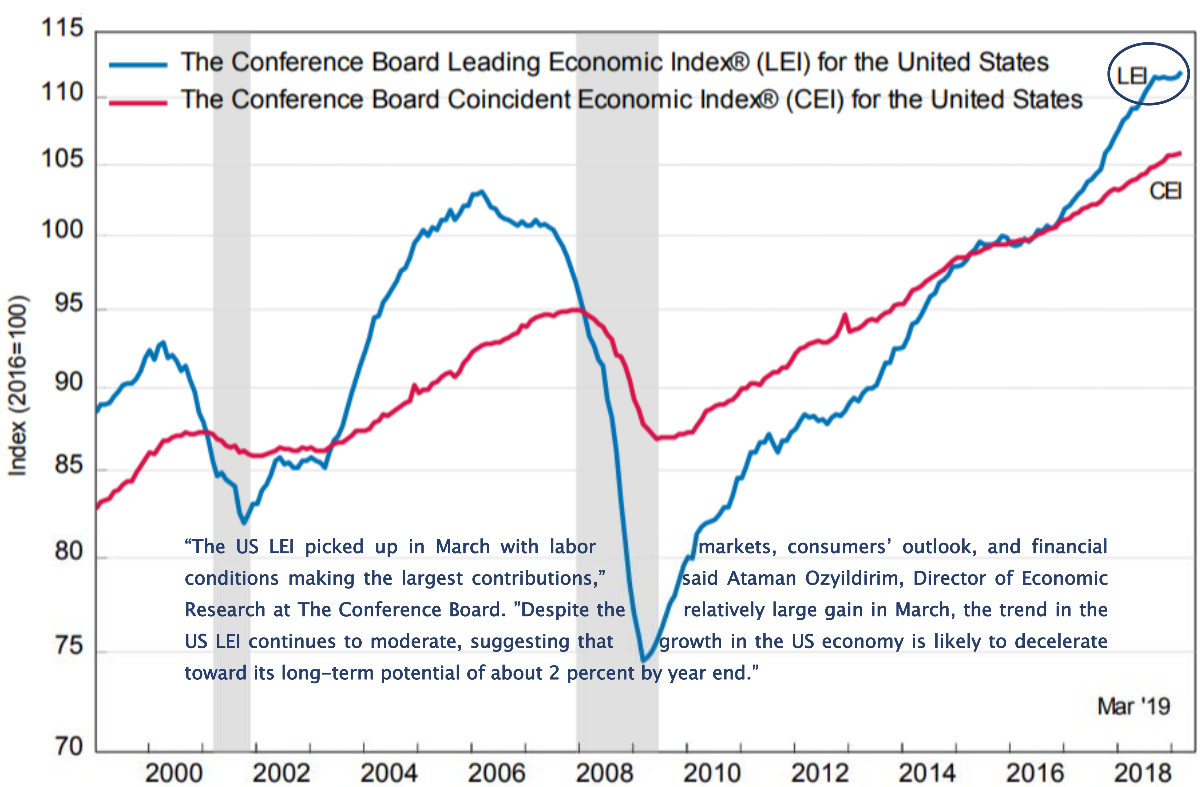
ECONOMY DECELERATES TOWARD MORE SUSTAINABLE PACE

A RARE OPPORTUNITY TO QUOTE MYSELF

After equities tanked in the fourth quarter of 2018, I offered a bit of salve by writing, "Although the fears of 2019 differ from those of 2011, I suspect the 20% correction from which we now seem to be emerging will, in time, be relegated to being a blemish on the historical record that's no more significant than the [unremarkable period of time] I happened to circle [on a graph]." Of course I believed what I had written, but I had little idea the dip that fairly well nullified returns for the entirety of 2018 would be reversed as quickly as it so far has been. Here's a recap of returns during the first quarter of the year and thank you for remaining planted during a difficult period:

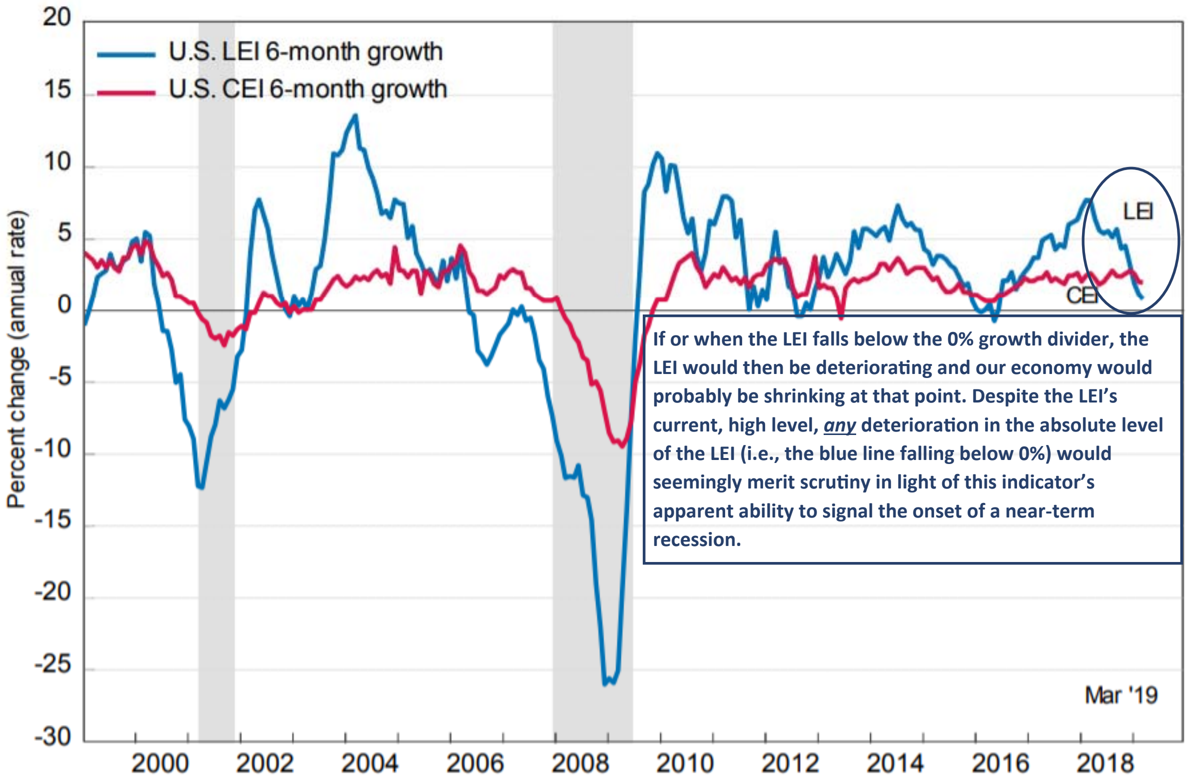
⇒ S&P 500 (large, domestic equities):	+15.0%
⇒ MSCI (emerging-markets equities):	+10.8%
⇒ NAREIT Equity REIT Index (real estate):	+17.2%
⇒ Barclays U.S. Aggregate (high-yield bonds):	+ 7.3%
⇒ Barclays 10-Year Municipal Bond:	+ 3.2%

LEADING ECONOMIC INDEX® IMPROVES A BIT MORE THROUGH MARCH ...



... BUT THE LEI SEEMS SET TO INFLECT

The following image depicts the rate of *change* of the Leading Economic Index. The circled area of the previous image indicates that the rate of improvement has recently begun to stagnate. That stagnation corresponds with a growth rate of approximately zero, as emphasized, here.



Latest LEI Trough March 2009, Latest CEI Trough June 2009
Shaded areas represent recessions as determined by the NBER Business Cycle Dating Committee.
Source: The Conference Board

One might assume that because the LEI is currently residing at a high, absolute level, the likelihood of a near-term recession may be remote. However, if you refer to the image on the previous page, you'll find that the *absolute* level of the LEI differed markedly prior to our two previous recessions. Regardless of the LEI's absolute level prior to the onset of our two previous recessions, the LEI did inflect sharply downward just prior to each economic event. Therefore, my sense is that one might pay less attention to the absolute level of the LEI and more attention to its relative rate of change. The LEI's rate of change has not yet lapsed into decline, but it appears to be on the cusp of doing so. With that, let's take a look at some other economic factors.

A DEAL WITH CHINA COULD LIFT THE OUTLOOK (AND THE LEI)

The prospect of a trade agreement between China and the U.S. seems likely. A deal is not yet at hand, but both sides continue to work toward one. Since each country has ample incentive to strike a deal, it seems safe to assume that the two sides will eventually find a solution. White House Economic Advisor, Larry Kudlow, said "We continue to make very good progress across the board."

For its part, Zacks Research thinks some kind of deal might be struck in May. If or when that happens, Zacks believes it could “usher in a multi-year rally which should take stocks to brand new, all-time highs.” Such a deal could also reinvigorate the LEI.

THE FED SEEMS TO POSE NO NEAR-TERM THREAT

In early April, the Federal Reserve released the minutes from its previous policy meeting. In short, it confirmed it was unlikely to raise interest rates this year. It later modified that release to indicate it was unlikely to raise rates for the foreseeable future. If the Fed believes the “foreseeable future” extends beyond 2019, this would be extra good news to investors since higher rates tend to reduce asset valuations. Or, the Fed might simply have been leaving its policy options open. Either way, the Fed’s current stance is unambiguously accommodative.

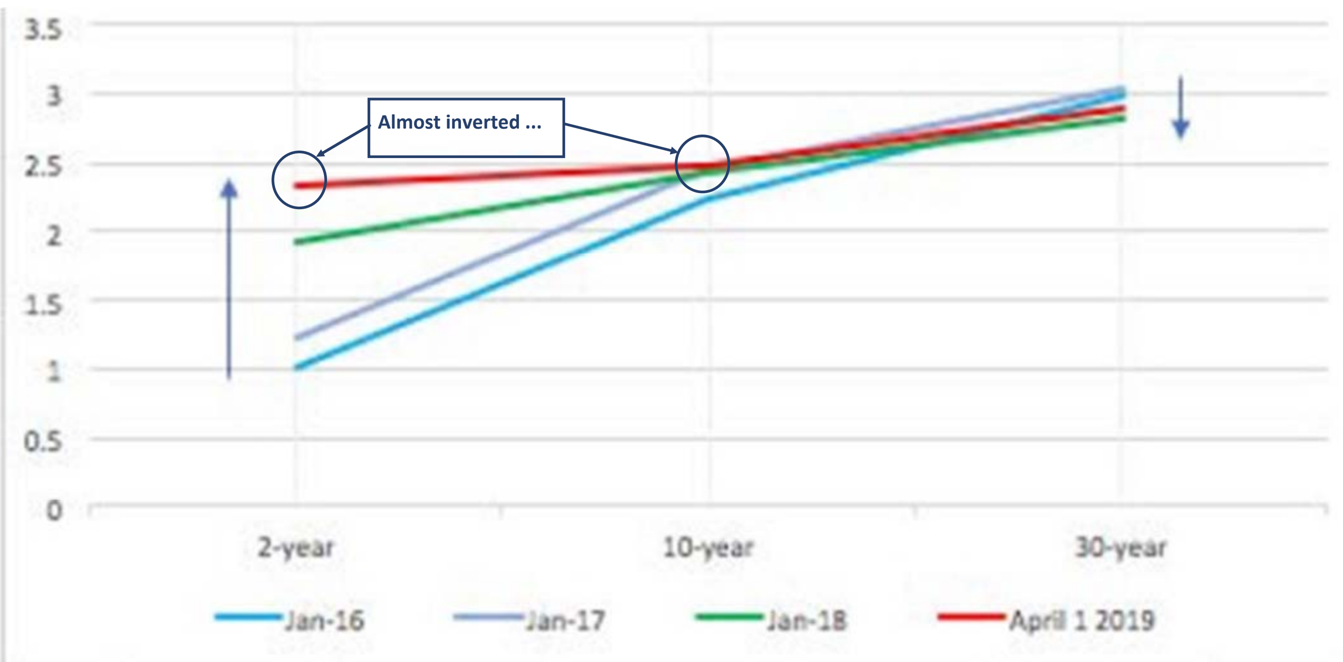
INTERNATIONAL MONETARY FUND SHAVES GLOBAL GROWTH OUTLOOK YET AGAIN

Last quarter, I shared a graph with you that suggested that most of the world’s developed economies were growing at rates that exceeded their sustainable maximums. In the context of that graph, I mentioned that the International Monetary Fund had reduced its 2019 outlook for global economic growth from 3.7% in October, to 3.5% in January. Since then, the IMF has further trimmed its 2019 growth outlook to 3.3% noting, “trade tensions and tariff hikes between the United States and China, a decline in business confidence, a tightening of financial conditions, and higher policy uncertainty across many economies.” Since the global economy has been growing at rates that appear to have been unsustainably high, these downward revisions from the IMF neither surprise nor alarm me. Global economic growth in excess of 3% would seem to leave plenty of good things on the table for investors.

THE POTENTIAL FOR AN INVERTED YIELD CURVE IS SPOOKING INVESTORS

To simplify this discussion, I'd like to begin by declaring (without proof) that the yields available from longer-term instruments generally exceed the yields available from shorter-term ones for a variety of reasons. Historically, however, this relationship has occasionally reversed itself.

As you can see below, the yields on shorter-term Treasury securities have risen substantially over the last few years while the yields available on longer-term ones have declined a bit. For reasons that are beyond the scope of this note, investors often compare the yields of 2-year and 10-year Treasury securities. To the extent yields on 2-year notes exceed those available on 10-year notes, the yield curve is considered to have "inverted." Because an inverted yield curve has often preceded the onset of previous recessions, investors sometimes conclude that a yield-curve inversion necessarily implies that another recession is imminent.



Source: The U.S. Department of the Treasury

INVERTED YIELD-CURVE HASN'T BEEN A DEATH KNELL TO EQUITIES

Even if the yield curve does eventually invert and even if an inverted yield curve can be relied upon to signal the next recession, it's worthwhile to know that stocks have actually tended to fare quite well between the time the yield curve inverts and the point at which a recession actually develops as some data compiled by Forbes shows:

2—10 Year Yield Curve Inverts	Recession Start Date	Months from Inversion to Recession	S&P 500 Price Return from Inversion to Recession
8/18/1978	2/1/1980	17.7	9.9%
9/12/1980	8/1/1981	10.8	4.3%
12/13/1988	8/1/1990	19.9	28.5%
5/26/1998	4/1/2001	34.7	6.1%
1/31/2006	1/1/2008	23.3	14.7%
Forbes: July 11, 2018	**Median**	**19.9**	**9.9%**
	Average	**21.3**	**12.7%**

Because an inverted yield curve is generally regarded as a signal of a forthcoming recession rather than the cause of it, and because the yield curve currently seems to be on the cusp of inverting, mutual fund sponsor Lord Abbett studied how accurately such inversions predict recession. In short, it found that curve inversions did tend to occur prior to a given recession, but it also found a number of false signals, i.e., instances where inversions were not followed by a recession.

I wonder if the folks at Lord Abbett read the same Forbes article I did and concluded that since recessions are a normally occurring part of our business cycle, a predictive signal that requires anywhere between 10 and 35 months to be correct is not usefully predictive. After all, if we're going to regard a signal that requires such long and variable lead times as being usefully predictive, I suppose it would then make sense to regard roosters that crow during the daylight hours as accurately signaling the next sunrise.

Because the stock market is forward-looking by its very nature, some investors believe pronounced market dips signal forthcoming recessions. Summing up the usefulness of this approach, famed investor Paul Samuelson once quipped, "The market has predicted nine of the last five recessions." After studying different indicators, Lord Abbett believes recessions are best predicted by indicators that track a wide variety of conditions such as the "Philly Fed" Index. The Leading Economic Index is constructed similarly.

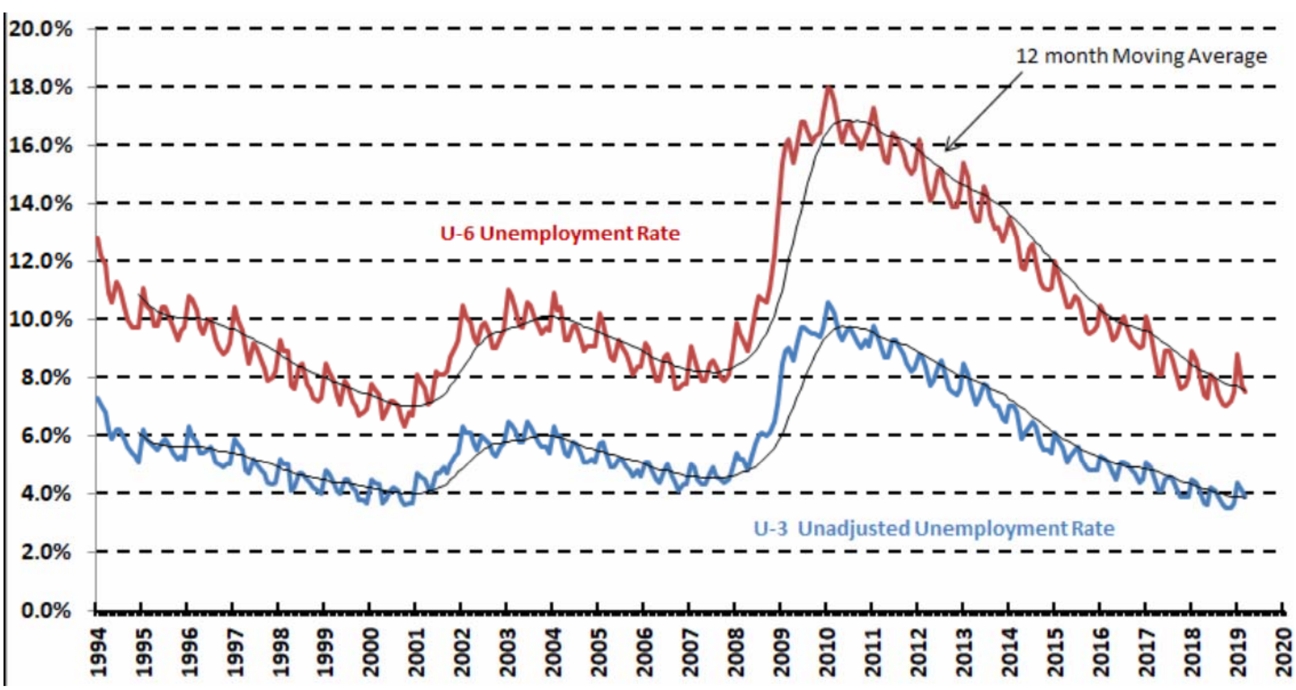
LOW MARKET VOLATILITY … A GOOD SIGN

Stock market volatility, as measured by the Volatility Index on the Chicago Board of Options Exchange recently reached it's lowest level since early October of last year (before investors became unnerved). Since the Christmas Eve selloff, volatility has declined by about two-thirds. When investors struggle to make sense of new information, volatility has tended to rise and stock prices have tended to decline. Recently, the converse situation exists, so stock prices have been drifting higher.

UNEMPLOYMENT REMAINS LOW & WAGES ARE RISING

At 3.8%, the unemployment rate remains historically low for an economy that's not on a war-time footing. (The rate fell to 2.5% in 1948.) A more relevant comparison would be to the 4.4% unemployment rate we had at the end of the 2007 expansion. February's much-weaker-than-expected employment report caused many to wonder if the good times were finally over but, as hoped, that report turned out to be an anomaly that resulted from the most recent partial government shutdown.

A more subtle measure of the health of the labor market is the so-called U-6 figure that accounts for people who would like to work, but who have become discouraged enough that they haven't looked for work recently enough to be counted among the unemployed. As you can see here, the employment situation looks pretty healthy.



Demand for qualified labor has begun to strain the supply of that labor, so wages are beginning to rise. For example, Bank of America recently raised its minimum wage to $17 per hour and indicated it would further raise that wage to $20 per hour (an 18% increase) by 2020. Similarly, Target recently increased its minimum wage from $12 to $13 per hour. By 2020, Target also intends to pay its help no less than $20 per hour. Compared to the $11 per hour it had been paying its lowest-paid workers during 2017, Target will have increased its minimum hourly pay 82% over that 3-year period of time, or by about 22% per year. Other than Ben & Jerry's, companies don't usually raise wages well in excess of the cost of living out of compassion or kindness. Instead, they raise wages because they need the help and because they believe it will benefit their business.

So far, the wage inflation that has taken place has not yet caused inflation to spike. To the extent companies are able to improve productivity enough to offset the wage increases that are now taking place, inflation could remain muted. The Fed might then remain on the sidelines with respect to interest rates, corporate earnings could continue to improve, workers could have more disposable income, and the standard of living for the workforce as a whole would continue to rise.

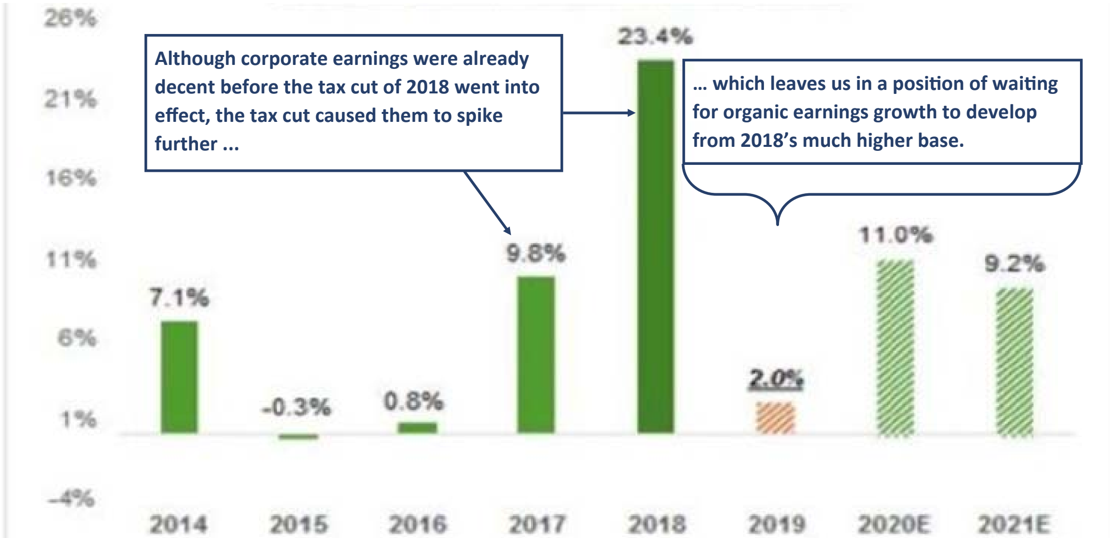
In case you didn't recognize it, I just described the virtuous cycle that has allowed the standard of living within the western world to leave regions that are captive to inferior economic systems in our metaphorical dust.

TOUGH CORPORATE EARNINGS COMPARISONS ... AT LEAST FOR A WHILE

As with the Leading Economic Index that's already at a lofty level, year-over-year corporate earnings comparisons have become difficult simply because the previous year's earnings were already so high. Because the tax cuts of 2018 are now baked into the previous year's earnings figures, we're now in a position of having to wait for organic earnings growth to reestablish itself.

For stock prices to press higher, investment math requires an expectation of continued earnings growth. Even if that growth stalls for period of time, investors are likely to remain mollified to the extent they expect earnings growth to resume. As you can see on the next page, analysts *do* expect that growth to resume … next year.

ANNUAL % CHANGE IN S&P 500 EARNINGS



AN ENCOURAGING WORD ABOUT THE POWER OF PRODUCTIVITY IMPROVEMENTS

Looking back through history, it's easy to see how productivity and, hence, our collective standard of living has been elevated by advances in metallurgy, pharmacology, the various engineering disciplines, computer science, nuclear imaging, biotechnology, global communication channels, the ubiquity of instantaneous information, etc. In the moment, though, it may be more difficult to identify the technologies and trends that may further improve productivity and, in general, our collective well-being. Since I'm exposed to topics like this as part of my regular routine, I'd like to take a moment to list a few of the trends and technologies that may positively impact our lives and the lives of future generations: gene editing that may enable us to "delete" diseases from our genome, neural networks that allow complex systems to "learn" on the fly, the Internet of Things that will allow "smart" devices to dynamically adapt to our needs, 5th-Generation information networks that will allow data transfer speeds and volumes that might have been unimaginable just a decade ago, etc.

Getting back to my original point, without the persistent accumulation of productivity improvements and that entire period we now colloquially refer to as the Industrial Age, it would not have been possible for people we now regard as being relatively poor to have a comparatively higher standard of living than people who were considered to be relatively well off only a couple of centuries ago. Investing isn't just about money.

— Glenn Wessel