CONWAY • JARVIS LLC
Investment Outlook

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The R Word

Recession: Defined as negative GDP Growth for two or more consecutive quarters. That's the word being widely trafficked in the media these days. Outside the US, there's a contraction occurring in the Rest of the World ("RoW"), raising concerns for the global economy. The trade conflict has become a war, weaponized with tariffs. The UK is looking like it will crash out of the EU. Germany, the economic engine of the EU, is teetering on the verge of its own recession. Many are asking, and rightly so, whether recession in the RoW could spread to the US. Presently, the markets and economic data tell the story of a healthy US continuing in its expansion while the RoW languishes. As investors, we remain focused on the *data* and leave the headlines to traders. We're continuing our drama-free assessment of risks to the US economy that we've identified and monitored over the past several years.

Divergence in the Markets Tells a Story

"Recession". Commentators in the visual media throw that term around as a "Hot Take" to dissuade you from changing the channel. What usually follow are opinions from investment professionals on both sides of the question. Occasionally, there are a few favorite and trusted experts that we follow who provide nuanced perspective and insight regarding the economy and the markets. Not one of them discards the *possibility* of recession in the US, but they enlighten us as to what conditions and events could end the current expansion and negatively impact the markets. Before we look ahead to what *might* happen, it's instructive to look back on what *has* happened in the past year from the perspective of an *investor*.

Looking at the treasury market indicates a growing Risk-Off tenor among investors outside the US. That would explain negative bond yields abroad and a moderate inversion of the short end of the US treasury yield curve. Uncertainty in Europe and the Emerging Markets ("EEM") have prompted a diversion of foreign sovereign and institutional funds to the US for safety's sake. With the US 10-year treasury rate currently at 1.75%, the desire for dollar-denominated assets has pushed the total return *with price appreciation* to more than 10% for the twelve months ending August 31. That's historically significant as stock returns for that same period pale by comparison. That's the definition of Risk-Off.

Global stock returns from the major markets tell a story of *where* greater levels of economic risk are perceived. The S&P 500 and DOW have returned 1.8% and 3.4% for those same 12 months. The NASDAQ, feeling the chill of government regulation over the Tech sector, was up a mere .6%. Developed Foreign ("EFA") and the EEM *lost* 3% and 4.4% respectively. From our perspective, that divergence points to a bifurcation among the theaters of the global economy. The winners: Those that fully embrace private sector entrepreneurship and market solutions through fiscal policy and the losers: those that rely on monetary policy and government to drive their economies.

Taken as a whole, the stock and bond markets are suggesting that the US has done the heavy lifting for the global economy for the past five years with an occasional assist from China. That changed early last year as the trade conflict with the US escalated. Since then China's stock market has under-performed even that of Europe and EFA by a wide margin while the S&P 500 has soldiered onward near its record high. This divergence has become even more apparent in the past six months with a S&P 500 return of 7% compared to EFA's 1% while China has fallen into negative territory (-5%). It's clear that the US and its strong dollar has become a haven for stock and bond investors throughout the RoW. For Now. How long that persists depends on what transpires in the next 12 to 18 months with regard to our identified risk factors.

Risks to the Economy

The decline of the Industrial/Manufacturing sector in the US has leveled off in recent months while Consumption remains robust. We could see the 2% GDP growth for Q2 continue through the end of the year. That's the good news. Regardless of how the US stock market has out-performed the RoW recently, opinion among investors remains divided as to what extent the global slowdown will affect the US economy. While we see the US expansion continuing into next year and perhaps beyond, Brexit, the Trade War, or a misstep in fiscal policy could change our outlook.

The Fed:

A monetary policy misstep has been obviated by the Fed's agile pivot from tightening to easing. While holding to their mandate for inflation and employment targets, they've peeked at the RoW and have aligned their policy with declining rates in the treasury market. They cut rates in July and we look for an insurance cut this month. **Our risk level remains at Benign.**

Trade War:

A lack of bi-partisan support on trade has emboldened China to dig in and forestall a meaningful and enforceable resolution prior to the general election. Talk of tariffs escalating has begun to negatively impact certain components of the economy. Manufacturing facilities and supply lines are being altered in response and those costs will weigh on margins for companies doing business in China. That effect could show up in the data and earnings by year-end. However, there's a hint of optimism. We're seeing signs that the actual *enforcement* of some announced tariffs may be deferred well into the future in anticipation of a constructive meeting between the principals. **We maintain our risk level at Significant**

Europe and the Global Economy:

New leadership has emerged in the UK. It may be short-lived. Boris Johnson has threatened to crash out of the EU with or without a deal on October 31st. A growing faction in Parliament favor kicking that can further down the road with an extension of the deadline. The European Central Bank ("ECB") has employed negative interest rates in the EU. Sweden, Denmark, Switzerland, and Japan have done the same. The Pound and Euro continue to weaken. The contraction in Europe threatens a recession that would have a global impact. All eyes are on the next GDP data point for Germany. **We maintain our risk level at Significant.**

Political Cycle:

The election process holds the potential for a change in fiscal policy. Any change in fiscal policy holds the potential to be viewed by the markets as a misstep that could derail the current economic expansion. Until a candidacy and platform from all participants is known, **We maintain our risk level at Moderate.**

The Outlook

We've already checked the box for a Fed that's acting prudently and rationally despite heavy criticism from some quarters. Any abandonment of our current fiscal policy *at a time of global economic stress* could leave the US vulnerable to *importing* a recession from outside our borders. That would be a first, but we've experienced a few firsts in the past decade so it's not unthinkable. At the current time, we can only entertain a possibility of that occurring. It is nowhere near becoming a probability. Looking ahead through the first half of next year, and absent any unanticipated event, a recession doesn't appear on the menu for the US economy.

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