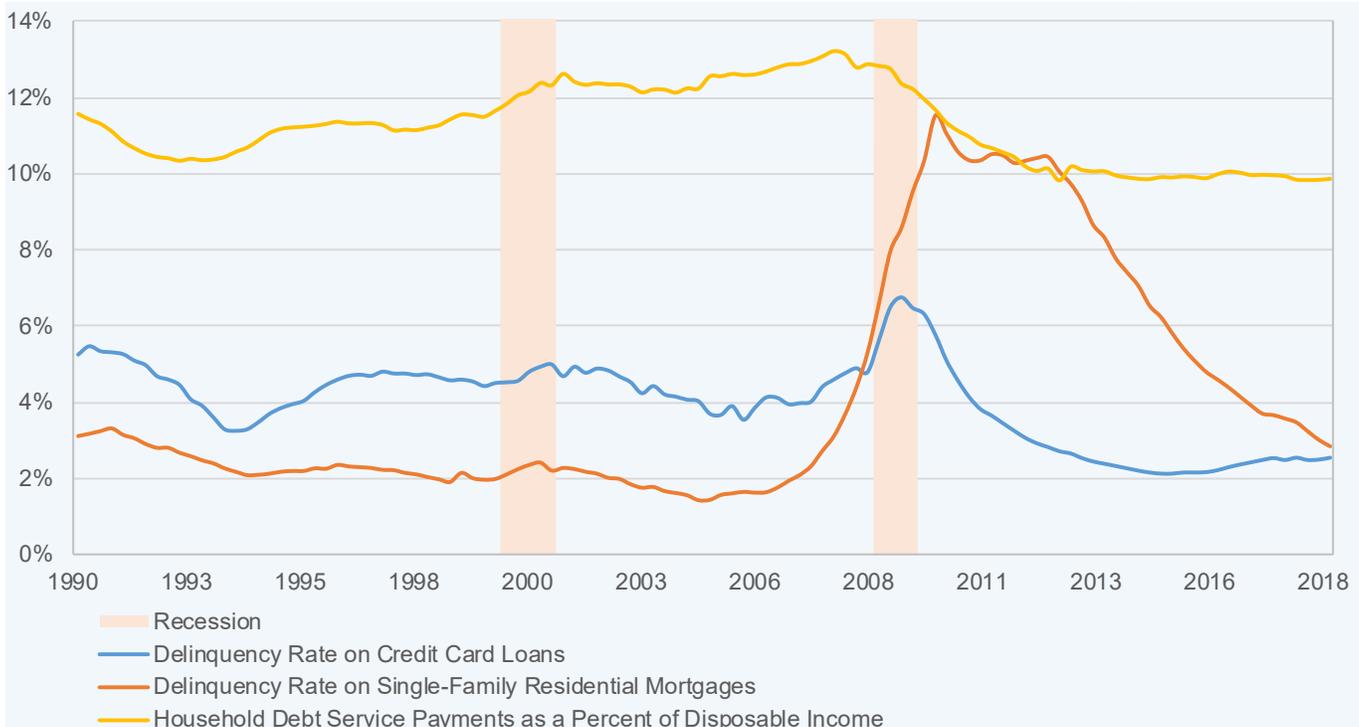
Not only has the Federal Reserve backed off, but other major central banks have also taken steps to reverse the slowdown in growth. The European Central Bank announced it would resume its quantitative easing measures later in the year and the People's Bank of China has been aggressively injecting liquidity into its economy since the end of last year. While there is fear that at some point central bank ammo will run out, for now their actions have certainly helped rescue assets from their Q4 freefall.

US Consumer is Healthy - The US consumer is in a strong position. Why is this important? Well, consumer spending drives over 70% of US GDP growth. From 2001-2010 the correlation between the share of consumer spending in GDP in a given year and real economic growth rate in that same year was -0.58. This suggests that when US consumer spending declines, US GDP growth tends to follow.

Not only does the US consumer drive domestic economic growth, but it also serves as a locomotive for the entire global economy. Our consumption habits lead to significant demand for global exports which in turn drives growth in export-oriented economies, such as China and Japan. As such, the US consumer is one of the most important inputs into the global economy and as the health of the US consumer goes so does the economy. The two main factors to test for consumer health are household wealth and employment.

- Wealth:** Similar to determining the financial health of a company, a good place to start to determine a consumer's health is to look at the household balance sheet. A consumer with too much debt on their balance sheet may not be able to spend as much in the future as their borrowing costs go up. They may also begin to default on some of their loans if they are unable to make payments. Thus, two important indicators to watch are household debt as a percentage of income and loan delinquencies. **Figure 5** shows household debt service payments as a percentage of disposable income (yellow line). This ratio shows the percent of income that goes to making interest payments. When the number is too high, the consumer becomes over leveraged and may begin defaulting on debt, which brings us to our second indicator – loan delinquencies. **Figure 5** also shows delinquency rates on two of the largest sources of household debt – credit cards (blue line) and mortgages (orange line). Both credit card and mortgage delinquencies are at relatively low levels, which suggest that the US consumer is maintaining healthy levels of spending. Leverage is down significantly since the last financial crisis which supports the fact that delinquencies are not at alarming levels.

Figure 5: US Consumer Leverage & Delinquency Rates are Trending Lower



- Income:** A healthy consumer balance sheet is maintained by strengthening levels of income. When the economy is robust, companies are usually trying to increase capacity and thus they tend to hire more workers. This causes the unemployment rate to decline. The opposite is true when the economy is in bad shape. Companies tend to put hiring on hold and even might issue layoffs which causes the unemployment rate to rise. As **Figure 6** shows, the US unemployment rate is at its lowest level in over 50 years. Not only is employment important, but so is annual wage growth. Over time the cost of goods and services tends to rise, an effect known as inflation. When a worker's wage growth is less than the rate of inflation, they will be in a worse situation a year from now because the cost of living has increased, but their wages have not kept pace. Until recently wage growth had been stubbornly low – an issue that has pestered economists. Over the past year, however, it has averaged over 3% annual year-over-year growth which is healthy figure.

Figure 6: US Unemployment Rate is at 50 Year Lows



When looking at both household wealth relative to debt and current employment levels, the US consumer is in a much better spot than prior to the Great Recession. So even though growth may be slowing globally, its most important engine – the US consumer – is still chugging along.

The Verdict: Bring an Umbrella

In Q1, stocks were telling one story, with bonds telling another. While the truth will come out eventually, investors don't have time to wait until after the fact to position their portfolios. Leading economic indicators such as manufacturing indexes, corporate earnings, and the yield curve suggest a slowdown ahead. However, two powerful players, central banks and the US consumer appear that they may be able to stave off a recession. Finally, major events (Brexit and US/China negotiations) will play a large role in determining whether stocks or bonds were right, but it is still too early to tell how these political events will play out. The longer negotiations are drawn out, the more severe the repercussions will be for long-term growth.

We believe that despite the best efforts of central banks, a global slowdown is inevitable. Hence we have positioned our portfolios in a defensive manner being underweight to both equities and credit relative to the benchmark and overweight to cash. While we do not see anything structurally wrong with the economy that would warrant a substantial deviation from one's long-term allocation, we do think that stock prices have gotten ahead of themselves and are due for a pullback. Slowdowns are part of the economic cycle and if one does develop, we are ready to take advantage of price dislocations and put the extra cash to work. We hope that stocks are right but are prepared if bonds are the ones telling the truth.

Important Disclosures:

Past performance is no indication of future results. Investing in securities involves risk and the possibility of loss of principal. Investing should be based on an individual's own goals, time horizon and tolerance for risk. The views of Miracle Mile Advisors, LLC ("MMA") may change depending on market conditions, the assets presented to us, and your objectives. This research is based on market conditions as of the printing date. The materials contained above are solely informational, based upon publicly available information believed to be reliable, and may change without notice. MMA makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to tell you when opinions or information in this report change. MMA shall not in any way be liable for claims relating to these materials and makes no express or implied representations or warranties as to their accuracy or completeness or for statements or errors contained in, or omissions from, them. This report does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities discussed in this report may not be suitable for all investors. MMA recommends that investors independently evaluate particular investments and strategies and encourages investors to seek the advice of a financial adviser. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. This report is not an offer to buy or sell any security or to participate in any trading strategy. In addition to any holdings that may be disclosed above, owners of MMA may have investments in securities or derivatives of securities mentioned in this report and may trade them in ways different from those discussed in this report. The value of and income from your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in your securities transactions. Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data. The information and analyses contained herein are not intended as tax, legal or investment advice and may not be suitable for your specific circumstances; accordingly, you should consult your own tax, legal, investment or other advisors, at both the outset of any transaction and on an ongoing basis, to determine such suitability. Legal, accounting and tax restrictions, transaction costs and changes to any assumptions may significantly affect the economics of any transaction. MMA does not render advice on tax and tax accounting matters to clients. This material was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax laws. The projections or other information shown in the report regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Physical precious metals, real estate, emerging markets and other more opportunistic credit investments are subject to unique risks which include but are not limited to liquidity, rate volatility, currency fluctuations and controls, restrictions on foreign investments, less governmental supervision and regulation, and the potential for political instability. In addition, the securities markets of many of the emerging markets are substantially smaller, less developed, less liquid and more volatile than the securities of the U.S. and other more developed countries. This report or any portion hereof may not be reprinted, sold or redistributed without the written consent of MMA.

Figure 1: Stocks and Bonds Diverged in Q1. The chart shows the S&P 500 Index level (left axis) and the yield on the 10-Yr US treasury (right axis) from June 2016 to March 2019. Source – Ycharts.com

Figure 2: GDP Growth is Decelerating across the Globe. Shows regional GDP growth for 2017 as well as estimates for 2018 and 2019 from the IMF. Source – International Monetary Fund as of January 2019.

Figure 3: Manufacturing Indexes are Trending Downwards. Shows the production manager index (PMI) for the US, China, and Euro Area over the last year (March 2018 to Feb. 2019). Level above 50 signals expansion while reading below 50 signals contraction. Source – Ycharts.com

Figure 4: The Yield Curve has Inverted Prior to the Last Five Recessions. Shows the spread between the US 10-Yr and 2-Yr Treasury from 1970 to 2019. Source – Federal Reserve of Economic Data.

Figure 5: US Consumer Leverage & Delinquency Rates are Trending Lower. Shows the delinquency rate on credit cards (blue line) and single family mortgages (orange line) as well as the household debt service payments as a percent of disposable income (yellow line) from 1990 to 2018. Source – Federal Reserve Economy Data

Figure 6: US Unemployment Rate is at 50 Year Lows. Shows the US unemployment rate from 1972 to 2019. Source – Federal Reserve Economic Data