ASTOR INVESTMENT MANAGEMENT | FUNDAMENTALLY DRIVEN.

OUTLOOK 2019

The Economy: Is It So Good It's Bad?

If a recession happens in an economy and no one is around to feel it, did we really have a recession? It's more than just an interesting philosophical question.

During Q4 2018, the markets acted as if a recession was coming. In fact, I heard many cries that one was already upon us.

But aside from the market, nothing else I observed was consistent with a recession or even a looming slowdown. It helps to remember that a recession isn't defined by what the market does. It's defined by two consecutive quarters of economic contraction, or sustained deterioration of multiple economic data points such as unemployment and GDP, and that surely wasn't happening.

It's true that recessions can conceivably be caused by Federal Reserve policy, and trade also has had an impact on the U.S. economy in the past. But with unemployment at extremely low levels below 4% and wages increasing at more than 2%, that's hardly a picture that looks like a recession, right? Or does it?

So, what has had investors so rattled about the economy and the market? Politics as usual and trade war rhetoric notwithstanding, it comes down to one thing in my view: volatility.

2018: The Year of Living with Volatility

If we look back at 2018, the one theme consistent throughout the year was volatility. Early in the year, we had a huge spike in volatility and an aggressive sell-off, just as the "sugar high" from the tax cuts were wearing off. That did some damage to confidence among investors and traders, alike.

The rally that followed was underappreciated, as concerns about the future direction of interest rates and employment accelerated. By the end of Q3 2018, investors were convinced that the coast was clear, and the markets reacted by putting in an all-time high for the year. No sooner had Q3 ended when volatility struck again, and the markets began one of the most aggressive 90 days of sell-off I've seen in years. Blame was put on program traders, the Fed, or a lack of buyers who left early for a holiday break. Whatever the cause, though, the economy barely flinched.

Throughout the year, our proprietary Astor Economic Index® (AEI) reflected a growing economy. That, in turn, supported high levels of beta (i.e., equities exposure) in our investment portfolios. We've said it before, and we'll say it again: we're not market timers. While we don't ignore the market, we don't respond to every zig or zag. We keep our eye trained on the AEI and the economy.

Markets don't go up or down in a straight line. Therefore, reacting to the market is unlikely to achieve your objectives. (For example, selling everything in December would not have been a good idea.) I have found that gradual adjustments at various time intervals produce better entry/exit points. From my viewpoint, employment trends (payrolls, jobless claims, etc.) and output trends (ISM, GDP) in 2018 were at levels that were unlikely to decline fast enough or hard enough to create a contraction.

Going into year-end 2018, retail sales for the holiday shopping period set records as consumers had more disposable income from higher wages and benefited from lower oil prices. The December jobs report was one of the strongest in years (adding an upside surprise of 312,000 jobs during the month), with revisions all upward.

And as if right on cue, the Fed made it clear that it would not raise rates indiscreetly, as the market had feared, and reiterated its data dependency. The market bounced back aggressively—but not enough to end the year in the black. But why the walk back from the Fed, do they see something? Do they also think it's so good it's bad?

But I want to reiterate an important point from the 30,000-foot view. As we said a year ago, given our expectation of higher volatility in 2018 (which the market delivered—and then some), a down market would not be out of line when looking at performance over a three-year period. In other words, one down year in 2018 would not be "off trend" when looking at market performance in the aggregate over a three-year or longer timeframe. So, volatility notwithstanding, the market maintained its overall upward trend.

So where does that leave us now? For starters, we found some very compelling statistics. We reviewed six major historical market declines in the level of the S&P 500 (at least 10% drawdowns, measured monthly) that were not directly associated with a recession. What we observed was that from the month the S&P 500 entered a 10% drawdown, 12 months later the market was up an average of 20%. But to be clear, these are the returns when drawdowns were not followed by a recession. All bets are off if the economy contracts.

10% Drawdown Begin Date	Drawdown %	12-Month End Date	12-Month Return
05-31-1977	-10.6%	05-31-1978	1.2%
10-31-1987	-30.2%	10-31-1988	10.8%
08-31-1990	-15.8%	08-31-1991	22.6%
08-31-1998	-15.6%	08-31-1999	37.9%
06-30-2010	-13.1%	06-30-2011	28.1%
09-30-2011	-17.0%	09-30-2012	27.3%
Average Drawdown		Average 12-Month Return Following 10% Drawdown	
-17.1%		21.3%	

Source: Bloomberg, Astor

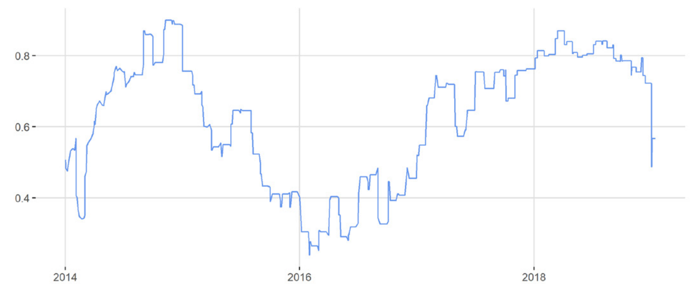
Now, let's look at where we are now and what, in our view, we could face this year.

2019: What Could Be In Store

As we enter 2019, the economy is still on solid footing. Can a recession of any magnitude occur when 96.1% of the workforce is employed and earning and spending more money? Probably not. Corrections in stocks? Sure, that happens. Repricing of risk due to uncertainty? Again, it happens. In this current environment, though, a full-blown wealth-destroying economic downturn, in my view, is unlikely. But this year, that environment ***could*** change.

The current economic expansion is one of the longest on record, but also among the weakest that we've seen. Expansions don't die of old age; rather, they get murdered! Can't tell you who/what the killer will be, but it won't be age.

Astor Economic Index® 2014 to date



Source: Astor

There is a case for caution. Given the proprietary way Astor looks at economic data, this could be the first time in many years that it wouldn't take many disappointments in a few data series to reduce beta exposure. Further acceleration in economic growth is unlikely to have the same impact on the market; in fact, slowing growth will probably have a greater negative impact on the economy than the actual pace of growth might otherwise indicate.

The AEI being at such high levels could conceivably set the stage for beta reductions in our portfolios in response to what would appear to be limited declines in the data.

If economic growth does not remain above-trend, and should it drop below average, we could get defensive—even if the economy isn't contracting. Therefore, we'll keep our finger tightly on the pulse of the economy.

The good news is how Astor manages portfolios with gradual reductions in exposure, so we can react accordingly to economic deterioration if that occurs, and even change course if the data do not follow through. For 2019, I would expect a bit more activity in beta adjustments in the portfolios.

Let's look at some relevant data:

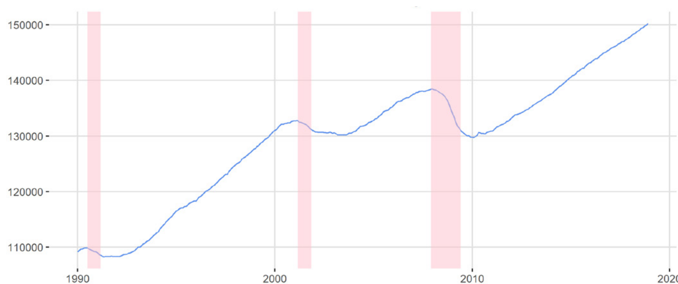
Employment

Jobless claims have been at historic lows for some time now. That's a good thing—for the economy.

Initial Jobless Claims, 4 Week MA

Source: FRED, NBER

US Non-Farm Payrolls



Source: FRED, NBER

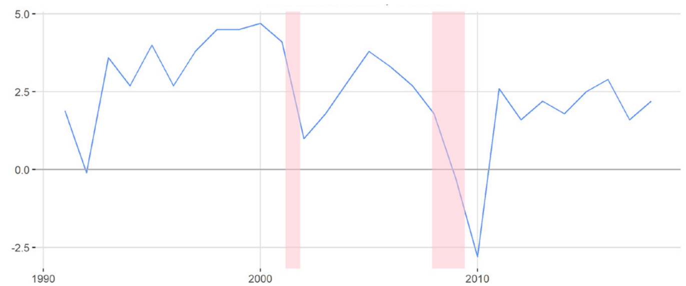
How long can the acceleration with claims and payrolls continue?

As time passes and the data gets pinned at an extreme, the impact diminishes as the economy strengthens. In other words, incremental increases in employment will have a decreasing impact on the economy. The offset is higher wages, which we've seen over the past 12-18 months. That has contributed to consumer spending, which makes up over 70% of GDP. On the other hand (yes, all economists have two hands to talk with), higher wages over time tend to be a large contributor to inflation. The economy runs a fine line between heading off inflation and killing job growth. Additionally, with employment trends at very high levels, smaller increases or slight decreases in the trend will likely result in lower AEI readings. Therefore in 2019, disappointing data will move us to defensive faster.

Output/GDP

Until recently, GDP has been at levels below those generally seen in recoveries and expansions. In recent quarters, GDP has picked up. As noted, with consumers working and enjoying more money, it's no surprise that consumer spending is supporting GDP. However, (and, yes, on the other hand) a long-time GDP average of 2.5% sets a pretty low bar for a scenario in which Astor could reduce exposure.

US Real GDP, Year Over Year

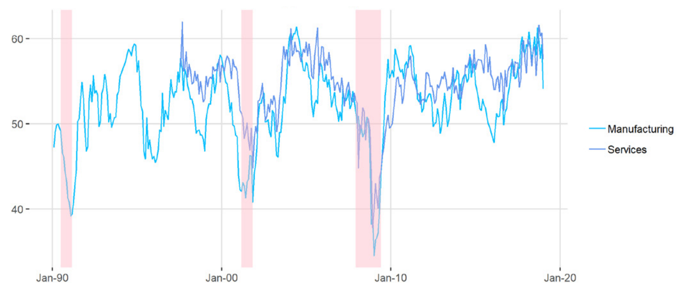


Source: FRED, NBER

Non-inflationary wage growth, a bounce in non-U.S. economies, and a resolution to trade disputes could support GDP growth. I expect some surprises to the upside from consumers and business investment.

Meanwhile, ISM has been a bright spot during the expansion, although more recently its rate of acceleration has stalled. It remains above the "50" level, which signals expansion.

ISM Purchasing Manager Indexes



Source: Bloomberg, NBER

Currently the data looks good. However, Astor, like the Federal Reserve, will be data dependent and back pedal a little bit on the positive expectations over the past several years. The data has been so good, that moving forward "less good" could cause us concern and lead to beta reductions.

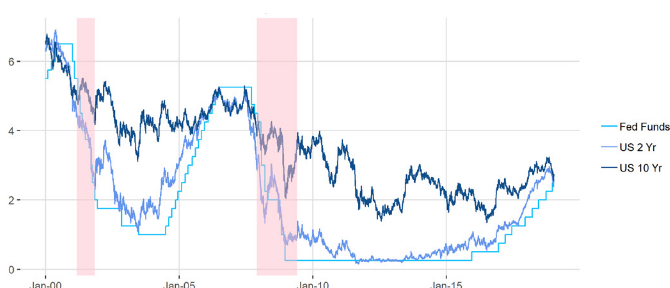
Interest Rates

There has been a lot of talk about interest rates lately. I find it surprising that many who aggressively spoke out against the Fed's zero-interest rate policy, claiming the economy and the stock market were being artificially inflated, are now chastising the Fed for raising rates too aggressively. Which is it?

Given the danger of deflation and the need to inflate the economy, the Fed's ultra-low interest rates and other mechanisms deployed for quantitative easing did produce a necessary and positive impact, in my view. As the economy matures (after all, it's been expanding for a decade), the time has come to "normalize" rates. Of course, the neutral level is a moving target. The exercise of raising rates, in and of itself, changes the neutral level, making it a much more difficult assessment.

Rates are still very low by historic standards, and in my view the economy can handle slightly higher rates. The two-year note, inflation, and GDP are all around 2.5%--that relationship should not be substantially out of line for continued growth.

Key US Rates



Source: Bloomberg, NBER

On the long end, there's a different story. Strong demand for risk-free assets globally is keeping long-term rates down and lowering long-term expectations for inflation. Since the Great Recession, lower levels of inflation have resulted from technological advancements, restructuring of the workforce, greater ability to control inventory, and changes in the way consumers purchase goods and services. This may create a new dynamic when interpreting the yield curve. I am not saying it no longer gives a signal; rather, it will need further interpretation when/if it occurs. For example, it most likely will take a longer time for an inverted yield curve to telegraph a contraction.

Bottom line: I think rates will come in below expectations, the Fed will fall short of the dot plot, and we will see interest rates in a range for a very long time—most likely years.

The Dollar, Commodities and Oil

The dollar has enjoyed a good run over the past few years, thanks to higher U.S. interest rates, the strongest global economy in quite some time, and political uncertainty. I don't see much of this changing in 2019. Trade has a big influence on currency, as do interest rate differentials. The trade drama has played out in the international currencies.

A stronger dollar makes imports cheaper and, conversely, exports more expensive for foreign economies. It would not be surprising to see tariffs partially offset by currency moves. This will likely create more volatility in the currency market, which is the biggest challenge for multinationals. A stable currency with visibility is the best-case scenario—but that is not the likely outcome in 2019, in my view. Currency moves are likely to have a negative impact on foreign stock markets.

In oil, more efficient energy consumption is likely to keep a long-term cap on prices. Of course, lower oil prices eventually create additional demand, which can support the price; but higher prices create additional supply and more interest in alternatives. This adds up to a range-bound oil market being likely for 2019, which could have a positive impact on the economy.

A Recession that Looks & Feels Different?

In summary, 2018 was an unusual year. Despite the volatility at the end of the year, the overall range was not too dissimilar from the average range. We just covered it all in 90 days.

Tax cuts are always debated as to their effectiveness. That debate aside, I do get concerned when debt grows faster than the increase in the stimulus from tax cuts. That happened in Q1 2018 but evened out a bit by Q4. This remains a concern in our view if growth doesn't surprise on the upside. In other words, we are borrowing for the growth—not growing from the tax breaks. Another interesting detail is that it's unusual to see stocks down in a year of tax cuts. This could be an anomaly—meaningless, but nonetheless noteworthy.

Also, of note about the economy are the diversity of growth and changes in the workforce. Given these factors, I believe it is quite possible that at some point we could see a recession in certain sectors, while other sectors are completely untouched. Different parts of the economy are less connected than they once were. This can create a smoother contraction than we've experienced in the past.

Think of it this way: does Google care about auto sales or interest rates? Does Uber care about healthcare costs or tax rates? Recession may feel different in the future.

Most investors, however, are expecting the next recession will look and feel much like the 2008-2009 financial crisis or even the tech boom-bust of the late 1990s and early 2000s. But in my opinion, the next recession, whenever it occurs, will be of the garden-variety type with more of an even impact.

During downturns, the markets are likely to perform differently as well. Rather than a swift, wealth-destroying move in stocks that shakes out the excess, downturns in the market could be softer, longer and more frustrating. The decline may not be as deep, but the recovery might take much longer. The next recession is more likely to frustrate than debilitate investors. The challenge will be having the patience to withstand it, if it occurs.

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