Elliott D. Pollack & Company

The Monday Morning Quarterback

A quick analysis of important economic data released over the last week

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The decline in the stock market over the past few months now qualifies as a bear market. This has created concern about the prospects for the overall economy. Indeed, of the eleven bear markets (usually defined as a stock market decline of 20% or more) since the end of World War II, seven have been associated with a national recession. Four have not. To put this in context, the current recovery/expansion is now in its 115th month. That makes it the second longest recovery/expansion in U.S. history. The longest is 120 months. Thus, by mid-year, if the expansion continues, this upcycle will be the longest in U.S. history.

Given the current unemployment rate, the shortage of labor and other factors, it appears that the cycle is "late in the game". That doesn't necessarily mean the cycle will end very soon. Expansions don't die of old age. They die because of imbalances such as asset bubble, too much debt or Fed policy errors. In fact, most recoveries die because the Fed tightens sufficiently to create a credit crunch. The tightening by the Fed causes lending to tighten significantly. This brings on a decline in investment and employment that can bring on a recession.

Most of the time, the Fed shoots for a "soft landing." In other words, they attempt to slow the rate of growth in the economy without causing a recession. Most of the time they miss. Yet, so far in this cycle the Fed tightening (increases in the Fed Funds Rate) does not appear to be significant enough to cause a credit crunch.

Let's look at the current situation. Currently, leading indicators are still rising. Consumer confidence remains very high. The Recession Probability indicator created by the New York Fed remains well below levels that have historically given a recession signal. The unemployment rate continues downward. Prices remain under control. So does consumer debt. And there are more than 7 million unfilled jobs in America.

On the other hand, there are things to be concerned about. There almost always are. The employment cost index is rising. This indicates that there is a supply/demand imbalance in labor markets. Auto debt delinquencies are rising. The yield curve (as measured by the spread between 10-year and 2-year treasury rates) is close to inverting. Home sales are weakening. Corporate debt levels are at the high end of normal. People are concerned about a trade war with China (unnecessarily in our opinion). And up until very recently, the cyclically adjusted price/earnings ratio was extremely high by historic standards.

None of the negatives seem overwhelming at this point. If the yield curve does invert, and if history is any guide, it would indicate a recession probably in 2020 rather than 2019. The weakening in home sales is all about affordability. Increases in the costs of building a home and rising interest rates are pushing down affordability levels in many parts of the country. Yet, affordability ratios nationally are just slightly below historic norms. In addition, the demographics of single family housing are extremely strong. And the supply/demand situation seems very favorable. It is, for the most part, the polar opposite of the 2007 situation. The current slowdown in home buying is probably a result of the recent rise in mortgage rates to the 5% level. Since most new buyers are millennials who have been weaned on very low mortgage rates, this shock is understandable. They will come to accept the new situation.

The major issue at the present time we believe is a shortage of labor. The labor force is growing at about 1.2% annually. As recently as 2002-2007, growth was more than 5% annually. This, and the relatively slow rate of growth in productivity, limits the long terms rate of growth in the economy and suggests that labor markets will be tight for some time to come. This should result in an upward push on wages and inflation. This upward push is what the Fed is trying to control.

The Fed getting too far ahead of the curve is a risk for this cycle. But, it is not there yet. Thus, at this point our conclusion about most of 2019 being a year of slowing but continued growth remains intact. While we are monitoring things closely and it is time to be cautious, our forecast for 2019 remains relatively unchanged.

U.S. Snapshot:

- Total nonfarm payroll employment increased by 312,000 in December. The unemployment rate rose to 3.9%. That's up slightly from 3.7% in November. The increase was due mainly to an increase in the labor force. Job gains occurred in health care, food services and drinking places, construction, manufacturing, and retail trade. For the year as a whole, job gains were 2.6 million. This compared to a gain of 2.2 million in 2017. November’s gain over October was revised upward to 274,000 from the 237,000 originally reported.

- Manufacturing expanded in December as the ISM's manufacturing index was reported at 54.1. Any gain over 50 indicates that the sector is expanding. It should be noted that the reading was down from 59.3 in November. So, while manufacturing is expanding, it appears to be doing so at a slower rate.

Arizona Snapshot:

- Total employment in Arizona grew by 3.6% in November compared to November 2017. For the first 11 months of 2018, employment was up 2.8% over the similar 2017 period. The state's unemployment rate was reported at 4.4% in November compared to 4.5% a year earlier.

- Total employment in Maricopa County in November was up 4.3% from year earlier levels. For the first 11 months of 2018, the county was up 3.5% compared to the first 11 months of 2017. The unemployment rate for the month stood at 3.8% compared to 3.9% a year ago.

- Total employment in Pima County was up 3.1% over year earlier levels in November. The 11-month vs. 11-month gain was 1.8%. The unemployment rate was 4.2% in November of both years.