MIDYEAR 2019 ECONOMIC OUTLOOK

The corrosive effects of policy uncertainty

INVESTMENT RESEARCH

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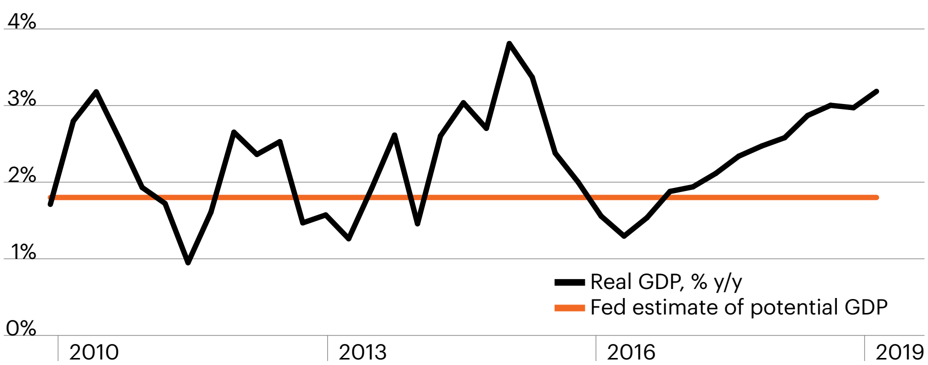
Executive summary

The economy is slowing—an uncomfortable prospect for markets. We expect economic growth to slow to around 2% in 2019; however, risks to this outlook have risen significantly. Policy uncertainty from multiple directions, including trade tensions and the Fed, could negatively impact the economy and amplify market volatility. This will pose challenges for investors, even though we expect the U.S. economy to avoid a recession for now.

Growth as good as it gets

GDP grew 2.9% in 2018, matching the fastest pace of this expansion and well above most estimates of our potential growth rate. That robust pace of growth was fueled by corporate tax cuts in 2017 and an added boost from greater fiscal spending. But in the first half of 2019, investors were reminded that the economy is still up against structural headwinds like low labor force growth and slow productivity gains, and the economy is now losing momentum.

REAL GDP GROWTH



Source: BEA, Bloomberg, as of March 31, 2019.

While we expect growth to slow, we still forecast a moderate deceleration to a relatively soft landing around 2%. The consumer, the largest sector of our economy, is looking healthy and continues to be supported by positive fundamentals. The unemployment rate remains at a multidecade low, and asset prices, along with a relatively healthy household balance sheet, indicate spending by consumers will continue to drive economic growth. This outlook for consumption is a critical part of our forecast that the economy will avoid a recession.

More broadly, the economy is now in its 11th year of expansion, the longest run of uninterrupted growth since World War II. And yet this expansion has also experienced the slowest growth, averaging just 2.2% since the end of the Great Recession. After all of the pro-growth policies of the last two years, the economy is reminding investors that the structural challenges to growth—low labor force growth and sluggish productivity gains—remain unresolved. Our "soft landing" outlook is a relatively optimistic one that could still feel stagnant by historic comparison.

READ THE ANALYSIS FOR EACH INDICATOR:

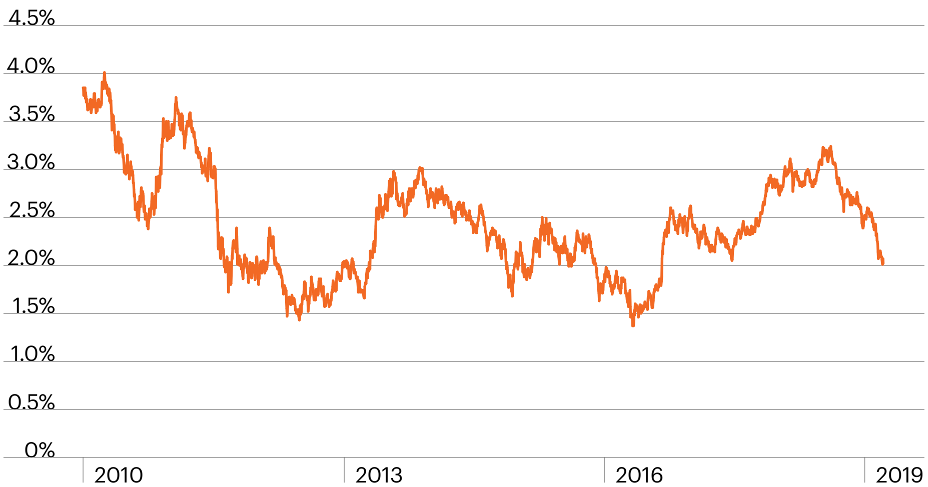
The corrosive effects of policy uncertainty

Risks to our soft-landing outlook have grown significantly, however. **Trade tensions** are the biggest risk to the expansion and have a corrosive impact on markets, business sentiment and the consumer. Many headlines on trade have focused largely on China, but there are ongoing trade negotiations with most major U.S. trading partners. In May, it was the unexpected announcement of tariffs on Mexico that shattered market complacency. Even if trade negotiations bear fruit and fresh tariffs are avoided, the increased volatility alone will pose a significant challenge to investors.

Monetary policy has seen an extraordinary shift so far in 2019. Just a little over six months ago the Fed was expected to raise rates about two more times. Now, markets are pricing in over three cuts by the end of 2019. Paradoxically, this extremely dovish pivot could actually add to market volatility going forward. Markets may be building in a reliance on rate cuts beyond what the Fed intends to deliver, which would be painful for equities to reprice. We see risks that the Fed could add to market uncertainty instead of offsetting it.

Whether the Fed delivers with one or three rate cuts, **interest rates** have plunged, a sign that fixed income markets are pessimistic about the growth outlook. Over the last quarter, the 10-year U.S. Treasury yield has fallen from 2.41% to just around 2.00%. This isn't just a U.S. phenomenon: In Germany the 10-year yield fell to -33 bps, the lowest ever, and the rest of the developed world has also seen interest rates drop. The amount of debt outstanding with negative yields has hit another record high and, along with overarching policy uncertainty, will keep U.S. interest rates low for the foreseeable future.

10-YEAR TREASURY YIELD



Source: Macrobond, as of June 30, 2019.

Sentiment indicators are more important than ever

Sentiment indicators are the data we will be hyper-focused on in the coming months. **Business sentiment** has deteriorated notably over the last quarter and poses one of the biggest risks to our forecast. Trade tensions are starting to pose a significant risk to business confidence, and this uncertainty has, in part, already caused investment spending to slow. Should business investment weaken further, it could push growth from moderate to stagnant.

Consumer confidence has proven more resilient to policy uncertainty so far. Yet because the consumer is the single largest sector of the economy, consumer confidence becomes even more of a focus for our forecast that the economy will avoid a recession. Currently, however, multiple factors are supporting consumer confidence, which remains near cycle highs.

Don’t ignore key recession indicators

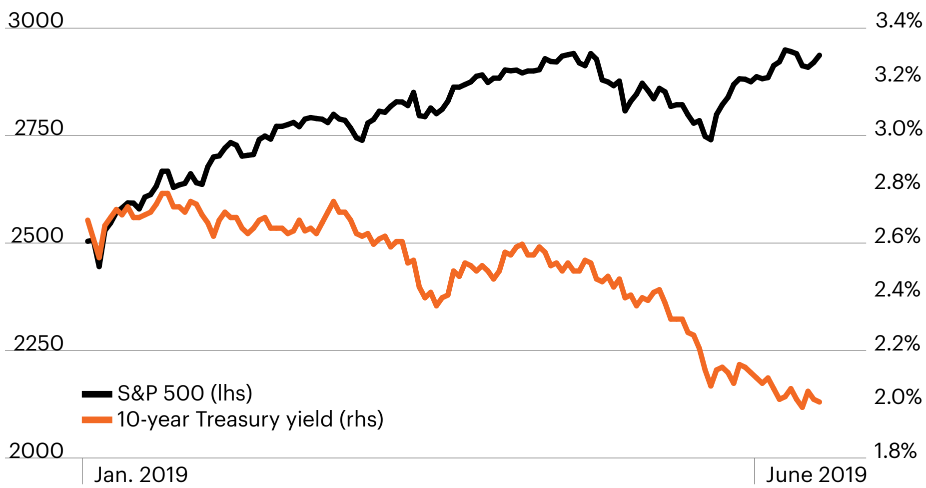
We are not forecasting a recession, and yet we are the first to acknowledge that risks have grown. In particular, **yield curve inversion** is casting a shadow on the economic outlook. Yield curve inversion has proven to be accurate historically in signaling that a recession could begin in the next four to six quarters. While there are factors that could mean this time is different, including international pressure pushing down long-term interest rates, we are watching yield curve inversion closely.

Initial jobless claims are our other canary in the coal mine—a historically good leading indicator of a recession. Happily, initial claims rest near multidecade lows, a reflection of the tight labor market and a sign that despite heightened policy uncertainty, companies have not yet resorted to layoffs. Still, with risks to the economy arguably on the rise, we are watching initial claims even more closely in the second half of the year.

Equity volatility looms, high yield stands to benefit

As if the economic slowdown and heightened policy uncertainty weren’t challenging enough to navigate, investors are also faced with equity markets flashing optimism while fixed income markets reflect caution.

EQUITY OPTIMISM VS. FIXED INCOME PESSIMISM



Source: Bloomberg, as of June 28, 2019.

Equities are on pace for their best year of this expansion, as the Fed’s dovish pivot has fueled stellar returns and kept realized volatility below historical averages. Yet a perfect storm of policy uncertainty is brewing, and we expect volatility to emerge in the second half of the year. Even beyond the possible impact on earnings from slowing global growth and rising tariffs, equity markets may be overly reliant on Fed rate cuts. Stock buybacks remain at record highs, however, which could support equities even if it won’t quell volatility.

Fixed income, however, is likely to show a divergence between core fixed income and high yield performance. We see the current environment of declining long-term rates and low corporate defaults as especially conducive for high yield bonds. Falling benchmark interest rates have recently provided a boost to core fixed income investments, but low (or negative) global central bank policy rates mean core fixed income has been beaten into a corner by rates. In this environment, investors need to look beyond the core, and high yield offers an attractive combination of exposure to growth upside alongside amplified income returns.

Trade tensions: The biggest risk to expansion

Trade tensions have a corrosive impact on markets, business sentiment and the consumer. Many headlines on trade tensions have largely focused on China, but there are ongoing trade negotiations with most major U.S. trading partners. In May, it was the unexpected announcement of tariffs on Mexico that shattered market complacency. Indeed, much of the volatility so far this year has come from trade-related headlines, not economic data.

Uncertainty about trade isn't just impacting the U.S. economy; it is dragging down global growth. In Germany, trade concerns have taken their toll on business confidence, and China's economy is slowing as well. The IMF noted the negative effects of policy uncertainty related to trade when it downgraded its 2019 global GDP estimate, and its advanced economies forecast is now just 1.8% for 2019.[1]

The threat to economic growth from trade tensions comes from multiple directions. For businesses, there is the direct impact of higher input costs. But uncertainty poses a serious headwind for large multinational companies that often have international production and revenue chains. Changing these is expensive and time-consuming.

Households, so far, have been left largely shielded from tariffs. That stands to change as tariffs that went into effect on June 1 will likely hit the consumer later this summer. Historically there is a grace period for goods in transit, which delays the impact of tariffs for several months. Last year, inflation on the sliver of consumer products that were subject to tariffs rose over 2.04%.[2] These weren't large enough categories to impact the entire CPI, but the latest round of tariffs casts a much wider net than prior rounds. In an expansion that has been notorious for sluggish real wage growth, tariffs act as a tax on households that could weaken consumer spending.

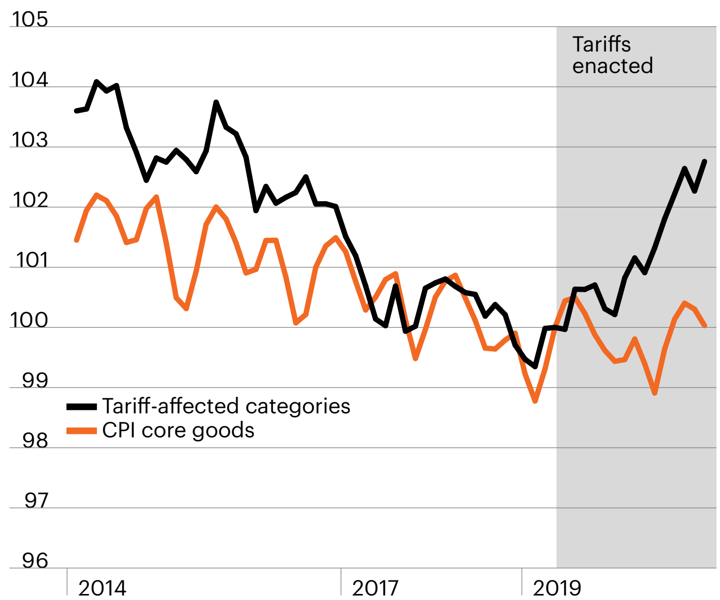
Like the rest of the markets, watching for evolving news on trade negotiations has become a full-time sport. But tensions seem to have risen, not cooled, after years of discussions. We see a meaningful risk of a flare-up in trade tensions or disruption from new tariffs pushing the economy from moderate growth to no growth, or worse.

ESCALATION OF TRADE TENSIONS AND TARIFFS

Date range	
Jan.–March 2018	
U.S.	25% tariffs on $34B of Chinese imports
China retaliates	25% tariffs on $34B of U.S. imports
Aug. 2018	
U.S.	25% tariffs on $16B
China retaliates	25% tariffs on $16B
Sep. 2019	
U.S.	10% tariffs on $200B
China retaliates	8% tariffs on $60B
May 10, 2019	
U.S.	Raises tariffs to 25% on $200B
China retaliates	20%–25% tariffs on $60B (effective June 1)
Going forward	U.S. threat to impose tariffs on remaining $325B

Note: Value of goods and percentages of tariffs are approximate.

IMPACT OF TARIFFS ON PRICE LEVELS



Source: BLS, FS Investments.
Note: Both measures indexed to Feb 2018 = 100. Tariff-affected areas include laundry equipment, other appliances, furniture and bedding, floor coverings, and motor vehicle parts weighted by importance to total CPI.

1 The World Economic Outlook, IMF, April 2019.

2 BLS, FS Investments, as of June 30, 2018.

Fed policy: A potential source of volatility

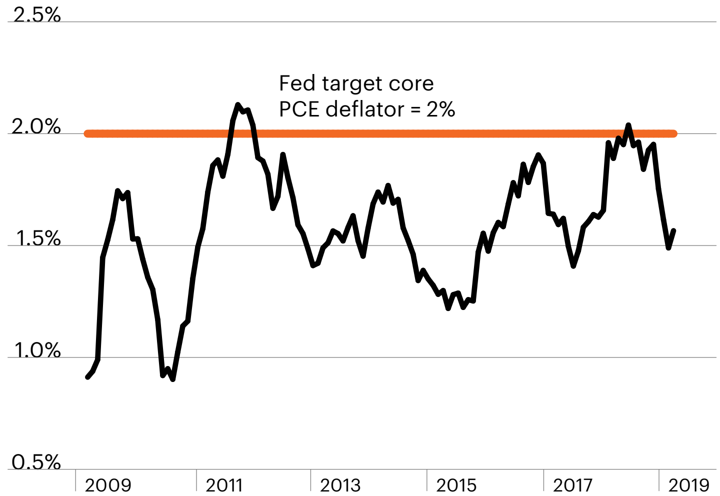
The Fed made a remarkably dovish pivot over the first half of the year and is widely expected to cut rates 25 bps to 2.00%–2.25% at the July 30–31 meeting. Markets now place 85% probability on two or more rate cuts in the second half of 2019. Yet while financial markets have gotten a boost from this policy shift, we see reason for caution, not celebration. Looking ahead, we see risks that the Fed adds to market uncertainty instead of offsetting it, a situation that could ignite significant volatility.

One risk is that significant Fed rate cuts are *already priced in*, meaning any indication the Fed will not cut as much as expected will be painful for equities to unwind. Additionally, there seems to be little consensus from Fed officials to explain this newfound dovish stance, which raises the risk of muddled Fed communication—a historically famous cause of market volatility. Then there is the risk of cutting rates that are already near historic lows. Each cut expends valuable ammunition should the economy face a deeper contraction.

Perhaps the biggest risk right now is to the Fed's credibility, which is arguably the backbone of U.S. monetary policy. At what point are Fed rate cuts no longer about supporting the economy, but about supporting the stock market? If the equity markets view the Fed's continued monetary easing as a sign of weakness instead of strength and stability, it could be a short-term gain but would be corrosive to the Fed's hard-won credibility, which could cripple monetary policy in the long run.

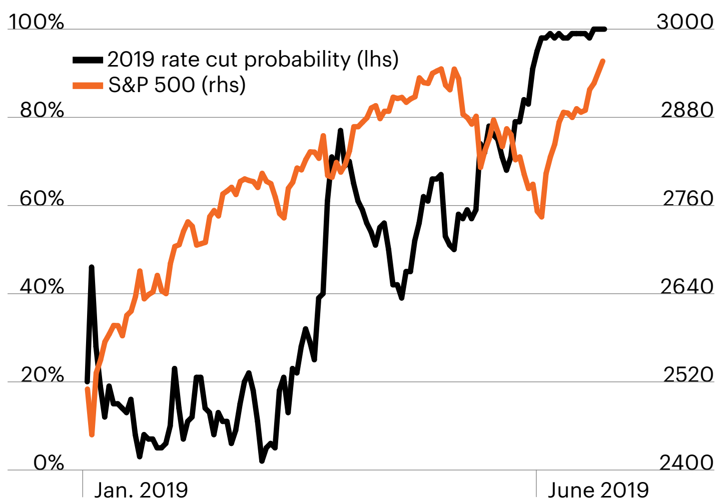
In the end, whether the Fed delivers one or more rate cuts this year, risks of a policy misstep seem unusually high for such a traditionally disciplined institution.

INFLATION REMAINS STUBBORNLY BELOW THE FED'S TARGET



Source: BEA, Federal Reserve, as of April 30, 2019.
Note: Core PCE deflator shown as % y/y since June 2009, the end of the last recession.

EXPECTATIONS OF RATE CUTS HAVE BOOSTED EQUITIES



Source: Bloomberg, as of June 20, 2019.

Low global rates: Pessimism deepens

Global interest rates continue to plunge, which reflects a growing pessimism about global growth prospects, particularly in the developed world. This international trend is pulling U.S. rates down as well—a dynamic we expect to continue in addition to domestic factors holding U.S. interest rates near historic lows.

The second quarter saw the trend of lower global rates accelerate. Data from the major EU countries, particularly Germany, has disappointed, and uncertainty around trade tensions has adversely impacted business sentiment. The European Central Bank (ECB) has begun discussing additional stimulus, and markets are now pricing in over 80% probability of an ECB rate cut by year-end. This sent the German 10-year government yield plunging to -33 bps toward the end of June, an all-time low. This decline is noteworthy, given that the average German 10-year yield was 1.63% during the EU's recession of 2011–2013.

Financial markets have long gotten used to Japanese markets with negative policy rates and long-term rates close to zero. But the specter of negative interest rates is spreading, adding to the global sense of pessimism that monetary policy is out of ammunition to stimulate growth. At present, debt with negative interest rates exceeds $13 trillion.

In the global financial system, international policy expectations and interest rates have an increasingly large impact on U.S. rates. The low global interest rates environment puts downward pressure on U.S. benchmark rates. Even a fleeting rise in U.S. rates—for example, from a piece of surprisingly strong data—can be viewed as a buying opportunity for foreign investors eager to find yield, resulting in a correction back to lower levels.

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AMOUNT OF GLOBAL NEGATIVE-YIELDING DEBT OUTSTANDING

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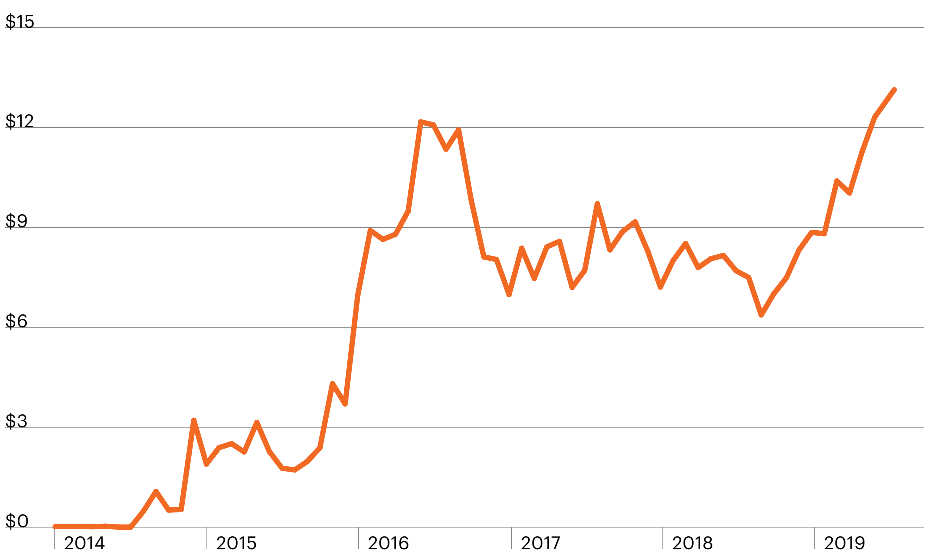


Source: Bloomberg, as of June 30, 2019.

Business sentiment: Confidence is evaporating rapidly

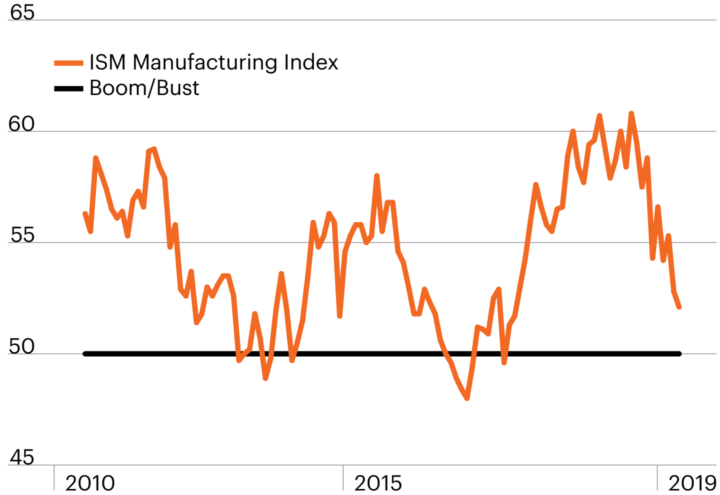
Business sentiment has deteriorated notably over the last quarter and poses one of the biggest risks to our forecast of a soft landing for the U.S. economy. Trade tensions are starting to pose a significant risk to business confidence, and this uncertainty has, in part, already caused investment spending to slow. Business sentiment is at the top of our watchlist going into the second half of the year.

Trade tensions are not a new feature of the landscape, and businesses have been dealing with tariffs, ongoing trade negotiations and the looming expectation of an economic slowdown for some time now. Yet in the last quarter, these clouds seemed to have gathered into a storm. The escalation of trade tensions is undeniable, and in May it spread from the immediate threat of greater tariffs on a broader range of Chinese goods to tariffs on Mexico. Critically, the global growth outlook has dimmed as well. Both the Fed and the ECB have signaled a willingness to ease monetary policy, but it is unclear whether one or even several rate cuts will ease the uncertainty for businesses associated with mounting trade-related conflicts.

The ISM Manufacturing Index, which had been notably strong since the 2016 election and started the year at 56.6, dropped to 52.1 in May, its lowest since October 2016, although it is still above the 50/50 boom/bust threshold. Early regional indicators for June show an even steeper drop, although it will be important to see if this feeds through to the national sentiment measure. Spending on business investment has also slowed, as seen in the monthly capital goods shipments data. The euphoria of 2017 tax reform is fading quickly.

We will be watching both the ISM manufacturing indicator and monthly core goods shipments as high-frequency indicators of businesses' appetite to invest.

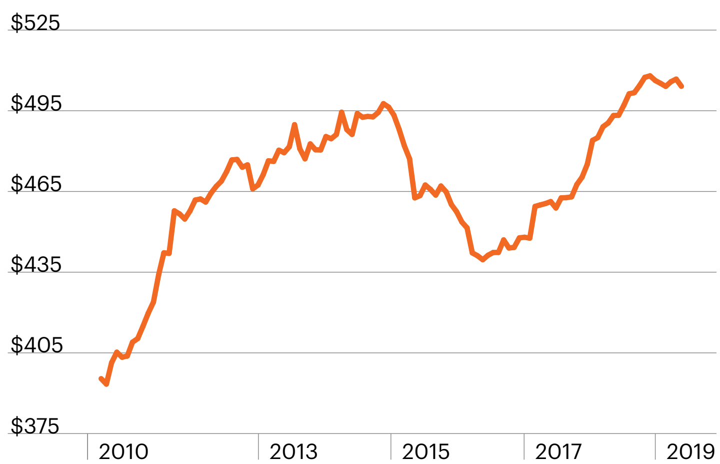
MANUFACTURING SENTIMENT HAS RAPIDLY DETERIORATED



Source: Institute of Supply Management, as of May 30, 2019.

ERODING SENTIMENT COULD BE IMPACTING INVESTMENT SPENDING

Total shipments ($B)



Source: Census Bureau, as of April 30, 2019.
Note: Shipments of durable goods, $ billions.

MIDYEAR 2019 ECONOMIC OUTLOOK

Consumer confidence: Confidence is key

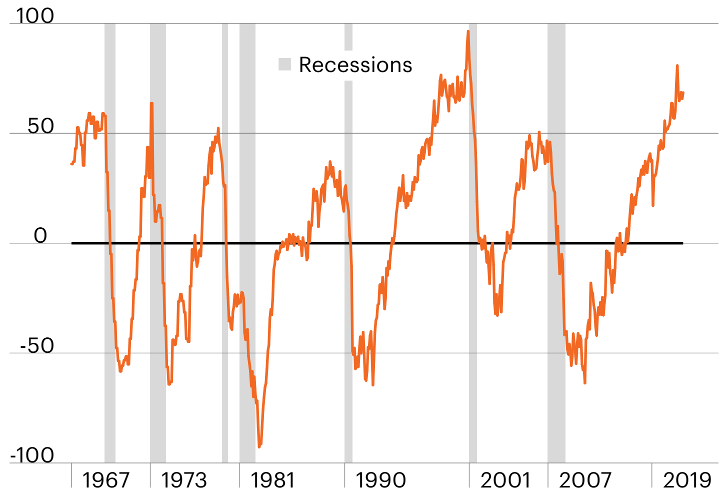
The consumer is the single largest sector of the economy, making up 69% of GDP. A solid pace of consumer spending is central to our broader outlook that the economy will slow but not dip into recession. Watching consumer confidence is a timely way of tracking household economic health. Currently, multiple factors are supporting consumer confidence, which remains near cycle highs.

In particular, the Conference Board's measure has averaged 128.1 so far this year, just below its 19-year high. A strong labor market is one of the most important supports for the consumer's optimistic outlook, which is what ultimately dictates consumer spending. Asset prices have also helped bolster household sentiment so far this year.

Risks loom, however. Recent volatility that afflicted Wall Street has not passed through to Main Street. Yet households are not immune to policy uncertainty. In January, the government shutdown knocked consumer confidence down to 15-month lows. The next round of tariffs, scheduled to take effect shortly, will include a wider range of consumer goods and essentially serves as a tax on households. Finally, the biggest risk is that businesses become adversely impacted by policy uncertainty and put the brakes on new hires, or even resort to layoffs. If consumers go into bunker mode and cut back spending, the risk that the entire economy falls into a recession increases sharply.

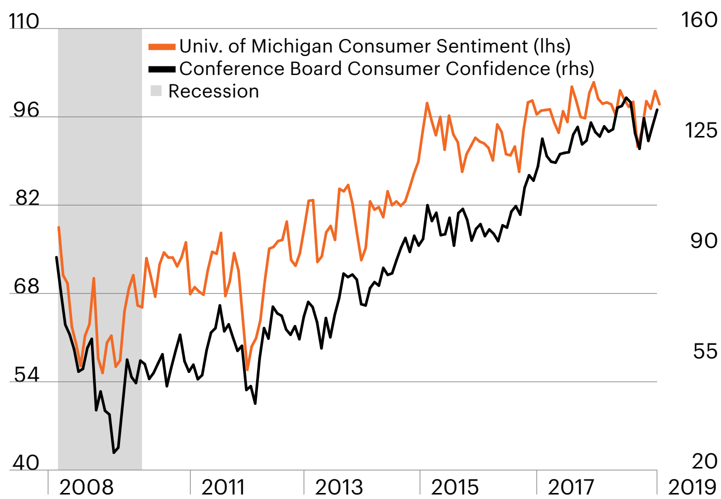
Our single favorite indicator of consumer sentiment is a simple spread between the Conference Board's present situations and expectations components. Historically, this has had a good track record of timing the start of a recession. At present, this spread rests near cycle highs. We will be watching this measure to see whether households are radically cutting back spending, which could put the entire economic expansion at risk.

CONSUMER CONFIDENCE SPREAD SHOWS ECONOMY IS LATE IN THE BUSINESS CYCLE



Source: Conference Board, FS Investments, NBER, as of June 30, 2019.
Note: Consumer confidence spread indicates the Present Situation Index minus the Expectations Index. Shaded areas indicate NBER recessions.

CONSUMER CONFIDENCE REMAINS NEAR CYCLE HIGHS



Source: University of Michigan, Conference Board, NBER, as of June 30, 2019.
Note: Shaded areas denote NBER recessions.

Yield curve inversion: The lingering shadow on the economic outlook

Yield curve inversion continues in the often-watched 3-month to 10-year yield spread, which is widely interpreted as a sign of pessimism from fixed income markets. This concern is well founded: Yield curve inversion is statistically one of the strongest predictors that a recession could start in the next one to two years. It takes a brave forecaster to declare that "this time is different," but there are several reasons why we are not yet sounding alarm bells that a recession is on the horizon for next year.

There are many ways to measure yield curve inversion, and the 3M-10Y spread is certainly closely watched for good reason. However, the 2Y-10Y curve is also an important leading indicator of recession, and though it remains relatively flat, it has not inverted. In other words, inversion has not been robust across the yield curve, and the 3M-10Y spread is not as deep as prior episodes preceding a recession.

Since the 3M-10Y yield curve inverted in March, the most pronounced it has been is -25 bps. This falls short of the three prior recessions, when this spread widened more significantly into negative territory, between -35 bps and -95 bps. Still, yield curve inversion has lasted consistently since late May. Many economists who are forecasting a recession in 2020 include yield curve inversion as part of their narrative.

Importantly, other factors are pushing long-term interest rates down, adding to yield curve flattening and inversion. This is contrary to prior episodes where the yield curve inverted when short-term rates were rising as the Fed constrained the economy by raising rates. U.S. long-term rates have plunged 66 bps since the beginning of the year, with more than half of that move coming in mid-May. Trade tensions, a dovish pivot by the ECB and broader global growth concerns have pushed global rates to exceptionally low levels, pulling long-term U.S. rates down with them.

Still, we are watching yield curve inversion very closely. The pessimism of the bond market is casting a shadow over the economic outlook and runs contrary to the optimism seen in the equity markets.

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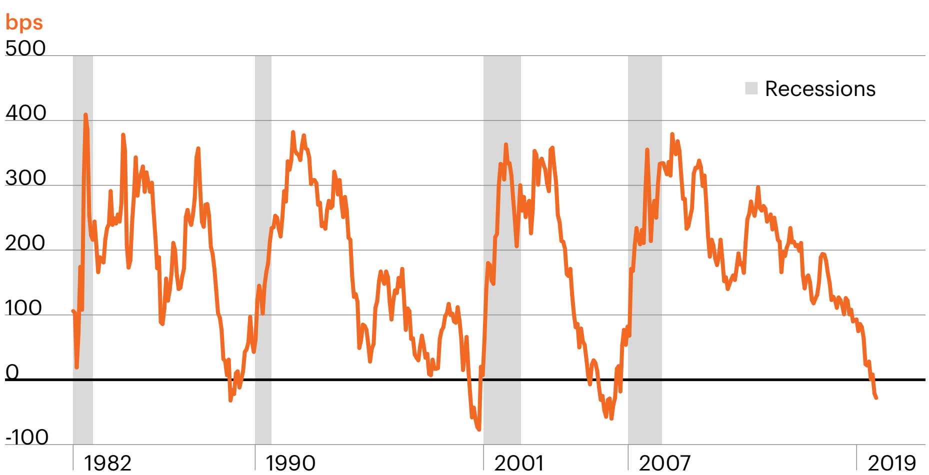
YIELD CURVE INVERSION IS CAUSING CONCERN



Source: Macrobond, NBER, FS Investments, as of June 1, 2019.
Note: Yield curve inversion shows the spread in basis points between the 3-month T-bill and the 10-year Treasury. Shaded areas denote NBER recessions.

Initial claims: The canary in the coal mine is still healthy for now

We have long highlighted initial jobless claims as one of our favorite leading indicators for a potential turn in the business cycle. Happily, initial claims rest near multidecade lows, a reflection of the tight labor market and a sign that, despite heightened policy uncertainty, companies have not yet resorted to layoffs at a macro level. With risks to the economy on the rise, we are watching initial claims even more closely in the second half of the year.

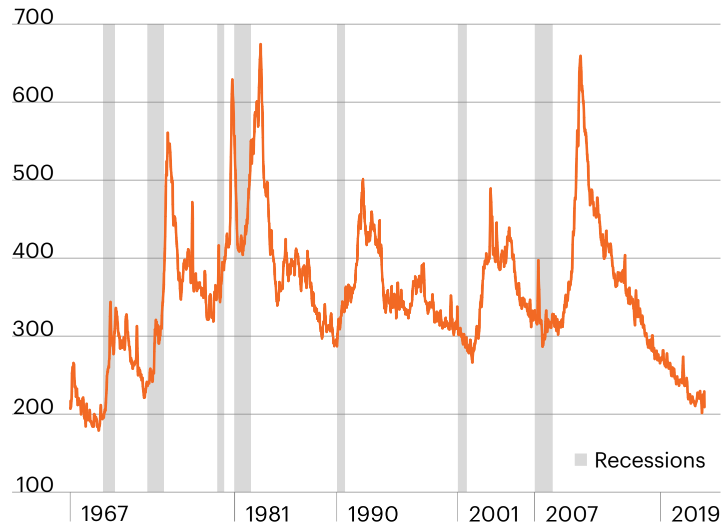
The labor market remains strong, a critical support for household consumption and, therefore, the economy. In the first half of the year, payroll employment showed some volatility and averaged 164,000 new jobs per month. This is a modest slowdown from the 223,000 pace of job creation in 2018, but nevertheless continues a record-setting run of 104 consecutive months of positive job reports. The unemployment rate was 3.6% in May, the lowest since 1969.

Concern about the economy and policy uncertainty related to trade is showing through in the business sentiment indicators, however. The ISM recently fell to a 30-month low of 52.1. Cautious sentiment can turn into caution in practice, which could translate into slower hiring or even layoffs. Historically, rising layoffs have had an immediate and negative impact on household spending, which could cause slowing U.S. growth to grind to a standstill, or even reverse.

Initial claims for unemployment insurance, when a worker applies for state-sponsored unemployment benefits, typically bottoms 9–24 months before a recession begins. A 20% increase in initial claims over an 8-week period would be a clear warning sign that broad-based uncertainty is causing companies to increase layoffs. Should claims rise to 275,000 over several months, we would become more pessimistic about our growth outlook.

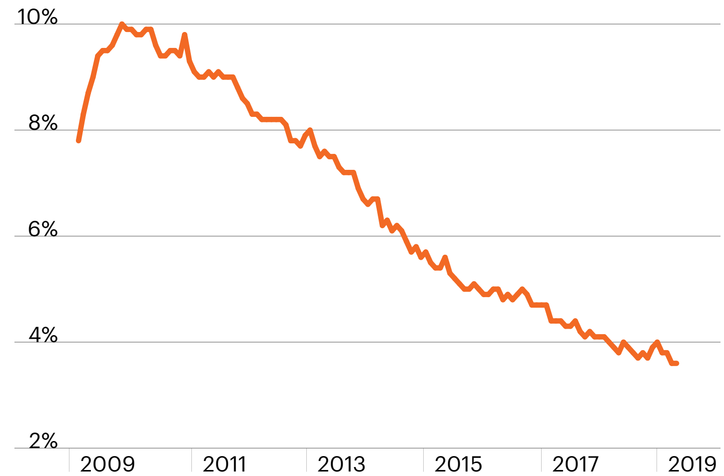
INITIAL JOBLESS CLAIMS HOVER CLOSE TO MULTIDECADE LOWS

4-week moving average (thousands)



Source: Department of Labor, as of July 5, 2019.
Note: Shaded areas denote NBER recessions.

THE UNEMPLOYMENT RATE IS AT CYCLE LOWS



Source: Bureau of Labor Statistics, as of May 31, 2019.

Equities: Volatility threatens strong returns

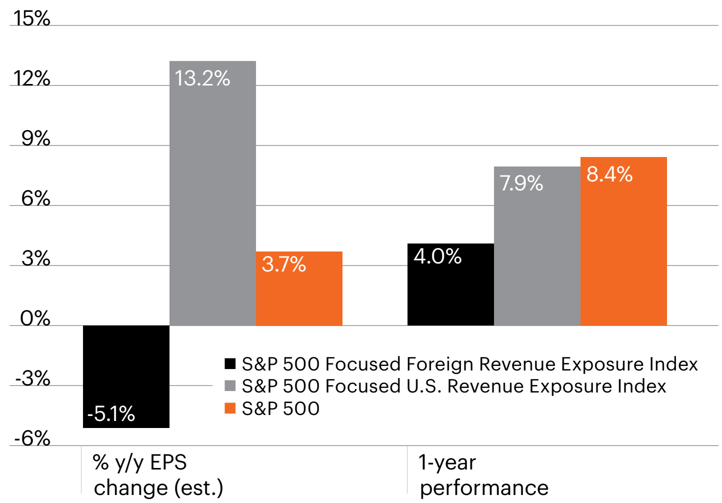
Equities are on pace for their best year of this expansion, and despite compounding uncertainties as we hit the halfway mark in 2019, realized volatility is below historical averages. Stellar returns have largely been fueled by the Fed's significantly dovish pivot, however. A perfect storm of policy uncertainty is brewing, and we expect volatility to reemerge in the second half of the year.

Equity markets are first and foremost challenged by diminishing fundamentals. Corporate profits fell 2.8% in Q1, the largest quarterly drop since 2015, reflecting, in part, decelerating economic growth. Trade tensions have also had a significant effect on U.S. earnings. Companies with a high percentage of revenue generated from foreign countries have seen earnings per share (EPS) drop over the past year, while companies with domestically derived revenue saw earnings rise.

Beyond moderating growth is a long list of policy uncertainty that we expect to stoke volatility. While investors have hope for a U.S.-China trade agreement, we see trade tensions as a genie that will not easily return to the bottle. Recently, it was the unexpected threat of tariffs on Mexico that caused volatility to spike in early May. This was quickly soothed by markets pricing in an additional 55 bps of rate cuts by the end of 2019. But relying on Fed rate cuts carries its own risk: The Fed may not ease as much as markets expect. Even the most dovish Fed official is well short of some market participants calling for four rate cuts.

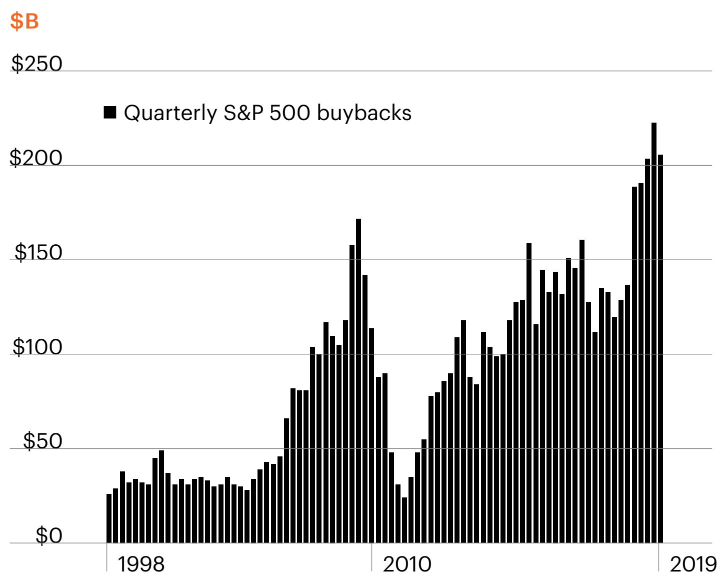
There are factors supporting equity markets as well. Record-high stock buybacks continue with no sign of slowing and could very well continue to bolster equity valuations in the short to medium term. With uncertainties lining up on both sides, we see higher volatility as the most likely scenario during the second half of 2019.

EXPOSURE TO TRADE POLICIES VARIES SIGNIFICANTLY



Source: Bloomberg as of June 30, 2019.

STOCK BUYBACKS CONTINUE TO HIT RECORD HIGHS



Source: S&P, Macrobond, as of March 31, 2019.

Fixed income: Solid fundamentals support credit

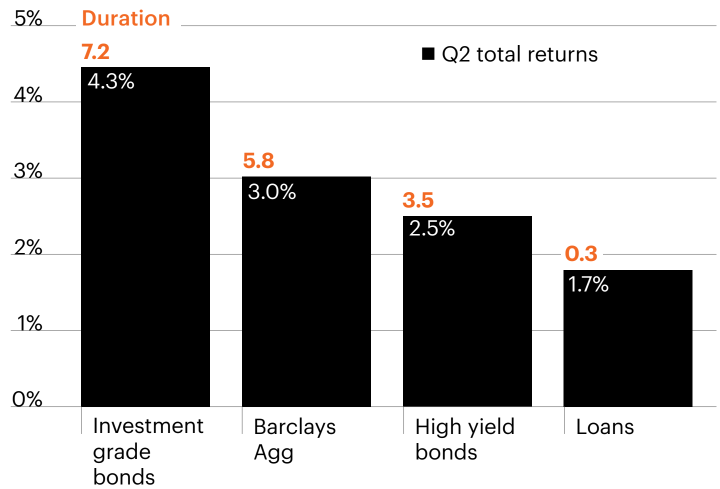
In the second quarter, long-term rates fell to multiyear lows, lifting returns for high-duration, or more interest-rate sensitive, asset classes. With that said, we continue to see an environment especially attractive for high yield bonds and, to a lesser extent, leveraged loans. With corporate default levels low by historical standards, spreads still wide of early 2018 levels, and core interest rates at their current low levels, we see the return premium offered by the credit markets as an appealing option for income-starved investors.

Relative performance over the past three months was largely dictated by the level of interest rate sensitivity, as the 10-year U.S. Treasury yield fell approximately 50 bps over the course of Q2. Investment grade corporate bonds, with a duration over seven years, were the top performers, while floating rate loans lagged their fixed rate cohorts. While outperforming in Q2, core fixed income has been further pushed into a corner by declining interest rates. The Barclays Agg, a proxy for core fixed income, is becoming more and more reliant on price appreciation to boost returns as the index now yields just 2.50%.

We continue to view credit as attractive given the higher level of income, with a preference for high yield bonds over loans. With falling rates making it more difficult to find income, high yield bonds yield over 6%, with the possibility of spread compression to drive price gains. Corporate fundamentals, which ultimately drive the attractiveness of credit, continue to be fairly benign. High yield bond and loan default rates are currently 1.46% and 1.30%, respectively, both low by historical standards.

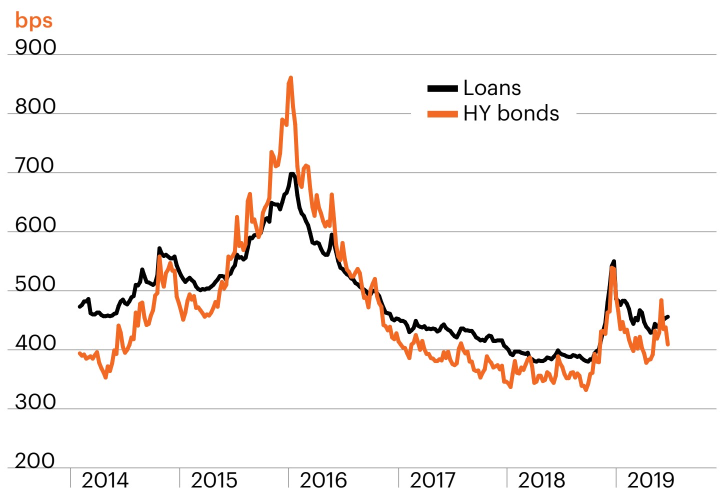
The path of rates has also driven a reversal in leveraged credit flows, as a flattening yield curve has altered investor preference. Investors have exchanged LIBOR-based floating rate loans for fixed rate high yield bonds. We see both as attractive, as spreads are still wide of early 2018 levels and corporate fundamentals remain solid. In the second half of 2019, we will be watching for signs of a business downturn that could impact the credit backdrop.

RETURNS DRIVEN BY SENSITIVITY TO RATES



Source: Bloomberg, ICE BofAML, S&P/LSTA Leveraged Loan Index, as of June 30, 2019.

SPREADS SEE VOLATILITY BUT END Q2 FAIRLY FLAT



Source: S&P/LSTA Leveraged Loan Index, ICE BofAML, Bloomberg, as of June 30, 2019.

Lara Rhame

Chief U.S. Economist

Lara is Chief U.S. Economist at FS Investments, where she analyzes developments in the global and U.S. economies and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the board of both the Economy League of Greater Philadelphia and Starr Garden Park.

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