STRATEGY INSIGHT

January 2019

People's United Advisors

Economic Overview

	2Q'18	3Q'18	4Q'18	1Q'19	2Q'19	3Q'19	4Q'19
Real GDP *	4.2%	3.4%	2.6%	2.3%	2.5%	2.3%	2.0%
CPI (year over year)†	2.8%	2.3%	2.3%	2.1%	2.2%	2.3%	2.3%
Unemployment Rate†	4.0%	3.7%	3.7%	3.6%	3.6%	3.6%	3.5%

------------------------------------ estimated ------------------------------------

* Quarter over quarter annualized † end of period

Increase from last reported

Decrease from last reported

Source: Bloomberg

Signs of Recession: All Clear for Now

Reports that the U.S. economy appears to be slowing have worried investors and contributed to recent stock market volatility. Foreign economies, and China's in particular, also appear to be slowing compounding investor concerns.

A slower growing economy is not a concern in and of itself. The worry is that economic growth will stall and the economy will fall into recession – a prime ingredient for a bear market in equities. The U.S. economy has been growing since 2009, and growth picked up last year thanks to the effects of the Tax Cuts and Jobs Act passed in December 2017. Those effects are waning, however, and growth in 2019 is likely to be less than in 2018. Current projections – reported in the table above – show growth decelerating to the 2.0% - 2.5% range.

We believe that the U.S. economy has a great deal of momentum to it, and the likelihood of a near-term recession is remote. None of the four sectors of the economy that have driven the cyclicality of the U.S. economy historically – housing, cars, business capital spending, and inventory investment – is overheated. Last month's Strategy Insight pointed out that housing investment has been depressed and car sales have risen to an equilibrium level. Business investment has been modest – largely making up for deferred investment during the Great Recession (2008). And inventory investment has been stabilized by new inventory management systems including just-in-time inventory management.

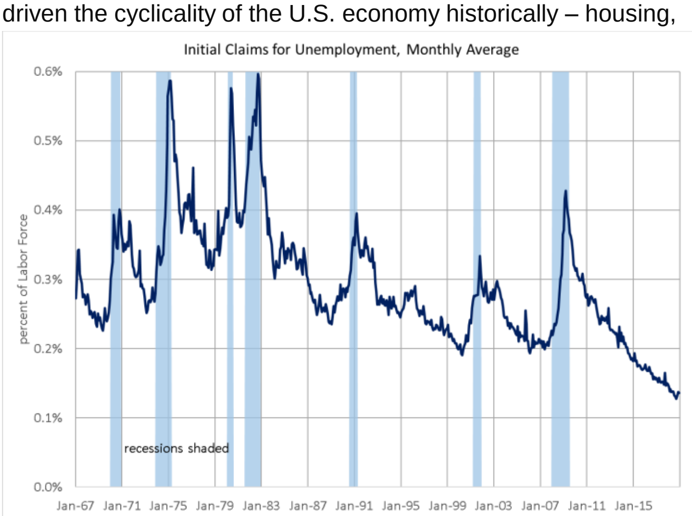

Chart Source: Bureau of Labor Statistics

Slower growth in the U.S. will keep the expansion going for longer, as it relieves strains on the capacity of the economy to grow – both through labor and capital investment. Paradoxically, slower growth is good for the investment outlook, so long as growth doesn't stall.

One measure investors should be watching as a stall indicator is the weekly report of initial claims for unemployment. Weekly initial filings have averaged less than 230,000 since early 2018, the lowest level since 1969. With a larger labor force, initial filings as a percent of the labor force are at the lowest level since data was gathered (see the chart at left). If initial filings turn up, investors should beware. Filings have troughed on average 15 months before the onset of a recession and 8 months before market peaks. For now, the signal is all clear.

Can the length of the current U.S. expansion match Australia's, which is currently in the 23rd year of its growth cycle? It will depend on continuing consumer and business confidence, prudent monetary and fiscal policies, and on the supply of labor. For now, despite investor worries, our outlook for continued growth is favorable.

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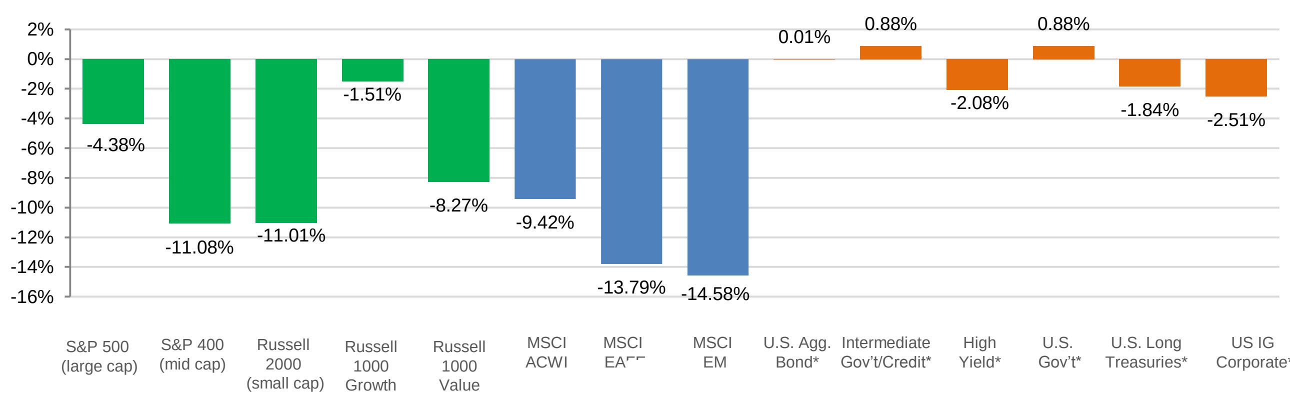
Equity: ”This is a new year. A new beginning. And things will change.” — Taylor Swift

- Last year's market decline of almost 4.5% belies a year of significant volatility. During 2018 we experienced one correction and the start of a second and larger one. Last year's second act began at the beginning of October with fears of a pending recession fueled by worries over the Fed's plan for rate increases, comments by Fed chair Powell, and concerns regarding global growth. The end result was a fourth-quarter S&P drop of 13.5%, a December collapse of over 9%, and the S&P 500 coming within 22bps of its first 20 percentage point decline since 2008.

- There was no place to hide in 2018, especially in the fourth quarter. All equity styles (large, mid, small-cap, value, growth) declined double digits in the fourth quarter, including international. Eight of the 11 S&P sectors were down for the year, and 10 of the 11 were in negative territory for the last quarter of the year.

- The new year is off to a positive start, however, with a 1% plus gain in week one. In addition to continuing economic strength, the start of 2019 saw positive comments from Powell regarding interest rates and hopes regarding trade with China.

Market Returns: Year-to-date as of December 31, 2018



Source: Bloomberg *Bloomberg Barclay's indices

Fixed Income: Bond Market telling Fed to hit the brakes on rate hikes

- Bond Market forward yields now indicate a cut in the Fed Funds rate will occur by early 2020, through a measure called the "near-term forward spread".

- The difference between the forward rate implied by Treasury bills 6 quarters from now and current 3 month T-bill rates is now negative for the first time since 2008.

- When the near-term forward spread turns negative, it indicates bets on easier policy over the next several quarters, presumably because [investors] expect monetary policymakers to respond to the threat or onset of a recession by cutting the Fed Funds rate.

- The front end of the Treasury rates curve is now inverted through 6 months-5 years and 1 year-7 years. The shape of the curve is as important as the slope for policy and economic forward indicators. There is currently a bump in the curve where the one year Treasury yield is higher than Treasury yields for 7 years. This appears to signify a higher likelihood of a policy mistake against a low inflation backdrop.

- If the Fed signals an intent to pause the interest rate hiking cycle at its March meeting, that may serve to normalize overbought long rates and allow rates to drift upwards so the slope of the yield curve steepens a bit.

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