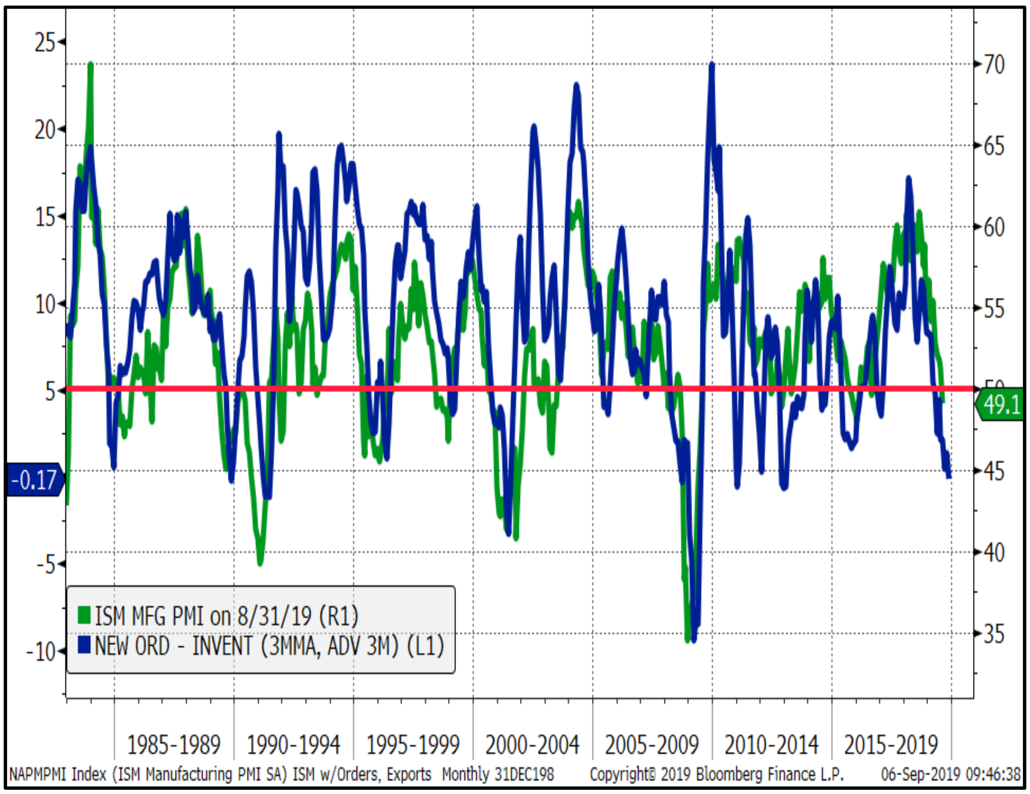
It'll Get Worse Before It Gets Better

Given a continued global economic slowdown within what we view as a late-cycle expansion, we continue to monitor closely a broad range of economic variables for any indication that our current "recession watch" status is in need of escalation to "recession warning." We don't believe we're at that stage yet, although we wouldn't necessarily expect the actual data, itself, to validate such convictions any time soon. In fact, things will very likely continue to look worse before they start to get any better.

This is certainly what we have already been seeing over the past year or so in the Institute for Supply Management's Purchasing Managers' Index (PMI), a broad gauge of the level of activity among U.S. manufacturing companies and, based on the performance of some of its underlying components, what we are likely to continue seeing at least for the next few months. Specifically, the difference between the New Orders component of the PMI – the most timely and forward-looking part of the index, since it is indicative of incoming economic activity yet to be performed – and the Inventory component, which looks at the stock of goods that businesses are already holding in their inventories ready for sale, historically has provided fairly reliable insight into the near-term future direction of the overall Manufacturing PMI index. As depicted in Chart 1, right, the fit between this measure advanced by three months and the PMI itself has been remarkably tight; thus, based on the recent behavior of the differential between New Orders and Inventories, the near-term trajectory implied for the PMI remains to the downside into year-end 2019. What also (hopefully) jumps out from this chart is the current level of the PMI index itself. We spend a lot of time talking about PMI indices (almost as much as we spend talking about inverted yield curves!), often noting the critical importance attached to the "50" level, which marks the "line in the sand" between expanding and contracting levels of activity. The August reading came in at 49.1 – not horrendously weak, but contractionary nonetheless and, based on the data we just saw above, likely to decline further in the months ahead.

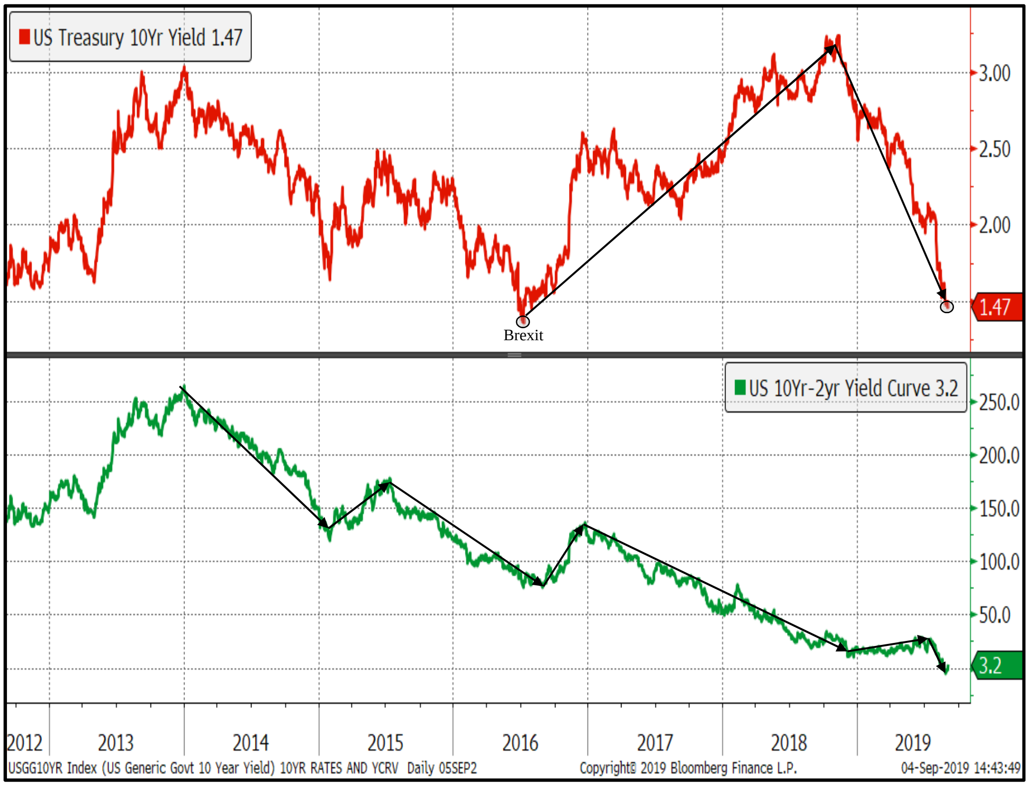
Chart 1: Manufacturing PMI Dips Below 50, Further Decline Likely



Bond Market Bought a One-Way Ticket, Got a Round-Trip

The bond market's recent message confirms its expectations for the above-noted incremental slowdown in activity. Investors have taken the yield on the 10-year U.S. Treasury down precipitously from a seven-year high of nearly 3.25% in late-2018 (the point at which all of Wall Street had become convinced interest rates were a one-way trade to the upside) to around 1.50% currently, only slightly higher than the all-time low in rates following the Brexit vote in mid-2016. Meanwhile, despite the near-uninterrupted decline in rates themselves over the roughly nine-month period since the cycle peak, the actual slope of the yield curve had remained relatively steady – i.e., while longer-term rates were declining, short-term rates were coming down as well and by a similar amount, keeping the difference between short- and long-term rates reasonably constant. A potential implication of such a dynamic is that much of the decline in longer-term rates over the first half of the year was driven by the drop in short-term interest rates stemming from expectations for a sharp reversal in the Federal Reserve's monetary policy stance. Since July, however, the steep decline in interest rates has been accompanied by a sharp decrease in the slope of – and even a brief inversion in – the yield curve, as longer rates dropped more than short-term rates, implying that there is now more to the story – at least in the mind of the bond market – than just expectations for easier Fed policy (see Chart 2, right.)

Chart 2: What's Eating the Bond Market?



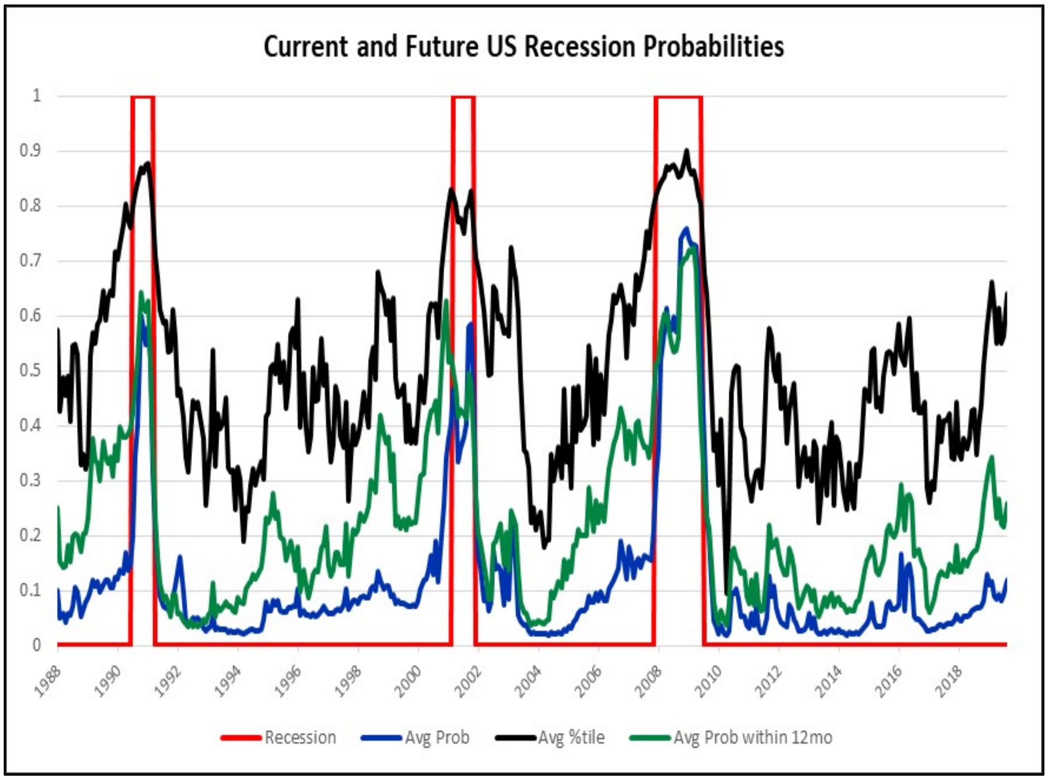
This more recent dynamic would seem to point to bond market investors pricing in a scenario (specifically, slower economic growth and a materially higher risk of recession) that would elicit a much more powerful policy response than anything currently being contemplated by the Fed. Given the nature of bond market math, meanwhile, the collapse in interest rates has taken bond prices to dizzying heights; certainly, this has made for impressive bond market gains over the past few quarters (investors in a 10-year Treasury have made over 8% year-to-date from capital appreciation alone, while holders of 30-year T-Bonds gained roughly 22% over that same time) but has left the bond market looking priced squarely to perfection. This inevitably limits any expectations for further meaningful gains from principal appreciation in the space; reinforcing this idea, we note – as we have often done noted in recent years – that starting yield (i.e., currently around 1.5%) remains the best predictor of a bond investor's return on a core, intermediate-term bond position over a five-year forward horizon.

There's a (Red) Flag on the Play but We're Challenging the Call

To err on the side of conservatism, the sub-50 PMI reading must be treated as a "red flag" within our ongoing assessment of the economy, a warning sign – alongside the flat-to-inverted yield curve – of a possible recession in the offing; there are, however, a couple of things to keep in mind as we attempt to process its true significance. First of all, it's important to note the recent contraction in U.S. *manufacturing* activity noted above does not translate directly to the U.S. economy as a whole: manufacturing only accounts for about 20% of our economic activity and the larger services segment has been doing considerably better. One reason people do often focus on the manufacturing side of things, however, is that it tends to be more economically-sensitive and, therefore, to give an earlier signal of a potential change in the cycle; thus, we cannot ignore it outright, but do need to keep things in perspective.

The other thing to remember, however, is that this move into "Contraction" territory is hardly the economy's first rodeo: in fact, a contractionary reading on the manufacturing PMI is extremely common during mid-cycle slowdowns (expansionary periods within which growth experiences a material – but temporary – slowdown from which it subsequently recovers), as we saw in the mid-80s and -90s, as well as twice so far (2012 and 2016) during the current, ongoing expansion. Given this frequency of sub-50 PMI readings during mid-cycle slowdowns as well as the continued strength evident in other key areas of the economy – most notably the labor market as well as consumer and business confidence – our assessment is that the near-term prospects for a recession remain subdued for now. In fact, while the implied probability of recession based on the Manufacturing PMI taken in isolation popped following the weak August reading, the overall likelihood of recession based on current, broad economic conditions increased only very slightly in the most-recent month (Chart 3, right), as it has now for several months in a row in response to the unrelenting decline in the slope of the yield curve and August's bout of stock market weakness. As it stands, even after the recent increase, the data currently point to only modest near-term recession risk, well below where we entered the year (following a brutal Q4 2018) and considerably lower than the levels typically evident historically during prior pre- recessionary periods. While conditions remain fluid – particularly so long as heightened trade tensions persist – and we will continue reassess our outlook in concert with the evolving economic data, the current landscape leaves us comfortable for the time being with our Investment Committee's exiting outlook that the next recession is still likely some 18-24 months out (i.e., some time around mid-2021.)

Chart 3: Recession Probability Rising Gradually but Not Yet Cause for Alarm



-Jim Ayres, CIO