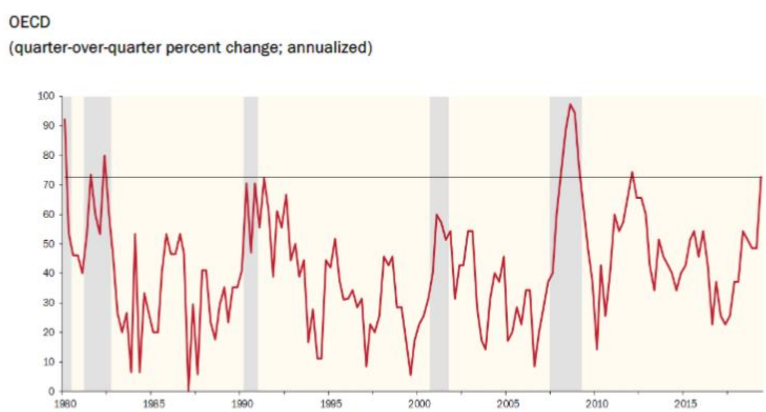
COHO PARTNERS, LTD.
Economic Commentary

Fourth Quarter 2019

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing,"

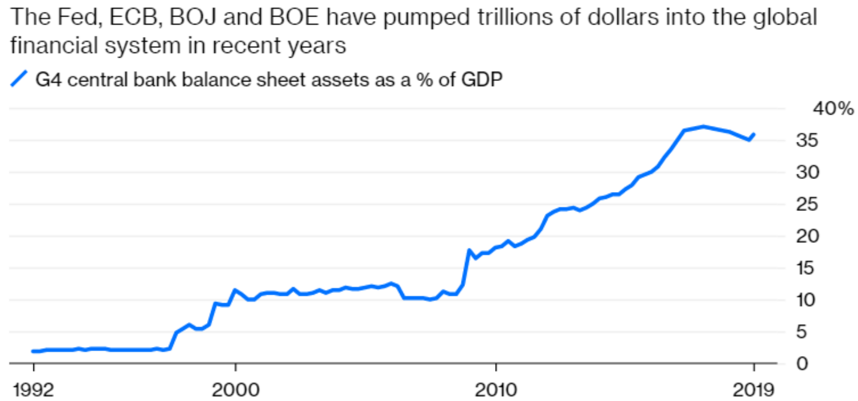
-- Chuck Prince, CEO Citigroup 2007

The share of countries that have seen their economies slow to a real GDP growth rate of 2% or less (see chart below from Rosenberg Research) has now ballooned to 73% from 54% one year ago and 23% just two years ago. Though not technically in a global recession, the share now growing at less than this stall speed level is higher than 2001 and the same as 2008, a synchronized global slowdown that reflects the mirror image of what we enjoyed in 2017. With nearly three-quarters of world GDP at or below this level, the OECD (Organization for Economic Cooperation and Development) leading economic indicator declined for 21 consecutive months until a flat reading in December broke that ignominious streak engendering some signs of optimism that perhaps a bottoming was near and we might return to the halcyon days of not knowing the names of central bankers.



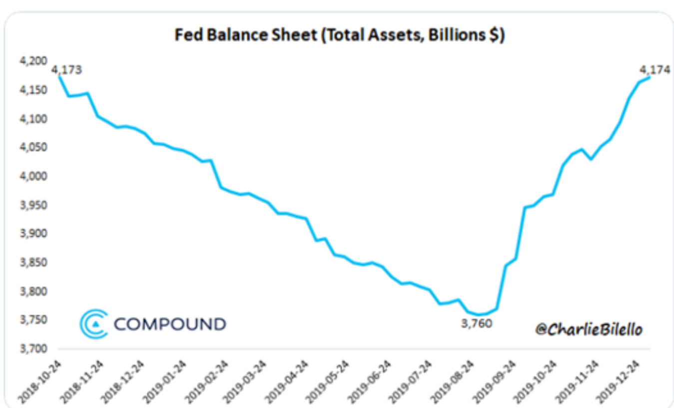
The flexibility and adaptability of global economies to changing conditions (none more so than here at home) has continued to increase and has fostered the longest economic expansion (entering the 127th month) in U.S. history allowing the most recently passed decade to become the first ever to avoid even one day of a recession. Wars and geopolitical events, oil price shocks and financial industry excesses are often economic cycle tipping points but have remained exceedingly quiescent during this decade. Increasing technological productivity has also kept a lid on price increases reducing the risk that the world's Central Banks would need to raise interest rates to fight inflation.

The containment of inflation has been critical as it has allowed a historically unconventional tailwind to emerge during this decade as a continuous source of economic support and on a global basis, monetary policy. As the year ended, the collective balance sheets of the Federal Reserve, European Central Bank (ECB), Bank of Japan (BoJ) and the Bank of England (BoE) have collectively risen from about 26% of total gross domestic product (GDP) in 2008 to the current level just short of 36% (see chart below from Bloomberg). Here the law of diminishing returns is out in full force, though, as during this time frame, global debt has increased over $128T while generating only a $37T expansion in GDP.



In our commentary entering 2019, we highlighted the two greatest economic and market risks as being escalating trade conflicts and changing Federal Reserve monetary policy. We wrote then, "Though trade conflicts have been a worry over the last year, for far longer we have expressed concern as to the impact on financial markets of Federal Reserve machinations following the Great Recession leaving near zero interest rates……. To be naïve as to the potential impact on consumer and business confidence that the unwinding of fiscal stimulus (via the reversal of Quantitative Tightening through the reduction of the balance sheet of the Federal Reserve) might have is to disbelieve the causation that such interest rate manipulations have had on all financial assets."

With balance sheet reduction on "autopilot" alongside the duality of the Fed insisting they would be raising interest rates several more times, the U.S. market dropped nearly 20% in 4Q 2018 and recession fears rose. As the Fed reversed course on further interest rate hikes in early 2019, stocks roared and posted one of the best total return years ever as fears of an oncoming recession faded. With a still contracting balance sheet, the overnight lending or repurchase agreement market (referred to as the repo market) froze up in September due to a shortage of reserves sending interest rates soaring. This, in turn, forced the central bank to also reverse course here, and they have since boosted balance sheet assets by over $400B further reversing much of the prior reductions (see chart below).

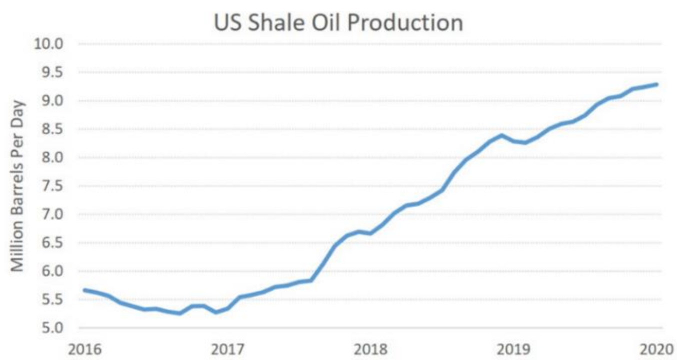


As seen above, the balance sheet of the Fed continues to rise faster than the most recent efforts at Quantitative Easing (QE) to which Jay Powell wants us not to compare. In the four months since these purchases commenced, the balance sheet has grown by over $101B per month which dwarfs the most recent QE3 that averaged $80B per month and the markets surged nearly 9% into the end of the year. We can understand the liquidity-driven, short-term influence on stock prices but need to be mindful that if policy makers get their wish and inflation returns, this might again be the major area of concern as the forces driving the current excesses will dissipate once the liquidity spigots are turned off.

UNITED STATES:

The U.S. economy continues to become more and more service and technologically focused, one far less driven by trade and manufacturing than other major economies. Historically, most recessions follow periods of interest rate tightening by the Federal Reserve in response to rising inflation concerns or a major impact on financial conditions such as those caused by oil price shocks, financial crises, or major geo-political events. While we have expressed concerns regarding a slowing U.S. economy, we have noted that these historical suspects have presented less of a headwind, especially once Federal Reserve Chairman Jay Powell reversed course on raising interest rates in late 2018.

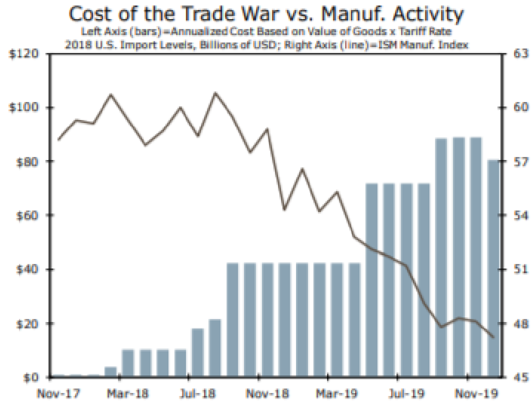
The recent killing of Iran's top general, Qassem Soleimani, may potentially represent such a concern. Iran controls the Strait of Hormuz, a key passage from the Persian Gulf through the Indian Ocean to the rest of the world. It is estimated that a third of the world's supply of liquid natural gas and almost 25% of total global oil passes through this strait. Still, the continued increase in U.S. energy production clearly blunts the impact on the U.S. economy.



Source: Bloomberg, RSM US LLP

American shale oil production has increased markedly during the past four years, growing to 9.2 million barrels per day from 5.2 million at the end of 2016. This is part of an increase of approximately 40% in U.S. oil production overall since late 2014. Another undeniable change in the U.S. economy over that span is that higher oil prices today tend to spur greater capital expenditures in the energy patch, bolstering domestic economic activity to offset the negative impact of rising gasoline prices. Though many feel that U.S. shale production has peaked, this increase clearly reduces our reliance on foreign sources of energy.

The supposition that a more service-oriented U.S. economy can smooth economic cycles and dull the impact of global trade and manufacturing concerns continued to be tested during 2019 with the escalation of the global trade war and the recent grounding of the Boeing 737 MAX airplane sending the confidence of U.S. manufacturers to the lowest level since 2009. The most recent reading of the Institute of Supply Management (ISM) manufacturing reading for December plunged to 47.2 indicating that industrial activity has now contracted in five consecutive months. Suggesting that the worst is not behind the sector was the reading on both employment and new orders that were the lowest in over a decade. The chart on the following page from Wells Fargo juxtaposes the rising cost of the trade war versus the ISM Manufacturing index.



Perhaps the recently agreed to "Phase 1" deal with China may engender increasing confidence in the C-Suites of global industry and reverse these data points but we are somewhat sanguine on that prospect. From a short-term economic perspective, we are quite pleased that the United States did not proceed with 15% tariffs that had been scheduled to go into effect on December 15th on nearly $160 billion worth of Chinese goods, including cell phones, laptop computers, toys and clothing. The U.S. also rolled back by half the tariff rate it imposed on Sept 1. on a $120 billion list of Chinese goods, to 7.5%. U.S. tariffs of 25% on $250 billion worth of Chinese goods will remain unchanged, seemingly providing U.S. leverage for a second phase of negotiations next year.

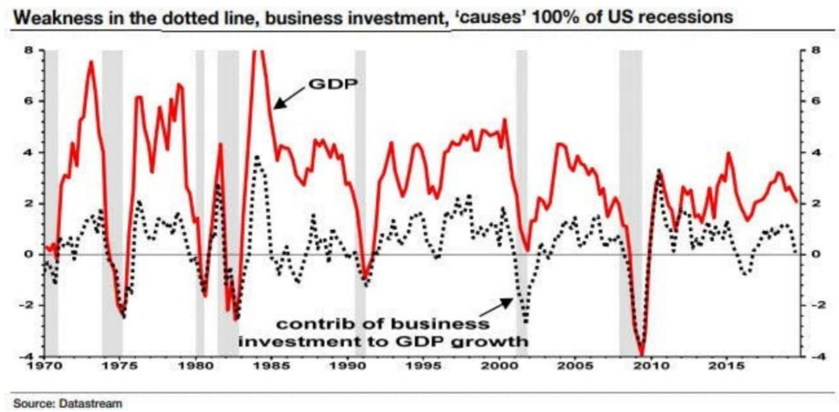
In turn, China canceled its retaliatory tariffs due to take effect that same day, including a 25% tariff on U.S.-made autos and committed to increase purchases of American products and services by at least $200 billion over the next two years. This critically includes U.S. agriculture products (desperately needed by both China and American farmers) by $32 billion over two years. That would average an annual total of about $40 billion, compared to a baseline of $24 billion in 2017 before the trade war started.

Therein lies our largest concern regarding the recent Phase 1 deal as it appears to have set highly unrealistic goals regarding Chinese purchases of U.S. exports. As the chart below from the Wall Street Journal shows, China would effectively be doubling their imports from the U.S. By setting such lofty goals, the risk of falling short is greater and the possible return to tariff wars remains. This may temper the confidence U.S. corporations need to resume investment spending. The target may be based more on political expediency than a thorough analysis of the potential demand of China and the ability of American farmers to expand output.

So where is the U.S. economic and financial market cycle now and what should we look for to help us discern whether a "soft-landing" or recession is more likely? Has the dramatic U-turn in monetary policy allowed the Federal Reserve to engineer an economic slowing while avoiding a recession? The economic expansion recently surpassed 126 months making it the longest in history. Job growth also set longevity records and the unemployment rate plumbs a 50-year low. With this backdrop, it is of little surprise that the Consumer Confidence index (see chart below) remains near cycle highs. However, these remain lagging indicators. Job growth has slowed. The unemployment rate that is touching the low last seen in 1969 was followed in 1970 by a recession. As one can see on the confidence chart below, the peaks always occur before a recession (vertical bars) and, therefore, tell us much about current conditions but little about the future.

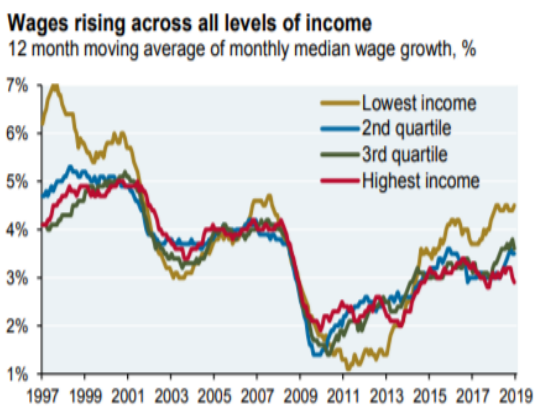
While there remain no smoking guns of market excesses or extremes, the leading indicators with a strong track record of foretelling economic downturns remain prevalent. The U.S. leading economic indicator (LEI) recently broke into negative territory on a 6-month annualized rate (chart below left from Gluskin Sheff) and is now flat over the last year (from a level of 5% at this time last year). Rather than focus just on consumer confidence that is quite ephemeral, one should also look at the confidence levels of CEOs. These are the individuals making the capital investment decisions for firms that lead hiring, hours worked and wage growth all of which are moderating. The chart below on the right contrasts CEO confidence levels with those of the consumer. Extreme negative readings (whereby CEO confidence is much lower) historically presage downturns in economic growth.

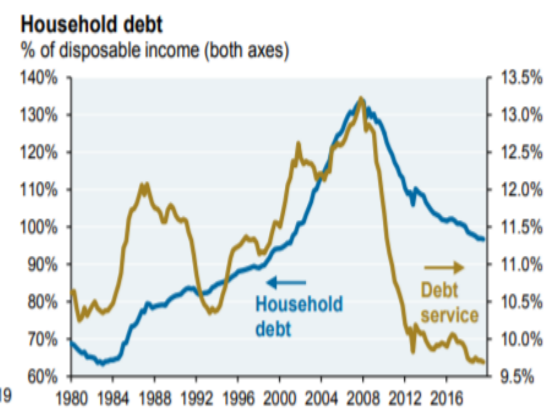
The importance of CEO confidence should not be understated. Though consumer spending remains near 70% of the calculation of gross domestic product, it is business investment that represents the critical lever and turns in this area have accounted for 100% of prior recessions (see chart on the following page). Consumer spending declines are usually modest (necessities must still be paid for) and are often a consequence of corporate actions. If CEOs find improved business clarity around the recent Phase 1 deal and recession probabililties recede, we may see an uptick in demand that releases the recent stockpiling of treasuries as banks start lending aggressivley again. This is what we are watching for that would increase confidence in a second half recovery. Still, we must be mindful that we are entering an election year with a tax policy divide between Republicans and Democrats that would threaten the confidence of any CFO to embark on a major multi-year capital expenditure.



Another reason to be on the optimistic side is that households have simply not loaded up on debt this cycle. While student loan and auto debt have surged, in general, consumers have been in a long period of enforced and then voluntary sobriety after the massive credit boom and bust that culminated in 2008. This leaves consumers in good shape. Additionally, the one direct and tangible benefit engendered by Federal Reserve policy has been the modest resurgence of the housing market. Following being a drag on the overall economy for years, housing has now perked up and is feeding off supply-demand dynamics that are more typical of an early cycle environment.

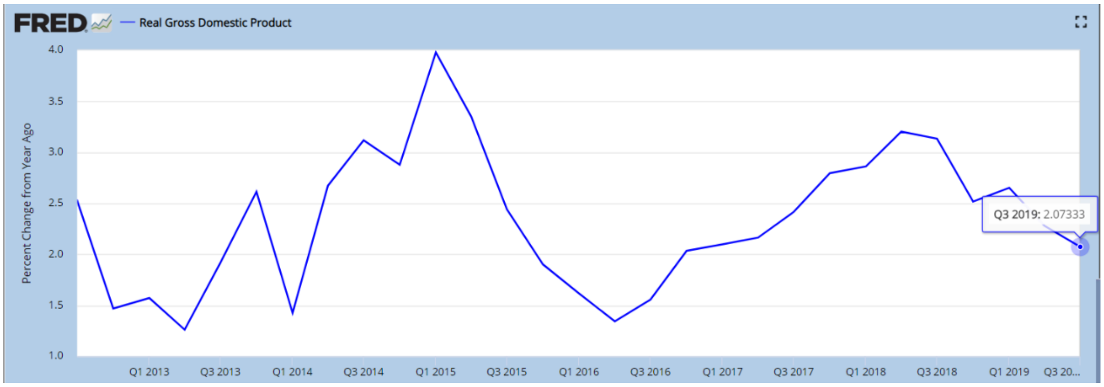
A continued strong consumer is critical to avoiding an economic slowdown and by many metrics the consumer is in good shape. Wages are still modestly rising across all income levels with the largest gains finally inuring to the lowest income quintiles who spend more of their incomes. Additionally, household debt as a percentage of disposable personal income along with debt service remain very comfortable for the U.S. consumer (charts below from JP Morgan).





Employment data will remain critical to the direction of the economy. Data on the consumer is currently quite solid. However, this is aggregate data and, following years of asset and wage gains benefitting the upper deciles, may be dramatically skewed away from the lower income cohorts. Their financial situations are more precarious and as much of the recent job and wage gains have found this group, the first signs of a slowdown make them more vulnerable.

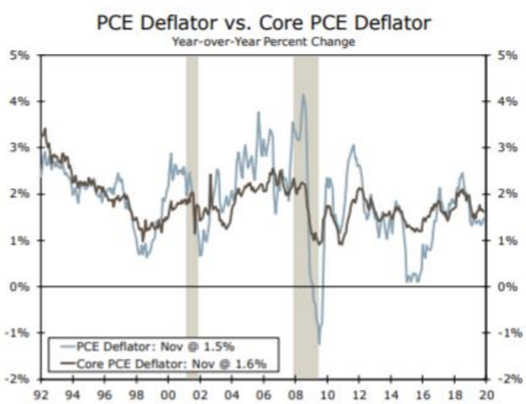
While we await the release of GDP for 4Q (we estimate a reading below 2%), we note that consumer spending and the return of modest contributions from Residential Investment (housing) have cushioned the slowdown in the past year, offsetting weak trade and business investment. Since peaking at a year-over-year rate of 3.2% in 2Q of 2018, GDP growth has continually slowed towards what we feel is a more sustainable trend growth rate near 2% (see chart on the following page).

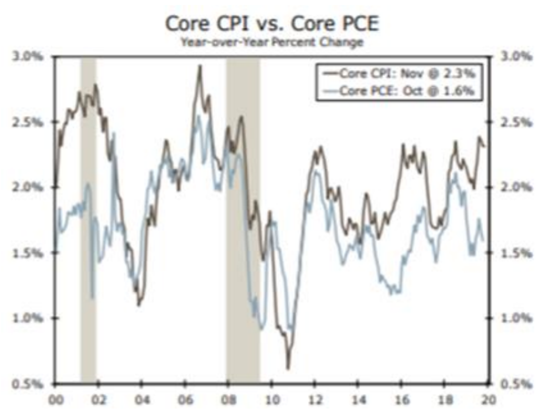


Though the odds of a recession in 2020 remain higher than what is comfortable, our base case for domestic growth in the new year are for continued growth though decelerating further towards 1.5%. While there remain many geo-political concerns that may pressure this narrative, we feel the primary suspect would be the dominos of continued weak business confidence and investment that leads to a slowing in hiring, wages and a turn in consumer confidence and spending. The halt of the production of the Boeing MAX 737 will pull industrial production into negative territory in the early part of 2020 and shave an estimated 0.3%+ from growth so the risks are higher in the first half of the year.

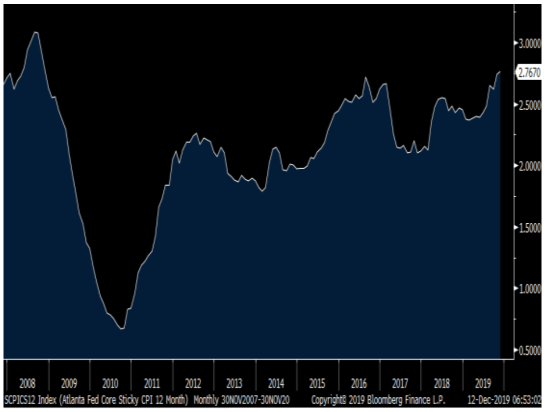
INFLATION:

The preferred measure of inflation followed by the Federal Reserve is the Personal Consumption Expenditure deflator (PCE) that continues to show tame even softening inflation. This metric shows year-over-year inflation (see chart below left from Wells Fargo) of roughly 1½% on both the headline and the important core (ex-food & energy) measure. The more widely followed inflation index is the Consumer Price Index (CPI). The reading on this indicator (chart below right from Wells Fargo) tells a different story and core CPI has been north of the 2% target since December of 2016. The main difference is in the measurement of healthcare costs as the PCE includes fixed payments from government programs such as Medicare and Medicaid (thus understating costs) while the CPI appears to more accurately reflect out-of-pocket costs of the consumer.





Other less followed measures of CPI show an even healthier pace of inflation gains. The Atlanta Fed puts out a model that removes the more volatile components of inflation called the “sticky CPI”. It has risen to 2.77%, the highest since 2008 (chart from Bloomberg top left on following page). The Cleveland Fed maintains a “trimmed CPI” and it too is now at an eight-year high (chart from Bloomberg on top right of following page). One of the most universally accepted views (and we have been in this camp for the better part of the last decade) has been that inflation is tame and even slowing. That may now be changing.



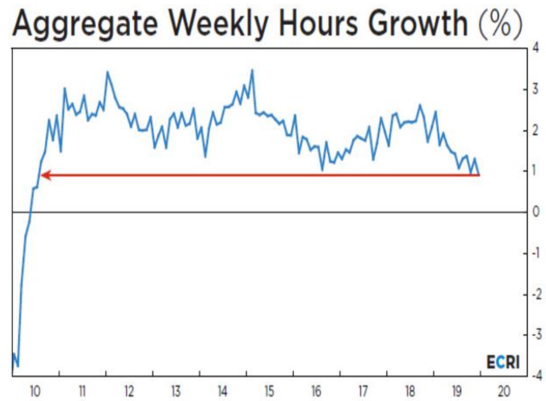
For the first time in decades, both domestic monetary and fiscal policy are explicitly designed to raise inflation levels. These pro-inflation policies along with reduced globalization (which reduces productivity) appear to be under-appreciated by the economic community. The advent of globalization ushered in a secular period of declining price growth as production of goods shifted to the most cost-efficient regions. As noted above, we appear to be in a cyclical period of modestly rising inflation, but we may also be entering a more secular period. The chart below from RBA Advisors and Bloomberg shows the five-year trend of core CPI going back to 1998 and it has moved up over the most recent period reversing part of a near 40-year trend.

EMPLOYMENT & WAGES:

The job market ended 2019 with continued solid employment growth with both the 3-month and 6-month averages a tick higher than the full year average of 176K net new jobs per month. Though the full year level of 2.1M jobs is the lowest level since 2011 (see chart below) and slowed more than 20% from the 2018 level of 2.7M jobs, it is still quite remarkable nearly 11 years into the recovery. Manufacturing suffered the brunt of the year-over-year slowdown due to the tariff and trade wars alongside weaker global growth.

Throwing some cold water on these still solid numbers is the upcoming February benchmark revision of the Bureau of Labor & Statistics (BLS) for the prior 12-month period. Their preliminary work indicated a downward revision by 501K jobs that would reduce these payroll growth rates by almost 20%.

Even before factoring in the upcoming downward revision, both the nonfarm payroll and ADP job reports depict a slowing in private sector job growth that is now the weakest since 2011. Additionally, the weekly hours worked has been decreasing on a year-over-year basis for nine months. As we have noted before this is an important leading indicator as in a very tight labor market with fewer and fewer qualified candidates, employers will first control the hours allotted to workers along with compensation in order to control costs and maintain quality employees.



Though wages overall have moderated over the back half of the year, the composition of these wage gains is showing a reversal of trends that have been in place for decades. Wages for the typical worker (non-supervisory employees who account for 82% of the overall workforce) are rising at the fastest rate in more than a decade (see chart below), interpreted as a sign that the labor market has tightened sufficiently to convey bigger pay increases to lower-paid employees. However, as we have seen much less of a benefit to managers and middle-income households, the most likely factor supporting the lowest-paid workers is a wave of minimum-wage increases as 29 states have increased minimum wages above the federal level, and 21 of those will lift the level again in 2020.

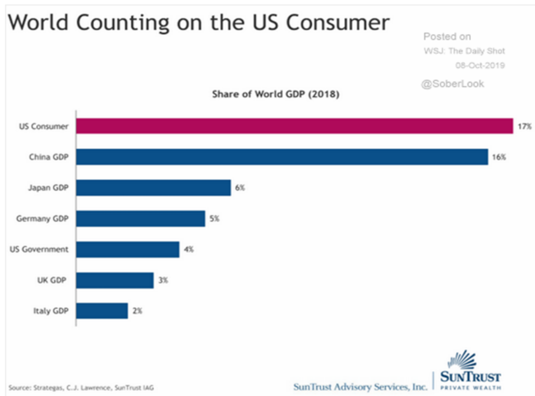
Source: U.S. Department of Labor and Wells Fargo Securities

CONSUMER:

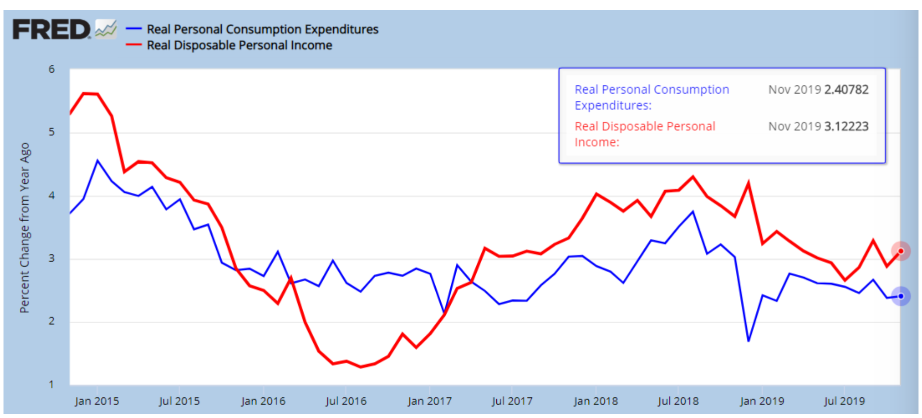
As we have made clear so far in these pages, it is difficult to overstate how critical the continued health of the consumer will likely be to the overall U.S. economy in 2020. With business investment, manufacturing and trade at or near recessionary levels, continued solid consumption will be the difference between a trend-like growth rate around 2% or a possible end to the current business cycle.

Household consumption accounts for almost 70% of the calculation of gross domestic product. While we noted above that historically it is business investment that may be the marginal lever that ignites economic slowdowns, years of central bank policy attempting to increase asset prices have tethered much of discretionary consumer spending to the performance of the financial markets. Therefore, the upper quintiles of income earners become critical as they are the households with more invested in these markets with powerful influences on spending. This was very apparent in the final quarter of 2018 as the S&P 500 fell by -13.6% resulting in a near collapse in household consumption and outright declines in retail sales during the opening two months of 2019 before the abrupt U-turn by Jay Powell reenergized the markets.

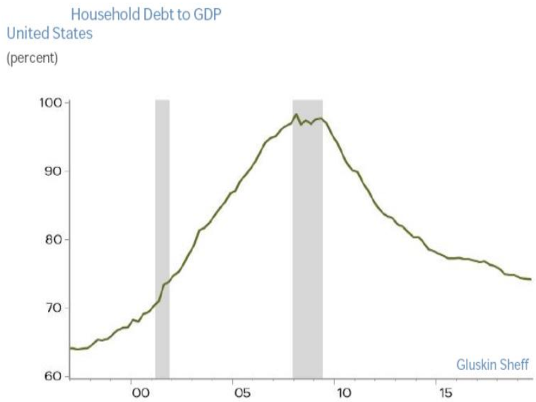
Not only is this true domestically but globally. The U.S. represents nearly 25% of global GDP and the consumer is 70% of that meaning that 17% of global GDP emanates for this group, a level higher than any other economy alone (see chart below).



The chart below shows both real (adjusted for inflation) disposable personal income alongside real personal expenditures. The chart clearly depicts the rise in incomes and spending in 2018 that benefitted from the Tax Cuts and Jobs Act of 2017 and the collapse (blue line) in spending that we noted following the correction in late 2018. Though wage and spending growth has moderated throughout the past year, incomes have remained above spending indicating a still cautious consumer.



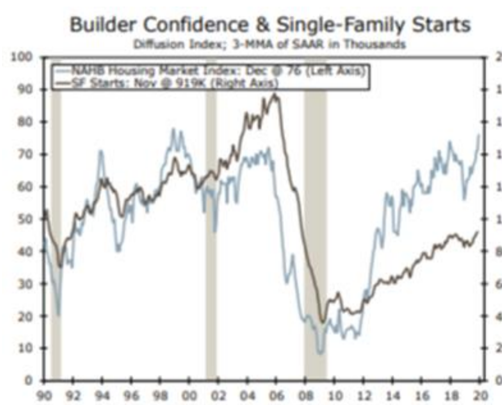
The U.S. consumer continues to slowly repair their personal balance sheets though they remain stretched by historical standards. The household debt-to-GDP ratio fell to 74.2% in the recently released 3Q Flow of Funds report from the Federal Reserve. This is the lowest level of indebtedness for this ratio since 2001 and far below the peak of 98.3% in 2008 (see graph below left). Still, the U.S. consumer appears cautious, and the four-quarter rolling average of the household savings rate is now higher (12.3%) than it was in the prior expansion. Though wage growth continues to moderate, the consumer has the wherewithal, but apparently not the inclination, to tap into savings to augment spending.



HOUSING/AUTOS:

Though the primary beneficiary of increased liquidity and lower interest rates have clearly been the financial markets, the one economic sector that has been advantaged by the change in Fed policy has been the housing sector. With house price gains averaging near six percent for the prior four years, the traditional drivers of demand such as strong employment and wage gains had been overwhelmed by affordability concerns. As the Federal Reserve was raising interest rates four times in 2018, the average national 30-year mortgage rate rose from 4% to over 4.9% in late 2018. It has since declined to 3.7% as we closed out the year. For the median priced home with a typical 20% down payment this represents a savings of $200 per month and buyers are re-entering the market.

The most recent data from November show overall housing starts rising to a 1.365M annualized pace (see chart below left from Wells Fargo), the second strongest since 2007. The more critical single-family space experienced a 2.4% gain and has averaged 916K starts on an annualized rate over the last four months, the best such pace also since 2007. Though the full year total will likely only match the pace of 2018, the trend is decidedly up and this is reflected in the improved confidence of homebuilders with the NAHB (National Association of Homebuilders) December reading touching a 20-year high (see chart below right from Wells Fargo).



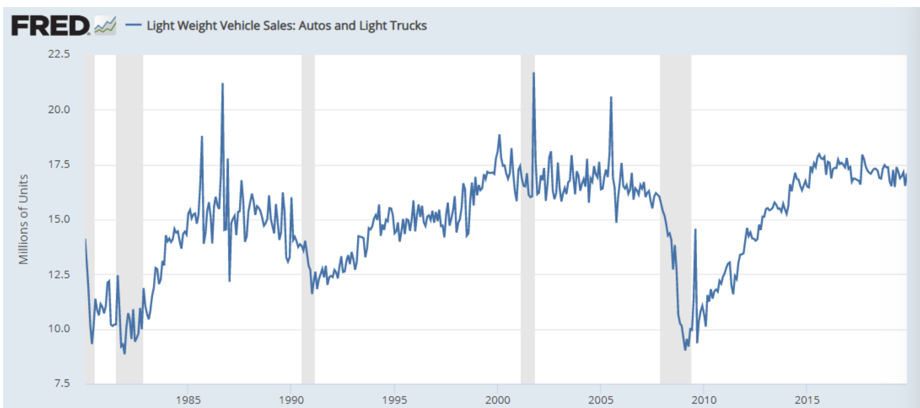
So, what does 2020 look like? Fannie Mae's Economic and Strategic Research Group estimates growth in single-family starts to exceed one million new homes over the next two years, a post-recession high. For perspective, however, the 25-year annual rate of housing starts is 1.2 million and peaked around 1.7 million during 2005. And that is not adjusted for population growth.

We focus more on housing starts when looking at the economy as they feed more into economic growth due to the labor, materials and ancillary home purchases that are required compared to the sales of existing homes. However, the existing home market represents about 80% of housing transactions and in this area there is a less sanguine view for a critical reason that has also benefitted the homebuilders, inventory. Real estate listings website realtor.com anticipates that home sales will drop with the housing shortage becoming the worst in U.S. history.

This contrary assessment is all about supply as the inventory of homes for sale has been falling steadily for several years and is at its nadir on the lowest end of the market, an area where builders have struggled economically to build and meet demand. Over the next two years, they expect that millennials will dominate the housing market, accounting for 50% of all mortgages. Just short of 5 million millennials will turn 30, which is when many people buy their first home, and the oldest will turn 39, generally when family dynamics kick in and people move to larger homes in the suburbs. However, another unusual dynamic is at play impacting supply.

More homeowners are staying longer in their homes, according to real estate brokerage Redfin, which analyzed Census data. The typical American homeowner has spent 13 years in their home, up from eight years in 2010, as for various reasons more households are choosing to age in place. Additionally, the supply of entry-level homes is also well below historical levels as during the foreclosure crisis, investors bought millions of distressed properties and turned them into rentals. The bulk of these properties were on the lower end of the price spectrum. Most expected these investments would be flipped as home prices recovered. However, with alternative income investments yielding so little, this did not occur and, basically, a new asset class has been created.

Domestic auto sales have risen steadily since the financial crisis over a decade ago when they bottomed out at 10.4M vehicles. After hitting a record 17.6M in 2016, we noted our thoughts of a peak and potential turn. Though the peak part was correct, sales have hovered around the 17-million mark in recent years (see chart below), providing an unusually steady environment for an industry accustomed to cyclical swings. To maintain this sales pace, the industry has resorted to major spending on sales incentives that have averaged around 11% of a car's sticker price, the highest level since 2008, according to industry experts at J.D. Power.



The industry enters 2020 with potential headwinds as dealers grappled with unusually large stockpiles of unsold vehicles for much of last year and struggled to off-load older models, forcing these steeper discounts. We wonder whether we have reached that critical point of unsustainability as consumers become dramatically stretched with car payments despite low rates.

U.S. consumers now hold over $1.3T in auto-related debt nearly double the level of a decade ago. According to Bankrate.com, the median U.S. household using a standard budget with a four-year loan, 20% down payment and a payment under 10% of gross income could afford a car costing a little over $18,300. But according to data from consumer credit reporting company Experian, the average auto loan has increased over this decade to over $32,000 for a new car. The industry in turn has resorted to longer and longer loan terms.

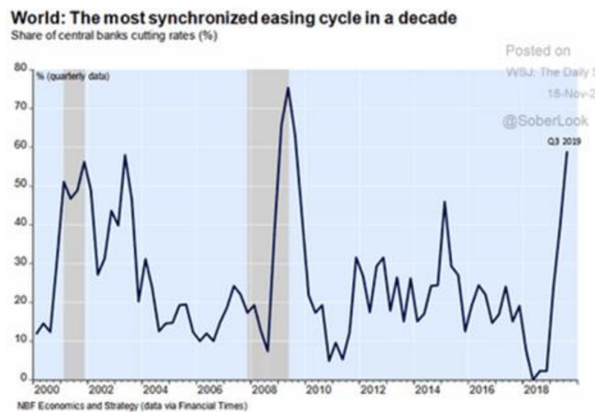
The average loan now extends to roughly 69 months. Seven-year loans now account for 31.5% of sales according to Experian compared to less than 10% at the start of the decade. As we have noted before, this creates negative equity for many car owners who do not pay off their debt before they trade in their car for a new one. Currently, about 33% of new car buyers roll the debt from their previous car loan into a new one and, again, this compares with only 19% before the financial crisis. The capacity to take on a new car is fast becoming a challenge. We continue to see rising subprime delinquencies and this is during a solid economic environment for the consumer.

INTERNATIONAL:

Though already slowing as we entered the latter portion of 2018, it is clear the U.S.-China trade war has had a major impact on global growth. In 2018, international trade grew nearly 6%, a pace that has recently decelerated to a near flatline reading. With global trade accounting for about 25% of global GDP, this is the primary cause of the decline in world growth from 3.7% in 2018 to an estimate by the International Monetary Fund (IMF) of 3% for the year just completed.

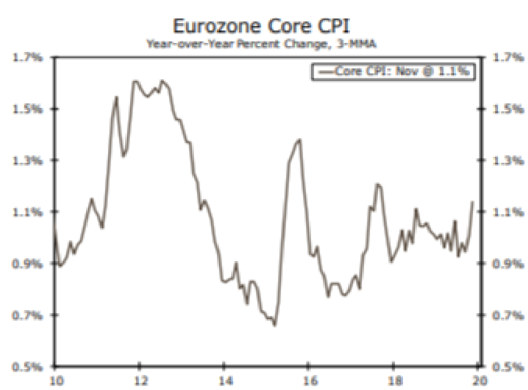
2019 was also notable for the convergence in economic growth between the U.S. and other developed international economies (chart below left). Unfortunately, this is not due to an acceleration of foreign growth but rather a gradual slowing in domestic growth over the last few quarters. This concern of late cycle slowing in global economies has recently been met with the most concerted effort of major central banks in bolstering the liquidity spigots. For the first time, central banks (BoJ, ECB, Fed and recently even the PBoC) are printing money in concert (chart below right) an effort that continues to underpin the markets.

Source: Datastream, Federal Reserve Board and Wells Fargo Securities



EUROZONE:

Prior to December, the manufacturing PMI had been inching higher and GDP growth in 3Q was a bit stronger than expected at a year-over-year rate of 1.1% (see charts below from Wells Fargo). Core CPI inflation has started to turn upward in recent months touching 1.3%y/y for both the headline and core readings in December. These green shoots may only be visible to the optimistic eye and reflect more of a sign of stabilization in the Eurozone economy rather than an imminent acceleration.



Former President of the ECB, Mario Draghi announced in September another stimulus package consisting of a rate cut on deposits along with a program of quantitative easing that would entail the purchase of €20B per month until achieving the elusive 2% inflation target. For perhaps the first (and last) time in his eight years in leading the ECB before turning over the reins to Christine LaGarde, Draghi and members of the central bank pleaded with the Union to have fiscal policy be the primary driver of economic growth. Without being more specific, Draghi was obviously targeting Germany which is the fourth-largest economy in the world and represents over 28% of the European economy.

Germany has continued to run fiscal surpluses and, despite the stagnation (flat GDP over the last three quarters) in its economy, it does not see how aggressive fiscal policy would counteract that as global trade issues (trade and manufacturing are almost 70% of their GDP) are almost solely the root cause. The construct of the Eurozone works much better in a growth environment.

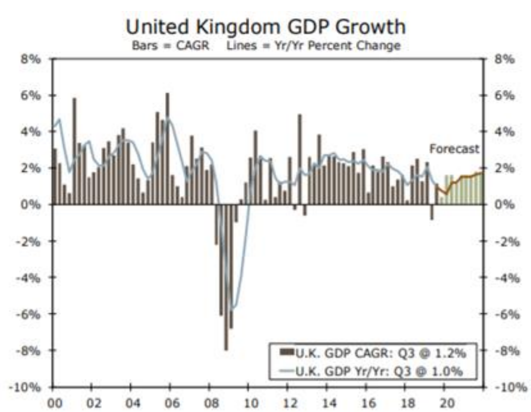
December was not as positive for economic data in the region as the Markit Manufacturing PMI index (equivalent to our ISM) declined to 45.9 in December, the lowest level since October of 2012 and the 11th consecutive month of contraction. Growth in the Eurozone has slowed since peaking at 2.4% in 2012 to what is expected to end up around 1.2% in 2019. Manufacturing readings such as these and the downbeat assessments on the new year lead us to anticipate a further slowing to below 1% in 2020

UK:

At the end of January following 3 ½ years of failed negotiations on Brexit, Britain will officially divorce from the European Union. For now, we see little change with the likelihood of the status quo over at least the 11-month transition period. During this time negotiations on a trade deal with the EU will occur alongside agreements on security, law enforcement and other issues. As it has already been 43 months since the original vote on Brexit, we would not be surprised should an extension of this period be required. An impasse could even lead to an exit without a pact, though we feel this to be a low probability event. Uncertainty will continue to reign in 2020. We feel the quote below from Thomas L. Friedman of the New York Times encapsulates our views on this entire process.

“What we’re seeing is a country that’s determined to commit economic suicide but can’t even agree on how to kill itself. It is an epic failure of political leadership”

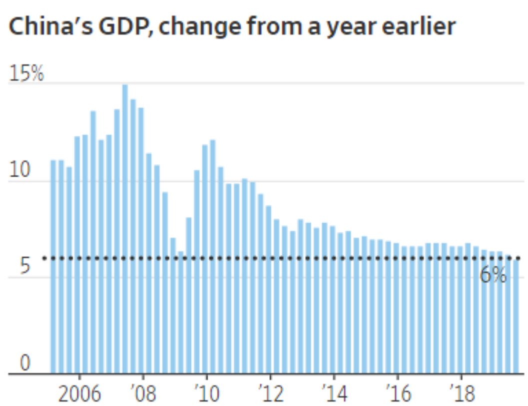
For much of the last three years we have been surprised at the seeming resilience of the U.K. economy which finally slowed towards 1% in 2019 (see chart below from Wells Fargo). As uncertainty continues to surround the future trading arrangements, we foresee a continued weakness in business investment and sentiment. With some easing in global trade tensions and more fiscal easing, we anticipate a similar if slightly slower growth rate in the new year.

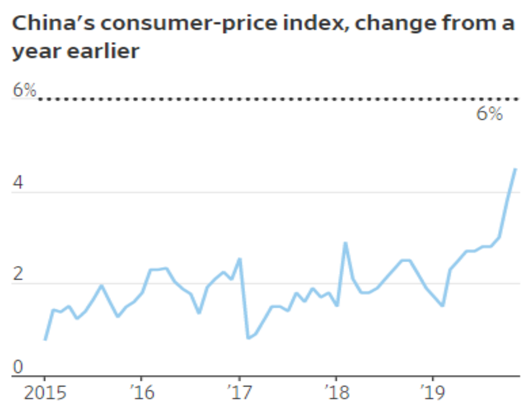


CHINA:

African swine fever was first reported in China in early August 2018. One year later, the entire pig population of China had declined by more than 40%. With China accounting for over 50% of the global pig population, this epidemic alone killed nearly 25% of the world's pigs. This is estimated to have economic losses of over $140B with the most recent inflation data showing inflation growing (chart below right from the Wall Street Journal) at 4.5% over the last year and estimated to rise to as high as 5% early in 2020.

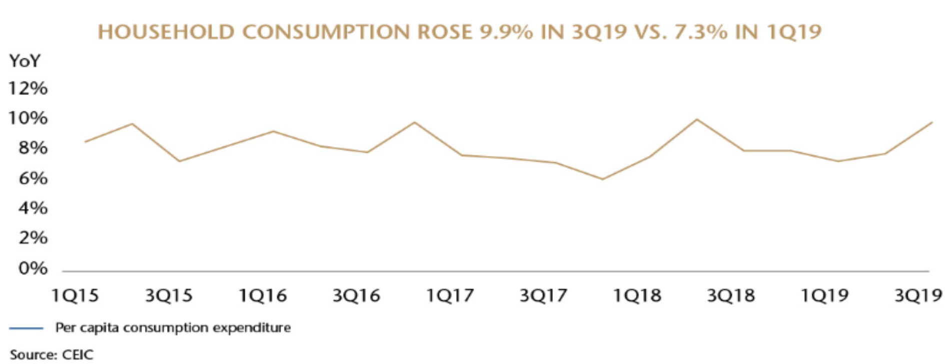
The prospect of heightened inflation at the same time as economic growth slows to the lowest levels in three decades (see chart below left from the Wall Street Journal) is leading many economists (including the International Monetary Fund-IMF) to lower growth expectations for the new year to 5.8%. This stagflationary environment handcuffs Beijing with the fear that lowering lending rates to boost growth might exacerbate rising prices and threaten social stability. Though inflation outside of food is tame (1.3%y/y), Chinese households spend nearly 20% of disposable income on food, more than twice the comparable U.S. household. This may have been the primary reason for China to quickly move forward with the Phase 1 deal with the U.S. as pork exports will surge to help fill the void.





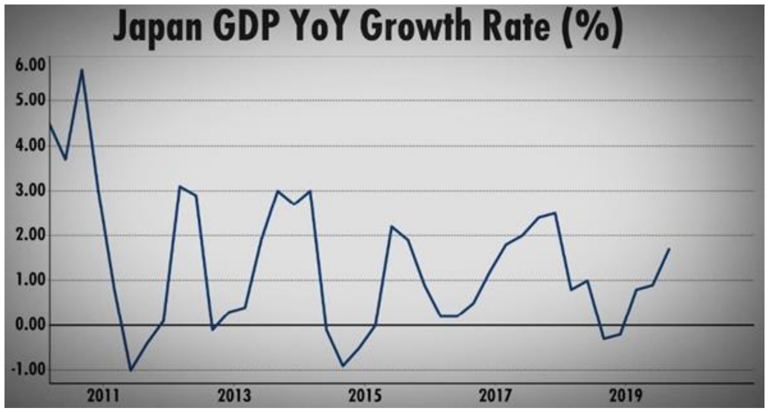
Despite these concerns, the hope is still for the trade deal to improve confidence in the business community and lead to stronger capital expenditures. Beijing appears comfortable with the current decelerating pace of economic growth and is preparing only modest stimulus for 2020 mostly to continue to counter slow global demand. This was partly executed on the first day of the new year, with the PBOC (People's Bank of China) reducing the reserve requirement ratio for banks (the amount they are required to have on hand) and unleashing an estimated $114B into the economy. If the trade deal were to fall apart, we would anticipate Beijing to initiate a larger stimulus and the deal represents the largest risk to the outlook for China.

Still, the main engine of incremental economic growth continues to be domestic demand. Though it may surprise many, consumption and services have led China GDP growth for eight consecutive years rather than manufacturing and construction. Demand now represents almost three-quarters of economic growth (see chart below) and curtailing the inflationary impact of pork prices is critical for this to continue.



JAPAN:

The final release of 3Q GDP in Japan showed a major upward revision with an annualized growth rate of 1.8% compared with the initial release of 0.2% (see chart below from ECRI). Capital spending and a surprisingly solid showing from consumption were the primary reasons offsetting the continued declines in exports and factory output that has been the weakest in years. For the full year, GDP growth will likely approximate 1%.



Private consumption in Japan accounts for about 60% of overall GDP and rose at an annualized rate of 2.1% during the quarter. Still many analysts fear that the jump in both business and household spending may represent a pulling forward of future demand in front of the October VAT tax increase that was moved to 10% from 8%. Early data from after the implementation of the tax indicate worsening household spending and retail sales figures suggesting the consumption hit from the sales tax increase will likely lead to a growth contraction in the 4Q. One positive may be that the last sales tax hike in 2014 was preceded by a consumption boom about four times as large as this followed by a -7.3% contraction in the following quarter. If that is any indication, the hit to consumption should be less than feared.

Before 3Q, Japan's economy has been exhibiting signs of slowing momentum, hit by soft global demand amid the U.S.-China trade war, the tensions with Korea and natural disasters such as Typhoon Hagibis. Those factors have put growth in a vulnerable spot, given concerns over cooling consumer spending after the tax hike along with the risk of a slowdown following the 2020 Tokyo Olympics. To counter these concerns, prime minister Shinzo Abe has launched Japan's first fiscal stimulus since 2016 with a larger-than-expected $122B package to repair typhoon damage, upgrade infrastructure and invest in new technologies

As with many developed central banks, the BoJ is fixated on elevating inflation towards the seemingly magical 2% level. Perhaps the VAT tax is their way of achieving that level as the December CPI ex-food & energy rose to 0.9%y/y from 0.7%. Employment remains tight with the unemployment rate falling further to 2.2% in November with the job to applicant ratio holding at the highest level in almost 50 years. What continues to be missing is the needed pick up in wage growth that contracted -0.2% y/y in the most recent data.

Expectations are for a further slowing of growth in 2020 below 1%. The continued impact of the VAT tax, ongoing global trade war combined with the intensifying trade and political dispute with South Korea are more than negating the positive economic impact of the 2020 Tokyo Olympics.

MARKETS:

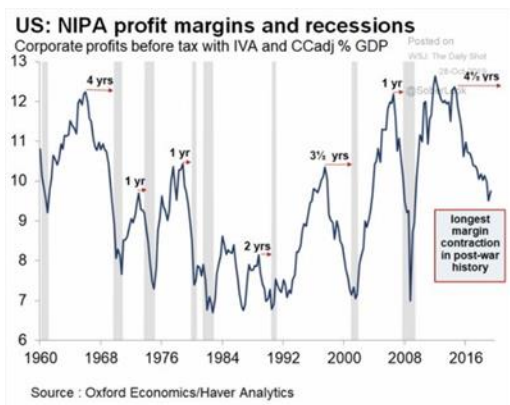
An escalating trade war amid rising geopolitical tensions were joined in 2019 by disappointing earnings growth, record corporate leverage ratios and trillion-dollar deficits. These were no match for the unprecedented fiscal easing from the Federal Reserve that represented a 180-degree turn from this time last year. While many gains were still concentrated in the largest technology growth companies, the past year was more distinguishable in that virtually all asset classes whether defensive or cyclical enjoyed banner years. We cannot recall another year whereby the major indices enjoyed gains of over 25% while at the same time asset classes usually associated with defensive and declining markets surged. This includes gold, long Treasury bonds and even oil that rose 18%, 18% and 30% respectively.

For the year, the S&P 500 surged 31.5% with the Dow Jones Industrial average moving ahead 25.3%. The more domestically oriented Russell 2000 index of smaller capitalization companies enjoyed a return of 25.5%. Though foreign stocks lagged through much of the first half of the year, the MSCI EAFE index of developed global markets finished the year up 22% while the MSCI Emerging Market index gained 18.4%.

In addition to gold and oil as noted above, even conservative fixed income positions joined the party with the Bloomberg Barclays Aggregate index gaining 8.7% while lower rated bonds in the Bloomberg Barclays High Yield index gained 14.3% in the face of consistent concerns about the excess leverage in this space.

In an interesting juxtaposition to 2018 which was a year with near 20% earnings growth and a modest decline in the overall indices, the gains in 2019 were entirely due to a reset of higher valuations. The markets ended 2018 with a price-to-earnings (P/E) ratio on forward 12-month earnings of 14.5x. We enter the new year with that metric now elevated to 18.5x based on analyst estimates of a near 10% earnings growth rate in 2020. We note that at the beginning of 2019, the expected earnings for the S&P 500 according to data from FactSet was for $178 per share. As we enter earnings season for the fourth quarter, it appears that will likely come in around $163 or completely flat for the period. As to the 2020 S&P earnings consensus estimates, they, not surprisingly, stand at the same $178 a share today!

This staircase-like gain of 10% in earnings may be particularly challenging in a 2% or less growth environment with revenue gains expected to move up from the 3.9% of this past year to 5.4% for 2020. Profit margins are under pressure courtesy of both tariffs as well as rising unit labor costs; not to mention the more secular weight of de-globalization. The chart below looks at the National Income and Product Accounts (NIPA) data released by the Bureau of Economic Analysis (BEA) that is far broader than just the S&P 500 as it also includes private and S corporations. The measure is not only more expansive but not subject to the same creative accounting often employed by public companies. This indicates that the current margin decline is more pronounced than what we see in just the major indices.



The associated chart on the following page from Charles Schwab looks at the NIPA broad measure of corporate after-tax profits, which have flattened out since 2014, compared to the S&P 500 which has been on a tear over the past year. The historically wide spread suggests either profits will eventually need to catch up to the market; or stocks may have to correct to move more in line with profits.

With valuations of the major indices elevated alongside potentially escalating geopolitical tensions and continuing trade conflicts, investors should expect increasing levels of market volatility. At Coho Partners our focus continues to be on downside protection. We seek to provide this from the construction of a differentiated portfolio populated with high quality companies with resilient earnings streams, growing dividends, strong balance sheets and reasonable levels of expectations and valuations.

Sincerely,

Rick S. Wayne, CFA

Eric M. Hildenbrand, CFA