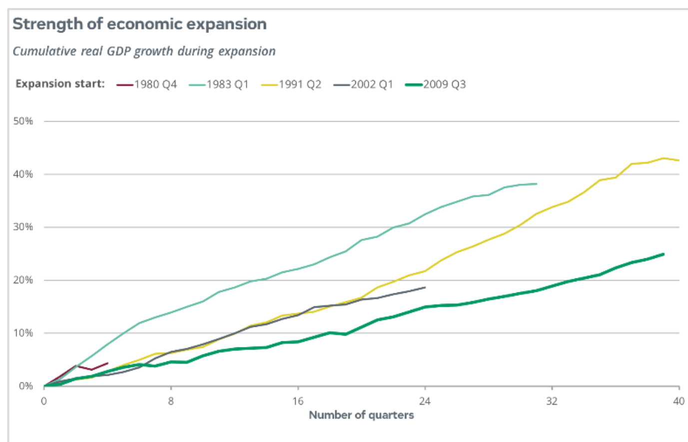
THIRD QUARTER 2019 MARKET OUTLOOK: CURRENT ECONOMIC RECOVERY STILL FACES OBSTACLES

July 2, 2019 | Mark Simenstad, CFA, Chief Investment Strategist

Entering the third quarter 2019, the U.S. economy is now in the longest period of economic expansion in the modern financial era! The recovery officially began in June 2009. But while economic growth has continued throughout this period, the growth has been modest versus previous recoveries.

A slower recovery, however, may not be a bad thing. Recessions often occur as a function of excesses in the economy that require an economic adjustment. For instance, think of the housing boom in the last recession, the internet bubble prior to that, and the savings and loan crisis in the late 1990s.



The difference in this cycle is that it would be difficult to identify any sector in the domestic economy that has reached bubble-like proportions that are significant enough to trip the U.S. into recession.

That said, there are some factors that may impact the *global* economy that would cascade back to the U.S. and be disruptive to the outlook for continued growth.

Trade disputes

The most significant of these factors is the potential for the current trade disputes between the U.S. and many of its trading partners to lead to a tariff tit-for-tat that could threaten global growth. The most visible is the China-U.S. trade dispute. In early May the administration re-imposed tariffs on $200 billion worth of Chinese exports and suggested that additional tariffs were in the pipeline should China not respond favorably to U.S. demands.

There was also the threat of new tariffs imposed on Mexico related to Mexico's efforts to stem the flow of migration from Latin America to the U.S. Europe also came into play with the threat of tariffs on automotive exports to the U.S. While each situation carries risks, our current expectation is that each of these will be favorably resolved. We are keeping a close eye on regional purchasing manager Indices (PMI's) and global exports to gauge the economic risks.

These issues appear to be having an impact on business confidence and behaviors. The uncertainty for future business activity created by these trade disputes seems to be manifesting itself in the declining confidence level that business managers have in future capital investment and hiring.

In the U.S., surveys of purchasing managers and suppliers are showing signs of deterioration, albeit still at levels that suggest the economic expansion can be sustained. Outside the U.S., particularly in Europe, those surveys suggest the potential for a much more significant decline in the outlook for global growth.

Europe – and Germany in particular – are more dependent on exports than the U.S., especially to China. The stifling impact of tariff uncertainties may be impacting behaviors in China as well. Both of these economic entities are now significant enough that an unfavorable outcome will likely cascade back to the U.S. economy.

Brexit troubles

Brexit has faded from the headlines recently amidst a leadership crisis in the U.K., with a "final" decision on Brexit now delayed until at least October. The recent resignation of Prime Minister Theresa May has set up a battle for the leadership of the Tory party. Whoever emerges as the new U.K. leader will face the daunting task of working out a final decision on its membership in the European Union (EU).

The end result will have far more impact for the U.K. than it will for the EU, which is why the EU is expected to stand strong in its demands. Stay tuned.

Interest rates dropping

Perhaps the most representative variable of these economic uncertainties, both domestically and globally, has been the decline in government bond yields. In the U.S., yields on 10-year Treasuries have fallen from over 3.2% in November 2018 to about 2% today.

Globally, in almost all government bond markets outside of emerging markets, yields are at their lowest levels of the past 12 months relative to average yields. In developed markets outside the U.S., short and intermediate bond yields are pervasively negative. About $13 trillion of sovereign bonds sport negative current yields.

The unexpectedly low inflation rate has been a key contributor to the low bond yields, both domestically and internationally. Many fundamental factors, particularly related to employment, would suggest that inflation pressure would become more robust, yet that has not yet materialized. Recent statements by both the Federal Reserve (Fed) Chair and the head of the European Central Bank have cited the benign behavior of inflation as a factor in their respective decisions to curtail further rate hikes – a key factor in the recent improvement in stock market performance.

Our proprietary economic indicators for the U.S., the U.K. and Europe are all signaling a heightened risk environment for economic growth. Most of the weakness appears to be a function of softness in the business outlook. By contrast, consumer trends, such as consumer spending, remain solid, indicating that if business uncertainties are resolved, the economic outlook would become more optimistic. But if those uncertainties are not addressed, it could negatively impact consumer trends.

A look ahead

At its June meeting, the Fed dropped all references to "patience." This is being perceived as a near certainty that the Fed will lower rates at its July meeting by at least 25 basis points. Frankly, it seems the market may be internalizing a 50-basis-point reduction, followed by another 25-basis-point reduction in September. This seems aggressive to us barring a significant reduction in global and U.S. growth expectations. While business data is soft, consumers are feeling pretty good and unemployment is an extremely low 3.6%.

Yield curve inversion

The yield curve is inverted for very short-term rates, such as maturities of less than one year versus maturities of 10 years. But that's the space where central banks have a lot of sway. If you look at maturities of more than one year, the curve is still rising, albeit modestly. Certainly, the interest rates levels do not indicate any impending surge in economic growth.

Equity outlook

While changes in price-earnings ratios (P/E) can affect stock performance in the short term, it is earnings growth that drives stock price performance in the long run.

In the current cycle, we have seen a rather meaningful improvement in the aggregate profitability of the S&P 500®[i], which is largely a function of the improvement of the profit margins of large cap companies in both the manufacturing and information technology sectors. However, both sectors appear to be peaking. In fact, information technology may be reversing course – at least for some sub-sectors.

Although many companies had a nice boost in profits in 2018 due to corporate tax cuts, that will not be the case in 2019. In fact, expectations for the reported earnings of S&P 500 companies for the second quarter are now negative. That is related, in part, to the decline in oil prices, but it is also a function of reduced expectations in the Information Technology sector (particularly hardware companies).

On a strategic basis, we are underweight our long-term equity targets, which we know are aggressive. Given both the economic and geopolitical risks today, we are comfortable in that position.

Bond yields sagging

Recession or not? Domestic bond markets appear to be pricing in low inflation, modest growth and no recession. While yields have declined substantially, they have not declined disproportionately relative to economic growth expectations. In terms of the economic outlook, it would be more disconcerting if we were seeing spreads widening. We are monitoring the latter.

Geopolitical concerns

Geopolitical issues always pose a risk, but the risks appear to be heightened today. In particular, risks to oil-producing areas are more germane to the economic outlook. Brexit will be back in the news, but is more of an EU-U.K. issue than a global issue. We believe that the turmoil in the Middle East is more relevant to the global economy and should be monitored more closely.

Stocks vs bonds

One disconcerting element of the current environment is the performance of stocks versus bonds, particularly from a global point of view. While stocks have done well this year, so have bonds. If you look back over the last twelve months, bonds have outperformed stocks. Historically, in periods when bonds outperformed stocks over a sustained period, it has often signaled a bad patch for the economy. That is a variable we are monitoring.

See **Second Quarter 2019 Market Recap: Stocks Rebound as Bond Yields Sag**

[i] The S&P 500 is a market-cap-weighted index that represents the average performance of a group of 500 large capitalization stocks.

Media contact: Samantha Mehrotra, 612-844-4197, samantha.mehrotra@thrivent.com

All information and representations herein are as of July 2, 2019, unless otherwise noted.

The views expressed are as of the date given, may change as market or other conditions change, and may differ from views expressed by other Thrivent Asset Management associates. Actual investment decisions made by Thrivent Asset Management will not necessarily reflect the views expressed. This information should not be considered investment advice or a recommendation of any particular security, strategy or product.

Past performance is not necessarily indicative of future results.

2615186-070119