# Third Quarter 2019

## Recession Watch is On but Recession Not Yet Forgone

### Economic Growth Winds Down but No Alarm Bells Just Yet


**The Team:**

Brian Steele, CA, CPA, CFA®
Laura Prust, CIM®, CPCA
Jeannine Campbell
Kelly Edmonds
Elizabeth Kernohan
Sam Ryder, CFA®
Matthew Bell, CFA®

## Quarterly Summary and How We're Positioning for Q4

Since ratcheting down portfolio risk in March following the inversion of the US yield curve, we have been on pause. Recessions typically occur six to eighteen months following yield curve inversion so we are now within the range. We are on high alert, analyzing incoming economic data for hints about where the economy and stock market is headed in the near-term. We believe that maintaining equity exposure is prudent until there is a clear signal that the current economic cycle has ended.

The US-China trade war has continued to weigh on the global manufacturing economy while the global service economy has been quite resilient. The JP Morgan Global Manufacturing PMI held its ground finishing the third quarter at 49.7 after hitting 49.4 in June (50 demarcates expansion from contraction). This means the global manufacturing sector is officially shrinking, but just barely, and the sector has stabilized for the time being. That said, weakness in the global manufacturing economy has started to drag on the global service economy, which is growing at its slowest pace since the energy sector driven downturn in 2016.

The ongoing Brexit negotiations has much of Europe on pause, as key Brexit issues remain unresolved. Anything but kicking the can down the road looks impossible, as both sides of the UK parliament are entrenched in their positions and nobody is budging. The broad European economy is stagnating with some countries experiencing negative GDP growth in Q3.

Employment remains strong globally with few countries experiencing rising unemployment rates. Hiring has slowed in 2019 after two years of impressive employment gains. Employment continues to grow and unemployment rates sit near all-time and/or cycle lows in most large economies around the world. The US labour market, typically seen as the hallmark for global employment, remains quite strong with monthly nonfarm payrolls still within a normal expansionary range and weekly jobless claims still holding near a 45 year low.

Stock markets were very volatile throughout the third quarter but ended fairly close to where they started. Bonds on the other hand were also volatile but ended markedly higher (and yields lower) as investors bet on falling global interest rates driven by the US Federal Reserve. The US Fed cut interest rates by 0.25% each in July and September and the bond market is currently pricing in another one-and-a-half 0.25% cuts by the April 2020. Early in Q3, the bond market appeared to be pricing in a recession with six interest rate cuts expected by the end of 2020. The bond market has rationalized a bit, and is now expecting a total of four cuts (the two previous plus two future cuts).

It seems as though almost everyone is expecting a recession to start sometime in 2020 or 2021. While the lead up to past recessions has come with a good number of market participants loudly beating the recession drum, there seems to be an almost unanimous belief that a recession will occur in the next year or so this time around. While we see many recessionary signs, we are hesitant to commit to a recession call until we see a deterioration in US bank lending and a turn in US employment data.

History supports taking a cautious approach to equity markets at the current time. By that we mean maintaining a neutral exposure to equity markets and a more defensive tilt with respect to sector exposure (i.e. overweight telecom, consumer staples, utilities and health care and underweight cyclical sectors).

Our favoured indicator remains the US Senior Loan Officer Opinion Survey (SLOOS) on Bank Lending Practices. This indicator has yet to indicate any stress in US financial markets, and as a result we remain confident that the US economy is growing at a healthy rate. The next release of this quarterly survey is set for early November. The US Fed's Beige Book report also offers some insight into US bank lending. This report is issued on a more frequent basis – eight times per year versus four times for the SLOOS – and the most recent report issued in October shows continued strength in the US economy.

## US-China Trade War

The trade war escalated throughout the third quarter as both sides seemed caught in a tit-for-tat exchange.

In the third quarter we saw the US side:

- Implement as well as threaten additional tariffs
- Label China a currency manipulator
- Order US companies to find alternatives to China where possible

While we saw the Chinese side:

- Implement new tariffs
- Allow its currency (renminbi/yuan) to depreciate relative to the US dollar
- Announce an accelerated reduction in US treasury holdings
- Halt purchases of US agricultural products

Subsequent to quarter end, the US side added a number of Chinese technology firms to its "entities blacklist" citing human rights issues. This is the same blacklist that Huawei is currently on which requires it to request US government approval to purchase US technology products.

Notwithstanding this action, the two sides came to a framework whereby China would purchase US agricultural products and open its markets up to US financial services companies while the US would refrain from initiating any new tariffs on Chinese imports.

Chinese GDP growth fell to 6% in Q3, its lowest rate of GDP growth since 1992. Expectations of a gradual decline in Chinese GDP growth is due to diminishing returns as the Chinese economy matures. That said, the decline has been a little more rapid than most expected, largely because of the US-China trade war and the slowdown in global manufacturing. The big question is if or when Chinese officials start to discuss fiscal stimulus to revive economic growth.

## Oil Price Summary

Quarter-over-quarter the price of oil was lower, finishing the quarter at ~US$54 (WTI) versus ~US$60 (WTI) at the end Q2. Oil prices were volatile throughout the quarter. Oil demand was lower than expected as manufacturing activity underwhelmed, while the Houthi attack on the world's largest oil refinery in Saudi Arabia caused concern about oil supply in the short-term.

**Positioning Heading into Q4**

We remain cautious towards equity markets due to the inversion of the US yield curve and worsening global economic data. We believe it makes sense to maintain meaningful equity market exposure at this time as it remains possible for the economy to rebound from current levels, particularly if China commences greater than expected fiscal stimulus. We believe it is more likely that a recession and market downturn occurs after a short-term, stimulus-induced burst in investor sentiment than following a long period of gloomy investor sentiment, which is where we are now. It makes sense to be overweight the defensive stocks but to maintain some cyclical equity exposure (e.g. financials, industrials, technology) as a potential economic rebound would likely benefit cyclical stocks in an outsized way.

If US lending activity worsens markedly as per the US Senior Loan Officer Opinion Survey on Bank Lending Practices, we would be decisive in taking a more defensive approach to equity markets and boost our allocation to fixed income and/or cash.

Sincerely,

Steele Wealth Management

The information contained in this report was obtained from sources believed to be reliable, however, we cannot present that it is accurate or complete. Information has been sourced from the RJL Bond Desk or RJ Private Client Solutions, unless otherwise noted. Index and sector returns represented in this commentary are measured using the S&P/TSX Total Return Index and S&P/TSX GICS Sector Indices as detailed in Raymond James Ltd.'s *Insights & Strategies: Quarterly Edition*. This report is provided as a general source of information and should not be considered personal investment advice or solicitation to buy or sell securities. The views expressed are those of the author and not necessarily those of Raymond James Ltd. (Member Canadian Investor Protection Fund).

This Quarterly Market Comment has been prepared by Steele Wealth Management and expresses the opinions of the author and not necessarily those of Raymond James Ltd. (RJL). Statistics and factual data and other information are from sources RJL believes to be reliable but their accuracy cannot be guaranteed. The performance outlined in the report is net of fees. The client account performance may vary from the model portfolio due to several factors, including the timing of contributions and dates invested in model. The performance reported is that of the account that represents the model, not a composite. Performance calculation for the models may be different than the index used as a reference point. It is for information purposes only and is not to be construed as an offer or solicitation for the sale or purchase of securities. This Quarterly Market Comment is intended for distribution only in those jurisdictions where RJL and the author are registered. Securities-related products and services are offered through Raymond James Ltd.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.