Recession watch: Low risk on the horizon

Economic and market commentary as of September 30, 2018

We are now in Year 10 of the economic expansion that began in June 2009. The U.S. continues to lead the global business cycle through this period of growth, but many signs indicate the current expansion is maturing.

Many investors are wondering how much longer this cycle of growth can last and whether a downturn is imminent. Recent headlines in the financial media and increased attention on the yield curve have raised investor worries about a coming recession. Like nearly all headlines, there is more hype than substance behind them.

> In our view, the current expansion phase **still has room to run** and there is low risk of recession appearing **in the next 12 months.**

Many economic and financial market indicators we watch currently point toward continued expansion rather than slowdown. However, investors should be attuned to the economic and market signs that may indicate the turning of this cycle.

It's important to remember that economic expansions don't have expiration dates. Rather, the economic cycle turns in a natural progression until business and consumer activity overheats and central banks apply monetary controls to cool the economy.

In this update, we'll analyze many of the indicators that can help investors better understand the evolution of the economic cycle and prepare their portfolios for what's ahead in coming quarters.

Recession watch: What the economy is saying

Stronger economic data over the last few months suggest an above-trend pace of economic activity for the remainder of 2018 and into next year, with low risk of the U.S. economy slipping into recession.

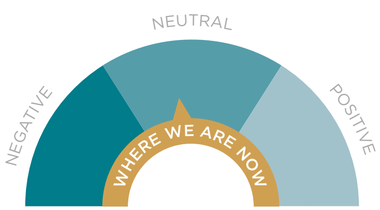
Current economic cycle review

The U.S. economy is growing at its fastest pace in several years, spurred by job gains, consumer spending, and business investment. Thanks to strength in the economy, year-over-year inflation has climbed to the fastest readings in years and is on track to remain at or above the Fed's 2% target over the next year.

Nationwide Economics (September 2018)

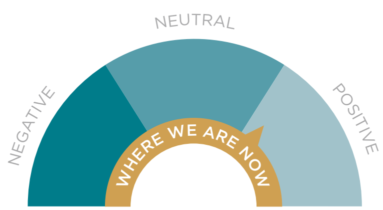
Key economic indicators

The key economic indicators we monitor continue to support the ongoing expansion rather than warn of any potential slowdown. Economic growth in Q2 reached the fastest pace in several years, fueled primarily by economic factors such as a strong labor market, robust consumer spending, and fixed investment expenditures from U.S. businesses. Inflation is running near the Federal Reserve's goal for price growth, keeping the Fed on this current path of quarterly rate hikes.



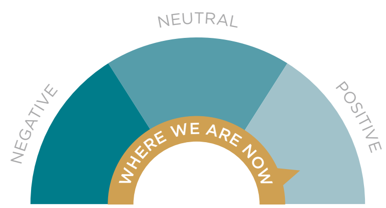
Yield curve

The difference or spread between short- and long-term interest rates is as small as it's been in 10 years. Until there is a sustained inversion of interest rates, the economy is likely to continue to grow with little immediate concern about a downturn.



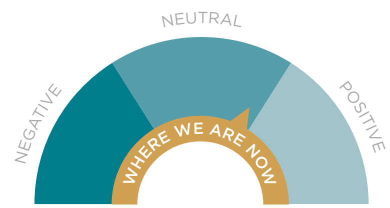
Payroll employment

Job growth appears stronger than it was one year ago. The three-month average of job gains is still near 200,000, a rapid pace for the age of the current expansion.



Jobless claims

Data on initial jobless claims also show improvement, with the four-week average at its lowest level since 1970. That's a good sign for consumer spending and a continuation of the current economic expansion.



Building permits

Growth in residential housing permits remains solid and to date, shows no signs of turnover in the housing market. Homebuyer demand for new housing is strong as the inventory of existing homes on the market remains historically low.

How to read this dashboard

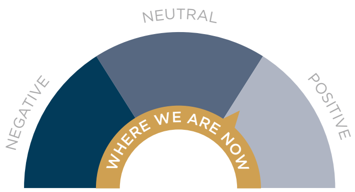
The key indicators shown above reflect the some of the specific data points we watch to help us evaluate where we are in the current economic cycle. A positive reading would be supportive of an economic expansion. A negative reading indicates a greater possibility of economic cycle turning into recession.

Recession watch: What the market is saying

U.S. stock markets are riding the fiscal stimulus tailwind. Corporate tax reform is having a noticeable impact on earnings, which is a primary driver of stock returns.

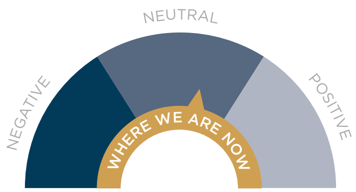
Key market indicators

U.S. equity investors have largely shrugged off concerns about tariffs and trade wars — the size of fiscal stimulus should continue to outweigh any negative impact that tariffs may have on the U.S. economy. While U.S. stock indexes continue to rally, the gains have been driven primarily by the technology and consumer discretionary sectors. The strength in earnings has kept equity valuations in check, and stocks continue to appear more attractive than bonds in the current market environment.



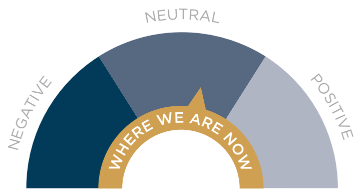
Earnings

The economic cycle is the primary driver of corporate earnings, and earnings drive stock prices. Given the current strength in earnings growth, it is hard to imagine that a stock bear market or a recession is likely in the near term. Earnings growth for all of 2018 looks likely to come in above 20% on a year-over-year basis — stronger than it has been in several years.



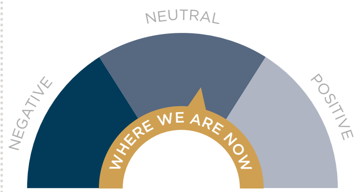
Valuation

Equity valuations have improved, with the forward price-earnings ratio of the S&P 500 falling from 18.5 times earnings in January to 16.8 at present. Valuations are slightly above historic averages, but with earnings improvement, we don't believe the elevated values are worrisome.



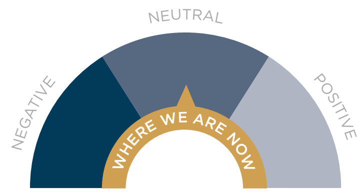
Fiscal/monetary backdrop

Accommodative monetary policy continues to provide a tailwind for equity markets, despite recent Fed rate hikes. Fiscal policy is affected by crosswinds: Tax reform has given corporate profits a lift, incentivized capital investment and sparked a trend of returning capital to shareholders. Trade and tariffs are a headwind, but a controlled one for now.



Credit

The current environment for corporate borrowing is extremely strong, but recent trends show investor demand for yield growing (e.g., greater flows from stocks into bonds.) Company balance sheets and earnings remain supportive, the absolute level of rates is low, and banks are accelerating lending to businesses.



Technicals

U.S. stock market indexes recently broke above resistance levels, giving a boost to the ongoing bull market. Breadth appears strong, with small caps outperforming large caps and growth outpacing value and defensive stocks for the year to date. Market leadership appears to be turning from momentum to quality, reflecting broad-based gains and an overall healthy market.

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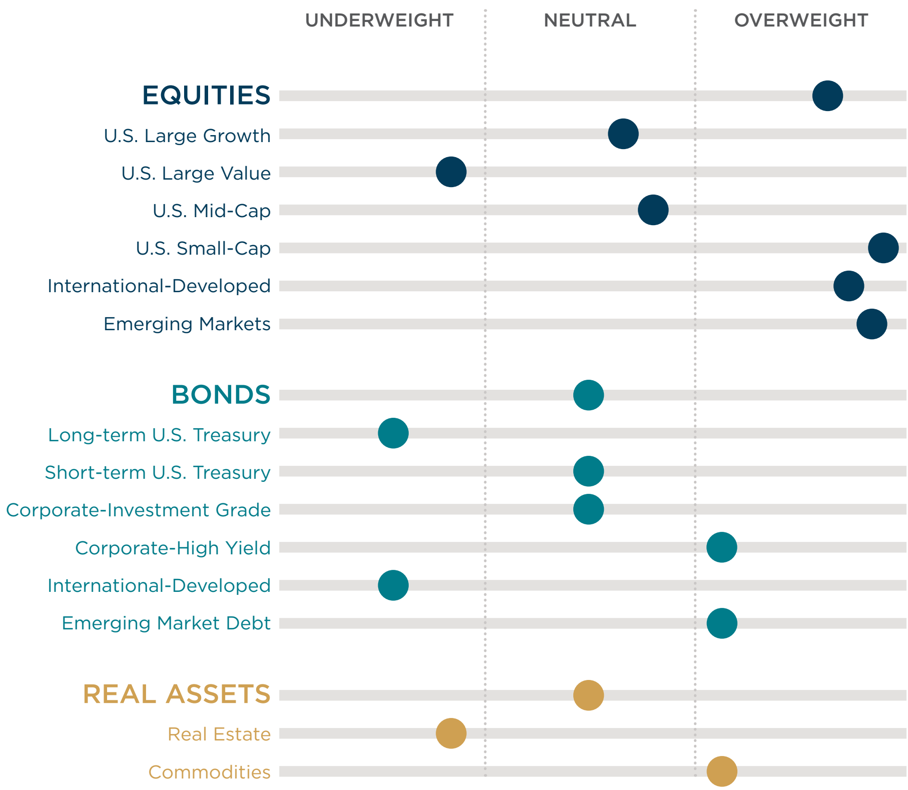
Investment opportunities and risks

Ongoing strength in the U.S. economy and U.S. corporate earnings should likely sustain the equity bull market. We see potential opportunities in small-cap and international markets, both of which have lagged the large-cap U.S. stocks through the current period of expansion. We also urge caution in fixed income markets, which are currently transitioning from the long-term decline in interest rates.



Nationwide Investment Research, (September 2018).

Opportunities

Quality growth: Large companies with strong balance sheets should be in good position to perform well in the late expansion cycle. Quality companies have more levers to pull to generate growth as the economic cycle ages (e.g., margin expansion, share repurchases, deleveraging, etc.) Tax reform is driving return of capital to shareholders in the form of dividends and stock buybacks.

International stocks: Advanced economies remain behind the U.S. in the growth cycle and still have room to play catch-up to U.S. markets in terms of equity market performance. The valuation gap between U.S. and international stocks remains wide.

Small-cap stocks: The late expansionary phase continues to favor outperformance over large caps. Similar to the story for international stocks, small-company stocks have lagged through the current cycle and have room to run.

Risks

Fixed income: Diversification will be key for bond investors as the interest rate cycle transitions from historically low yields. Active fixed income strategies are well suited for this phase of the cycle, as they can shorten duration when interest rates rise. If there's any saving grace for bond investors, it's in the moderate pace of rate increases to date; we expect 10-year Treasury rates won't be sustained above 3% until the end of 2019.

Bond proxies: Stocks in traditional high-yield sectors — including telecom, utilities and real estate — would seem to be good defensive allocations as the economic cycle turns, but would likely underperform in a rising rate environment.

Developed market bonds: Rates in Europe remain at the low end of the range; with quantitative easing coming to an end in the European Union, rates will most likely rise.

Key takeaways

1

We currently see a low risk of recession in the next 12 months and opportunity for the ongoing economic expansion to continue.

2

Key indicators of economic health support continued expansion with little possibility of a slowdown.

- A flattening yield curve bears watching, but an inversion (which would be a recession signal) seems unlikely in the near term

3

Financial market signs indicate **the equity bull market still has room to run.**

- Company earnings are poised to continue the boost from tax reform and other fiscal stimulus, which should support further equity market gains

4

We see opportunities in small-cap and international stocks in the current market environment.

- Fixed income markets in general appear riskier than stocks, but investors can help manage the rising interest rate environment with active bond strategies

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