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Q4 2019 | Capital Markets Outlook

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Facing facts of a creeping contraction

As we enter the final quarter of the decade, the signals of late cycle behavior continue to grow louder. But, as the old trader adage says, "nobody rings a bell at the top." We do not believe this is the time to sell everything and run. However, tactical caution is warranted, and it is evident in our current positioning. We are taking lower-than-average risk across asset classes.

What follows is a rundown of the most worrying items on our macro radar, as well as a couple of caveats that are keeping us from getting more bearish.

Wishful thinking

First, we want to push back against a narrative that emerged in the financial press at the end of the third quarter. This argument asserts that U.S. growth has bottomed and is turning for the better. The most popular datapoint in this narrative is the Citi U.S. Economic Surprise Index. This index indeed *has* been strong in the third quarter. However, when citing this index, most commentators ignore an important fact: This indicator shows how high frequency economic data tracks *relative* to consensus forecasts of each item.

For example, on September 24 the Conference Board released results for its monthly survey of consumer confidence. The median forecast for that release as measured by those submitting forecasts to Bloomberg was 133.0 and the actual survey came in at 125.1 — a

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY		●	
U.S. large cap		○	●
U.S. small cap		●	
U.S. value		●	
U.S. growth		●	
Europe		●	
Japan		●	
Emerging markets		●	
FIXED INCOME	●		
U.S. government	○	●	
U.S. investment-grade corporates	●		
U.S. mortgage-backed			●
U.S. floating-rate bank loans	●		
U.S. high yield	●		
Non-U.S. developed country	●		
Emerging markets	●		
COMMODITIES	●	○	
CASH			●

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro			●
£ Pound			●
¥ Yen	●		

negative surprise relative to expectations. Putnam, like Citi, also tracks this high-frequency macroeconomic data. We standardize the magnitude of surprise by the historical volatility around those expectations. This step gives us some sense as to whether the "beat" or "miss" is large or small. We then track those readings through time [see Figure 1]. Our historical perspective gives us context for comparison. While U.S. economic data has indeed been coming in better than forecasts, that does not mean the data has been *good*.

Figure 1:

U.S. economic data surprises are close to neutral, not positive

Putnam GAA U.S. Surprise Index 3-month level change

Source: Putnam.

Don't focus on one indicator

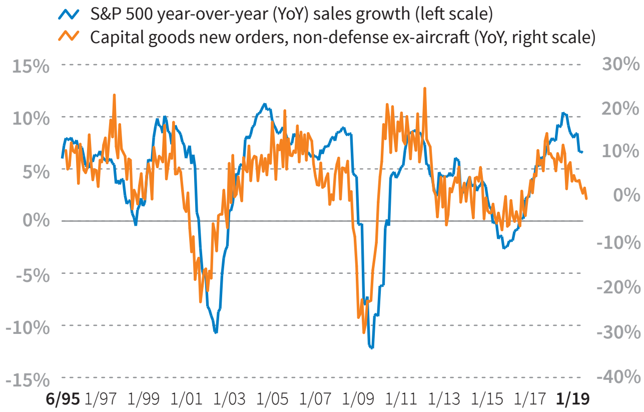
We are often asked what indicators we use to judge the risk of recession. Our response is that forecasting the probability of recession is fraught with peril from an econometric perspective. Recessions have been few and far between from a statistical perspective. The National Bureau of Economic Research (NBER) has officially date-marked 11 recessions since the end of World War II. Together recessionary months total 122. That's 14% of months from August 1945 through September 2019 — assuming we are not now already in a recession! The NBER, to muddy the waters even further, does not use the popular recession shorthand definition of two consecutive quarters of declining real GDP. Instead, the NBER considers a whole host of factors. It uses phrases like "a significant decline in activity" and "a period of diminishing rather than diminished activity." This puts greater emphasis on monthly data. So, suffice it to say that the statistician in us is loath to try to put a point estimate on a phenomenon so infrequent and having such an opaque definition.

Manufacturing is weakening

Now, to return to discussing the myth of a turn in the U.S. economy. Over the past couple of quarters, we have discussed at various times the abysmal economic data coming from Germany and South Korea. These two large economies are bellwethers for global manufacturing given their outsized dependence on exports. In September, South Korean exports fell at a 21.8% year-over-year rate, worse than at any point during the commodity-induced slowdown in 2015–2016. In Germany, the IFO Institute's survey of business conditions recovered a bit from August. However, it is still at the lowest levels since the eurozone sovereign credit crisis in 2011–2012. And, as we have said before, while the U.S. economy is somewhat of a closed system (less export-dependent), S&P 500 profits are not. Mega-cap U.S. company revenues and profits are highly sensitive to global capital expenditure trends [see Figure 2].

Figure 2:

S&P 500 revenues follow CapEx



Sources: Putnam, Bloomberg, U.S. Commerce Department.

Summing up the data

All of this data is important. Our thinking about recession risk results from a large mosaic of information. As asset allocators, we care about how markets will react. We care very little about whether the NBER will declare a recession.

We view the current deterioration in activity as very slow moving. As such, it seems possible that what we see as a gap between risk asset prices and fundamentals could persist for a bit longer. Having said that, we take very little solace in the bull's argument that stocks are the only alternative. The volatility spikes over the past year (in the fourth quarter of 2018 and in May and August of this year) are likely to persist and are typical "late-cycle" behavior.

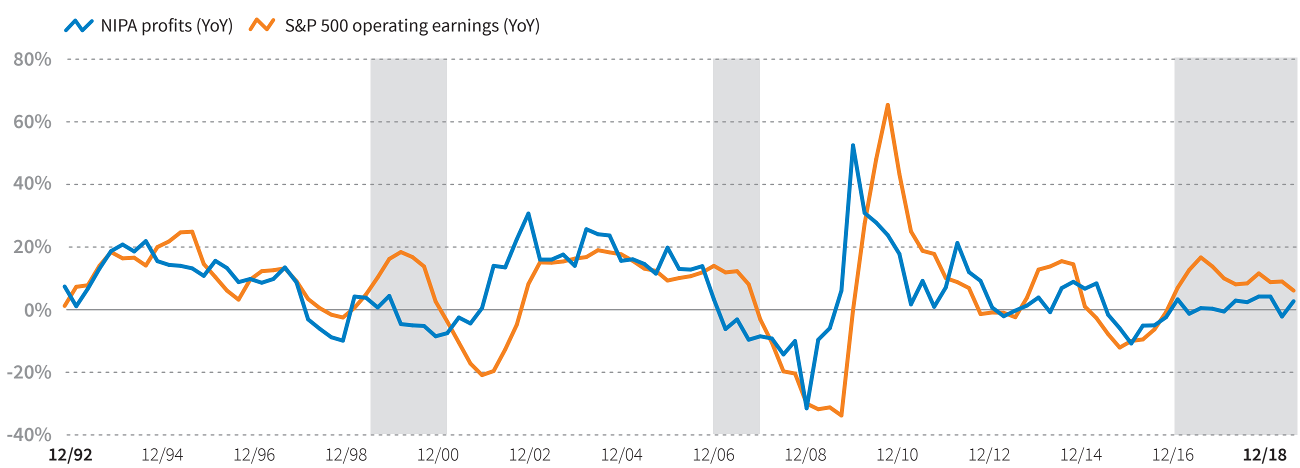
Profits remain at risk

Another classic late-cycle phenomenon is the large downward historical revision to the Fed's measure of corporate profits across the whole economy from their flow-of-funds data. This news was underreported. The Fed posted a downward revision to the data over the past several years. It shows the corporate sector essentially posted zero growth in profits since mid-2015. Ahead of both the bursting of the tech bubble in 2000 and the global financial crisis in 2008, S&P 500 reported operating earnings growth began to fall at a faster rate than the Fed's measure of the aggregate profitability of the entire U.S. corporate sector [see Figure 3]. Aware of this history, during the third-quarter earnings season we will be paying close attention to corporate commentary about growth expectations and capital expenditures.

Our overall asset allocation positioning is little changed from the previous quarter. We are now only very slightly overweight U.S. large-cap equity and are neutral on duration, but we continue to be under-weight riskier parts of the credit market as well as underweight commodities.

Figure 3:

Profits in broad U.S. corporate sector tell an unpleasant story



Sources: Bureau of Economic Analysis (NIPA — national income and product accounts) and Putnam. Past performance is not indicative of future results.

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