In December 2017, Congress enacted the Tax Cuts and Jobs Act, which promised to create a surge of new business investment in plant and equipment, accelerate growth to above 3% annually, and increase wages. The stock market rose 26% in the 14 months leading to the actual passage of the TCJA in anticipation of the tax cuts, and continued to reach new highs in the first half of 2018 as growth forecasts and earnings expectations were revised dramatically upward. Alas, as was the case of the prior tax cuts of the 1980s and 2000s, the reality failed to measure up to the promise.

Now, less than 20 months after implementation of the tax cuts, economic growth is slowing to below 2%, and two-thirds of chief financial officers surveyed by Duke University expect the economy to fall into recession by the end of 2020. The President blames the Federal Reserve for keeping short term interest rates too high, while corporate executives (whose companies were the biggest beneficiaries of the TCJA) blame the President's ongoing trade wars with China and our other trading partners. Both are right.

The Institute for Supply Management (ISM) manufacturing index shows that production contracted for the second consecutive month in September, and is now at its lowest level since the Great Recession a decade ago. That same index was at a post recovery high as recently as last fall. Comments from the survey's participants clearly cite global trade as the most significant concern, and their concern is evidenced by the contraction in new export orders that began in July 2019. The survey also reflects a continuing decrease in business confidence, which is indicated by statistics showing that investment in non-residential building and equipment slowed dramatically in the second quarter.

Some analysts are pointing to the ongoing strike at GM as a factor in September's weak results, as the walkout's impact has begun to adversely affect production at GM's suppliers. They expect that manufacturing surveys will improve when the strike ends, and they are probably correct, at the margin. And it must be said that the weakness in the current data is not yet at a level that foretells of an *imminent* recession. But it is the trend that must be noted, not just the current numbers. The surveys measure eleven areas of manufacturing data - new orders, production, employment, backlog, exports and imports, among others – and eight of those areas are contracting. What's more, six of those eight areas are contracting at a faster pace than in prior months.

If weakening production data is one leading indicator that is flashing amber, a persistently inverted yield curve is another. As we have pointed out in past *Outlooks*, every recession in the last fifty years has been preceded by an inversion of the yield curve. The reciprocal is also true, that every inversion of the yield curve has been followed by a recession within 12-24 months. Short term interest rates rose above the 10-Year Treasury rate briefly in March, and then again in May. We noted in this piece on both occasions that the yield curve needed to invert over a sustained period to be a meaningful leading indicator. So it is worth noting that the curve has now been inverted every day but one since July 31, a period of more than two months.

Long term interest rates rise and fall in anticipation of changes in economic activity, and the 10-year Treasury rate was at 3.2% as recently as November 2018, just as manufacturing data was peaking. That rate has plummeted through-out 2019 as growth forecasts have been revised downward, bottoming out at 1.47% in early September. As a result, long term bonds have produced historically high returns over the last year. The 20-Year Treasury Bond ETF has produced a 25% return year/year, while the S&P 500 index is up less than 3% over the same period.

Meanwhile, the Fed has moved too slowly to lower short term rates, at the same time as the lag effects of four rate increases in 2018 are beginning to be felt in the economy. Given the Fed's dual mandate to maximize employment and stabilize prices, its focus on current data rather than leading indicators is understandable. But the bond market is clearly discounting a growing possibility that the Fed may not be able to engineer a soft landing for the longest economic expansion in our history.

As it pertains to equities, attempts at binary forecasts, such as recession or no recession, miss the point. What is important is that future earnings expectations are almost certainly unattainable even if the economy avoids recession and simply slows further from here, as expected. Earnings results for all of 2019 will likely come in 8-10% below prior estimates, while consensus estimates for 2020 remain 11% above this year's expected results. With the economy slowing, the Fed conflicted, and the leading indicators becoming increasingly negative, it would seem that future earnings expectations need to be viewed with more than a normal dose of skepticism.

This is not a call to abandon ship, but we think that it may be prudent to move some risk assets to the safe harbors of cash or short term government bonds. There are no financial bubbles or excesses in valuations that would cause a market meltdown on the order of what was experienced during the dot.com meltdown of 2000-2002, or the Great Recession of 2008. But we believe that we are at a point in the economic cycle where the risk/reward equation from equities appears increasingly unfavorable, and capital preservation should become a more important goal for the foreseeable future.


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