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ECONOMIC OUTLOOK

U.S. Outlook: Aging economic expansion still flexing its muscles

Key takeaways

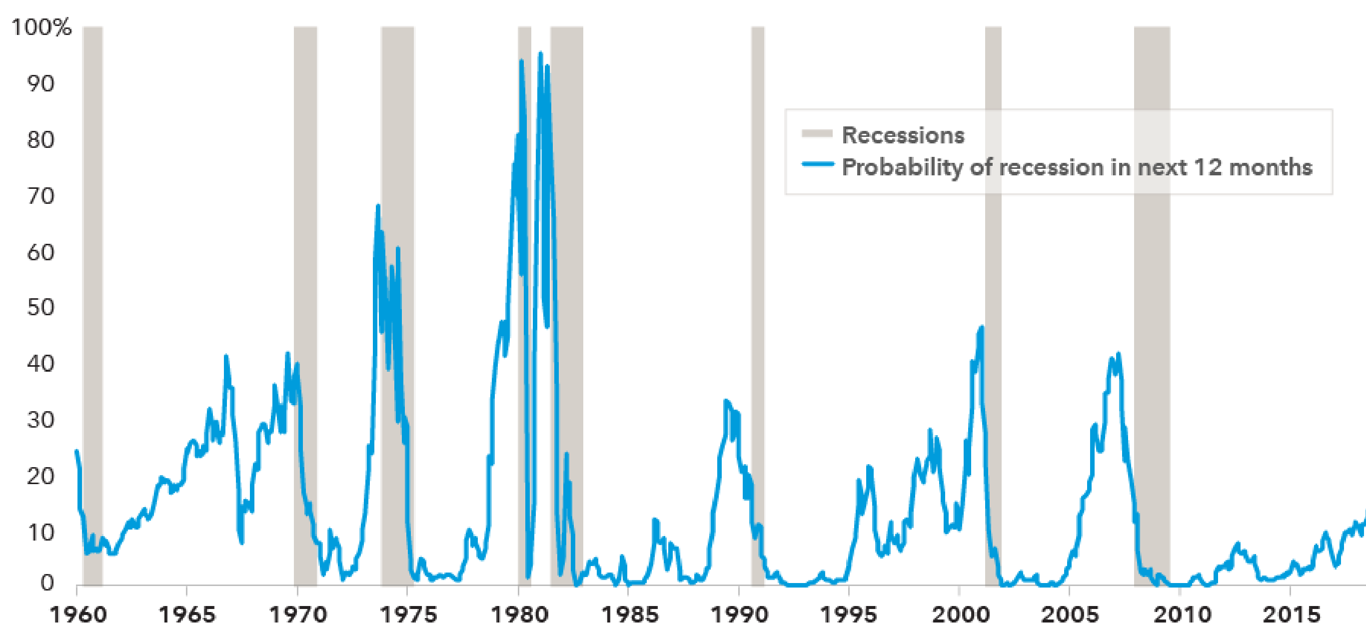
- The late-cycle U.S. economy continues to enjoy strong momentum.
- Expect rising volatility and slowing growth.
- Manage your expectations for future equity returns.
- Look for companies that can maintain dividend payments and businesses with long runways of growth.

Age is just a number. But at 114 months and counting, it's fair to say that the U.S. expansion may be eligible for its AARP card. Consider that the average expansion since 1950 has been 67 months long. Does the advanced age of the business cycle indicate the U.S. is due for a recession in 2019?

"We are presumably late in the game, but there is always the possibility of extra innings," says portfolio manager Don O'Neal. "These cycles can go on for a long time. It all depends on the fundamentals."

Recall that game three of the 2018 World Series reached the 18th inning – double the innings of a typical game – and clocked in at seven hours and 20 minutes before Los Angeles Dodgers infielder Max Muncey ended the contest with a home run swing. So it is with economic cycles. They can continue indefinitely until a catalyst surfaces to put an end to growth momentum.

That usually translates into imbalances that build up in the economy over time, such as the housing bubble in 2007. The strength of the current expansion has been modest by historical standards and significant imbalances have not yet surfaced. Indeed the likelihood of a recession in the next 12 months recently stood at just 14.9%, according to the Federal Reserve Bank of New York. The same model had exceeded 30% before each of the last seven recessions.



Sources: Federal Reserve Bank of New York, Thomson Reuters. As of 10/31/18.

"We have not yet seen the excesses that would be red flags for an imminent recession," says Capital Group economist Jared Franz. "I expect to see an economy that is still positive in 2019 but growing a bit slower, and the risk of recession will rise throughout the year."

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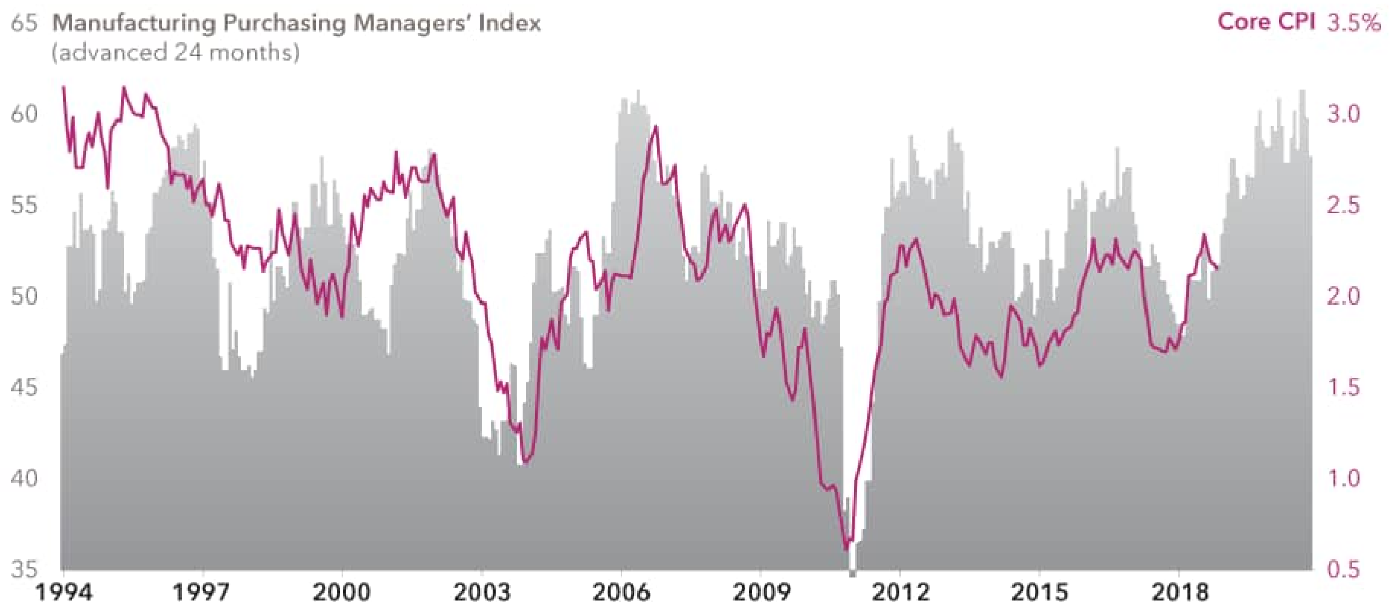
Momentum is strong, but inflation is rising

Rather than slowing down, the U.S. economy continues to demonstrate its resilience.

With unemployment at its lowest level in 49 years, wage growth has ramped up. In October, average hourly earnings rose 3.1% from a year earlier, the biggest gain since 2009. What's more, consumer spending is strong and industrial production continues to be solid.

The Purchasing Managers' Index (PMI), a measure of manufacturing activity, recently stood at 57.7, indicating expansionary conditions. Any number above 50 indicates expanding manufacturing activity. Rising manufacturing activity has been an indicator of rising inflation.



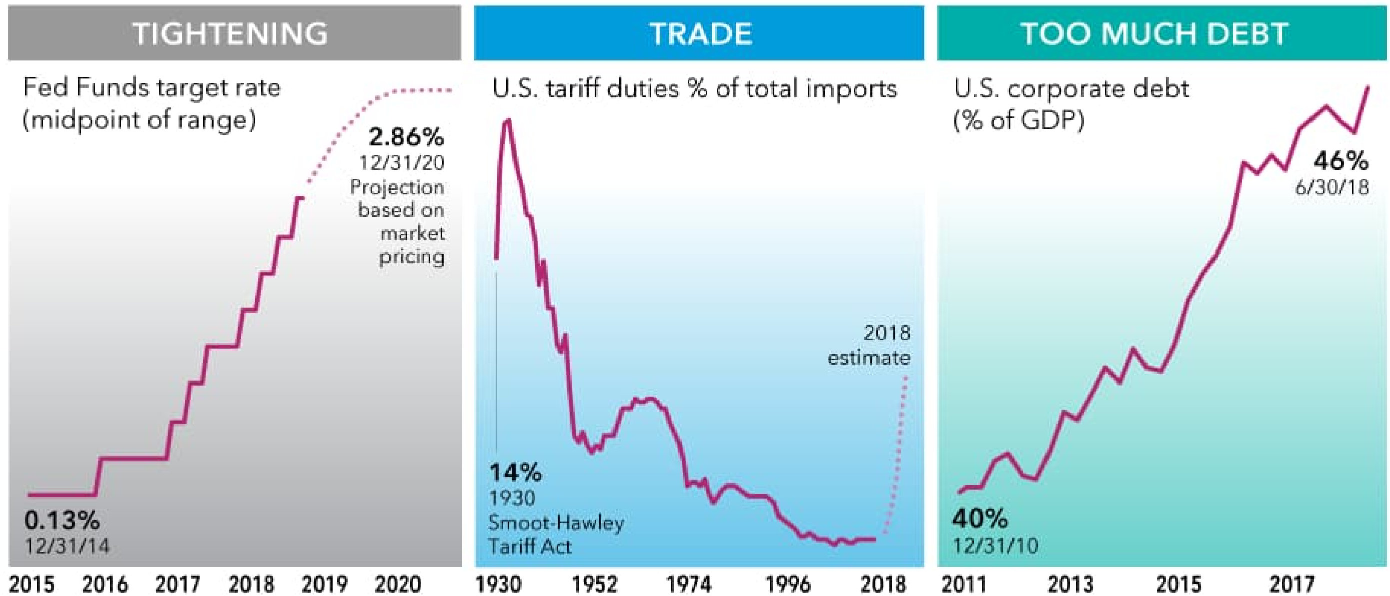
"These conditions all suggest continued growth in 2019," says Capital Group economist Darrell Spence. "But the strong employment and wage growth, the manufacturing activity and the resource utilitization rate – a measure of spare capacity in the economy – give you a sense of the direction of inflation and the signal is pointing clearly upward."

Core inflation – the measure that strips out volatile energy and food prices – was at 2.2% in September. Including food and energy, inflation hit 2.83% in September.

Three T's spell more volatility in 2019

Indeed, after years of calm, volatility returned to the U.S. stock market in 2018. Investors can expect more volatility in 2019, driven largely by three key factors: tightening by the Fed, trade tensions and too much debt.

Expect three T's to drive market volatility higher



Sources: Bloomberg, Federal Reserve, Thomson Reuters. Fed funds target rate projections based on pricing in the futures markets as of 10/31/18.

Reacting to a strong U.S. economy, a tight labor market and moderately rising inflation, the Fed is expected to continue raising short-term interest rates in 2019.

"If the Fed sees inflation pick up, it will take more aggressive action," Spence says. "And investors will have to reset their expectations, which could induce further volatility."

This is happening at a time when government, corporate and consumer debt are all dramatically on the rise. Rising debt costs could have a significant impact on the bottom line for companies.

At the same time, global trade has taken center stage as the U.S., China, Europe and others seek to rewrite the rules of world commerce in their favor. With these trade battles still evolving, it's difficult to calculate a precise impact on the economy, but tariffs will be a drag on growth.

"Our base case assumes 10% tariffs on $200 billion of Chinese imports, plus some retaliatory tariffs from China," Franz says. "That would likely reduce U.S. GDP growth by about 50 basis points, or half a percentage point."

Of course, if the tariffs are expanded the impact would be greater. "This is a very fluid situation

that we will monitor closely throughout the year," Franz says.

With stiffer headwinds, expect more modest equity returns

Looking out at the coming year, rising inflation likely will put increasing pressure on corporate profit growth, which soared 26% in the third quarter of 2018. Also, the impact of the tax cuts enacted at the end of 2017, which propelled profit growth in 2018, will fade as the year progresses.

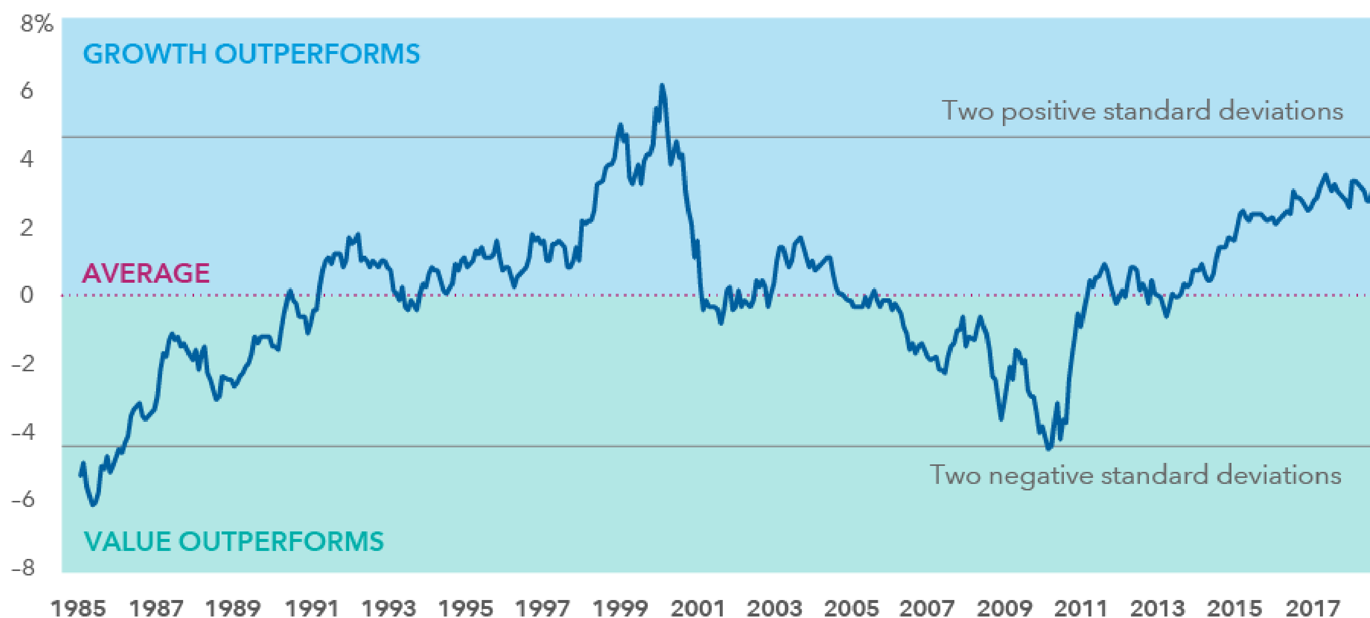
Spence believes profit growth will remain positive in 2019 but should slow down. "I expect earnings growth in the single digits, which would be consistent with an economy that is still growing but at a slower rate," he says.

What's more, after a 10-year bull market U.S. stocks have gotten expensive. The S&P 500 Index has advanced nearly 400% over that timeframe, and market valuations have expanded. As of October 31, the forward price-to-earnings (P/E) ratio for the S&P stood at 15.3 — hardly nosebleed territory, but elevated by historical standards and at a level that suggests market returns will be more modest over the next five years.

"I don't see how the overall market can generate better than single-digit returns over the next few years," says portfolio manager Greg Johnson. "There will still be opportunities to pursue superior returns, but at this stage selectivity is critical."

Value-oriented companies have lagged the market

Indeed, a look beyond broader market results reveals that not all areas of the market have advanced at the same pace. A small handful of leading-edge fast-growing companies have driven much of the market return in recent years, many of them innovative companies in the technology and consumer discretionary sectors of the market. Online retailer Amazon, for example, has soared about 2,500% since the end of the last bear market. Many so-called value-oriented companies have trailed the broader market and have more modest valuations.



Source: Thomson Reuters. As of 10/31/18. Annualized trailing 10-year relative total return of MSCI USA Growth versus MSCI USA Value.

Of course, some companies have lower valuations for a reason. Many have more modest growth prospects, says portfolio manager Alan Berro.

“I have avoided some companies in the consumer staples area over the last several years, including many of the food stocks and household products stocks, because I did not see the growth potential,” Berro says. “So even with lower valuations, I viewed them as expensive.”

How does Berro think about investing this late into a bull market? “I look for companies whose prospects are misperceived by the market,” he says. “It is a little harder today, but there are always opportunities.”

For example, shares of pharmaceutical and biotechnology companies have been pressured in recent years due to patent expirations and headlines focused on curbing drug pricing, leaving select companies with relatively attractive valuations.

Some of these drugmakers have invested heavily in the development of cancer therapies that may represent new growth opportunities. “When you look at a company like Merck, they have developed a cancer drug called Keytruda, which many expect will be a first-line cancer therapy with the potential to generate billions of dollars in revenue.”

Berro also focuses on companies that can maintain their dividends in the event of an economic downturn. “That often means looking for conservatively run companies with strong balance sheets and good cash flows,” he says.

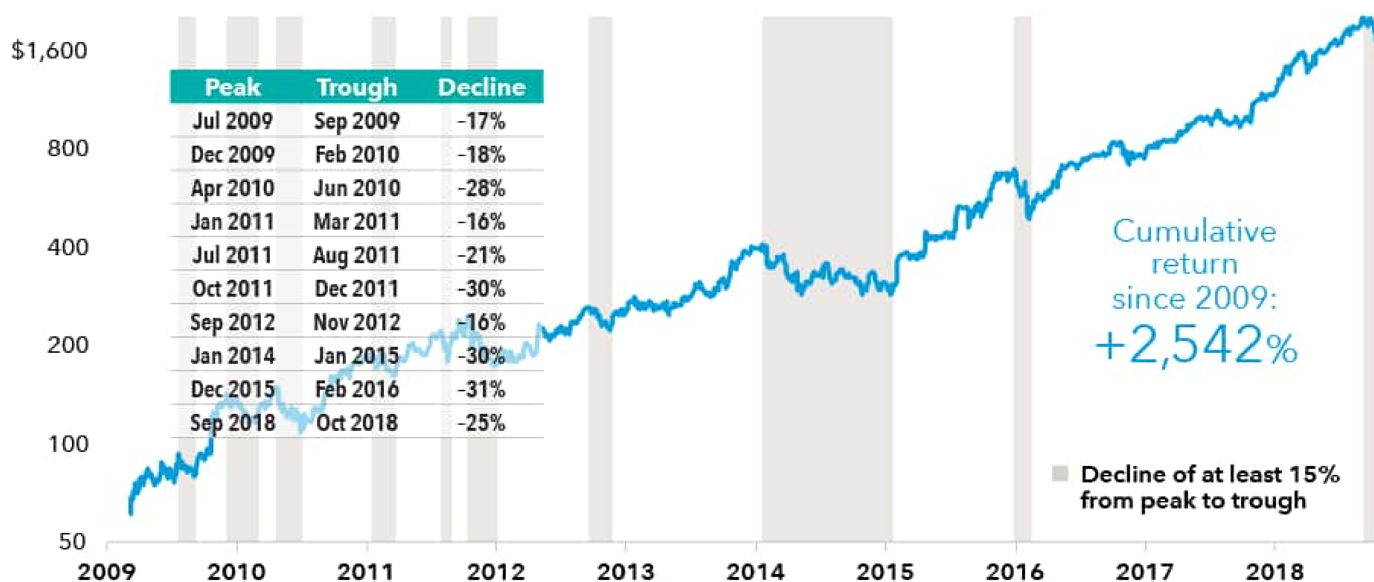
Look for long runways, deep moats

For growth-oriented investors, not all companies with higher P/E ratios are expensive. Some technology companies whose shares led the bull market have businesses with long runways of potential growth. Consider cloud computing, software and services that run on the internet. By 2021, cloud spending will rise to $302.5 billion, nearly double the $153 billion spent in 2017, according to industry researcher Gartner. The movement of IT workloads to the cloud is boosting demand for the services of Amazon's cloud computing unit, Amazon Web Services (AWS), for example.

Investors in high-flying innovative companies, however, should expect volatility going forward. Since the financial crisis of 2008, Amazon shares have declined at least 15% on 10 different occasions, and more than 30% in three different periods. But following each of the previous corrections, its shares hit new highs.

Amazon had 10 sharp declines on its way to a 2,542% gain

AMZN price per share



Source: RIMES. As of 10/31/18. Price per share based on USD.

"In the early days of a market correction, stocks that have done the best in the recent period often come down the most," O'Neal says. "But over a long-term horizon, the outlook for these companies can continue to be strong."

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