2019 Q1

Economic Review and Outlook

Following a month-long delay due to the government shutdown, officials confirmed what economists and investors already suspected – the economy is slowing. Specifically, economic growth decelerated in the fourth quarter to an annualized real rate of 2.6% from the unsustainable 4.2% and 3.4% growth rates in the second and third quarters of 2018. Overall in 2018, the economy expanded at an above-potential rate of 2.9%. We expect growth to continue to slow towards the 2.0% - 2.5% pace characterized by the post-Financial Crisis expansion, though we caution the potential for Q1 2019 growth to surprise to the downside. However, as we detail in the letter, the domestic economy is on reasonably sound footing, and the economic expansion has room to run if the Fed sticks to their new narrative of being patient.

The Power of Patience

What a difference six months can make. When we published Covenant's 2018 Mid-Year Economic Review and Outlook, the economy was booming. Propelled by tax cuts and fiscal stimulus, the nine-year-old economic expansion reached a higher gear and posted GDP growth of 4.2% in the second quarter. Economic activity was brisk, and the momentum carried through to the third quarter when GDP grew at an above-trend annualized rate of 3.4%.

Against this rosy economic backdrop, the Federal Reserve continued on a path of normalizing monetary policy. Taking the reins from Janet Yellen in early 2018, Fed Chairman Jerome Powell raised interest rates once a quarter throughout the year signaling confidently that the economy could not only handle higher rates but that shrinking the Fed's balance sheet (i.e., Quantitative Tightening) would be on "autopilot." However, the central bank's bravado in late 2018 was misplaced, and Powell admitted as much in January of this year when he and other members of the Fed signaled they would pause the "normalization."

Even though interest rates remain well below their historic average, we suggest that historical averages are less important than the change in the level of interest rates. In this regard, the Fed has raised interest rates 2% in the last two years. Based on financial market feedback (i.e., higher volatility in the prices of financial assets and lower long-term interest rates) and recent fundamental economic data (slowing growth), the Federal Funds rate is near the current "neutral rate" – the interest rate level at which the economy is growing near its maximum potential rate and inflation is stable. Tightening beyond the neutral rate can push an economy into recession while remaining too far below the neutral rate can lead to corrosive inflation.

Fine tuning monetary policy is complicated as the "neutral rate" is not observable. That is, the precise level for neutral interest rates cannot be calculated, but only estimated. Since the level of interest rates that has neither a stimulative nor restrictive effect on the economy cannot be calculated, the Fed relies on a host of financial models to estimate where interest rates are relative to the neutral rate. However, the economy is an enormous and complex ecosystem, and changes can take months or quarters to identify in the data. As such, the latency

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period between monetary policy changes and economic feedback is extended, creating ripe opportunities for monetary policy mistakes.

Indeed, the adage "Economic expansions don't die of old age; they are murdered by the Fed" comes from the Fed's poor track record of raising rates to a level that chokes off economic activity and leads to a hard landing (i.e., recession) rather than a soft one. Having said that, in the mid-1990s, the Fed accomplished the improbable.

The story began in 1990 when the U.S. experienced a shallow recession that lasted eight months. The Fed, led by Alan Greenspan, followed their traditional monetary policy playbook, cutting the Federal Funds rate to stimulate growth. The economy recovered rather quickly and by 1993 GDP growth was 2.8% and accelerating. Beginning in 1994 the Fed started to aggressively raise interest rates, and within a year the Federal Funds rate increased from 3% to 6%. By all accounts, the Fed intended to continue raising rates as the economy expanded at an annualized rate of 4.7% in Q4 1994. However, in early 1995, a young Janet Yellen (serving on the Federal Reserve Board of Governors) proffered a motion to pause the Fed's rate hiking cycle. Although the Fed's financial models called for more hikes to cool economic growth, Ms. Yellen and a handful of her colleagues were concerned about conflicting data showing a decline in economic activity.

Though it took some convincing of Chairman Greenspan, eventually Ms. Yellen prevailed, and the Fed paused their rate hiking campaign in early 1995. It was the right call. In the ensuing months, slowing economic activity began to show up in the data, and the Fed shifted from raising interest rates to reducing them just a few months later. Had the Fed continued raising rates in 1995, they could have pushed the economy into recession. Instead, the Fed's patience and willingness to change course in response to the data extended the expansion through the turn of the millennium.

Source: FTN Financial. Photo circa 1995, Alan Greenspan (center), Janet Yellen (lower right).

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Currently, Chairman Powell and the Fed are trying to recreate the 1995 Fed mojo by engineering a soft landing for the economy and extending the nearly ten-year-old expansion. In this regard, we applaud Powell's dovish pivot in January when he announced a break in raising the Fed Funds rate and signaled that Quantitative Tightening would end later this year. We can only assume the Fed is seeing the same slowing trends in the economic data that we are tracking and recognized the recessionary risk of additional rate hikes at this time.

In the pages that follow, we review recent economic data trends and offer our outlook on key sectors of the economy:

- The Labor Market
- Consumer Spending & Confidence
- Inflation
- Manufacturing
- Construction

It’s worth mentioning that the partial government shutdown, which began on December 22nd and extended for a little over a month, embedded noise in recent economic data. Some impacts of the shutdown are direct, but there are other first and second derivative effects from the government shutdown that may not be identified in the data for several months. In the best of times interpreting and forecasting economic trends is a challenging endeavor given the conflicting signals offered by the gallimaufry of available data. The government shutdown introduced additional complexity and potentially false signals that the Fed and its army of economists will need to carefully consider going forward.

LABOR MARKET

Labor market conditions continued to tighten throughout 2018, and a new phenomenon emerged in which there were more jobs open than unemployed workers to fill them. Overall, in the last twelve months, approximately 2.5 million jobs were added, and the headline unemployment rate reached a cycle low of 3.7% by the end of the third quarter. The strength of hiring prompted discouraged workers and others not previously considered part of the official labor pool to re-join the market, pushing the labor force participation rate up from 62.7% to 63.2% over the last twelve months.

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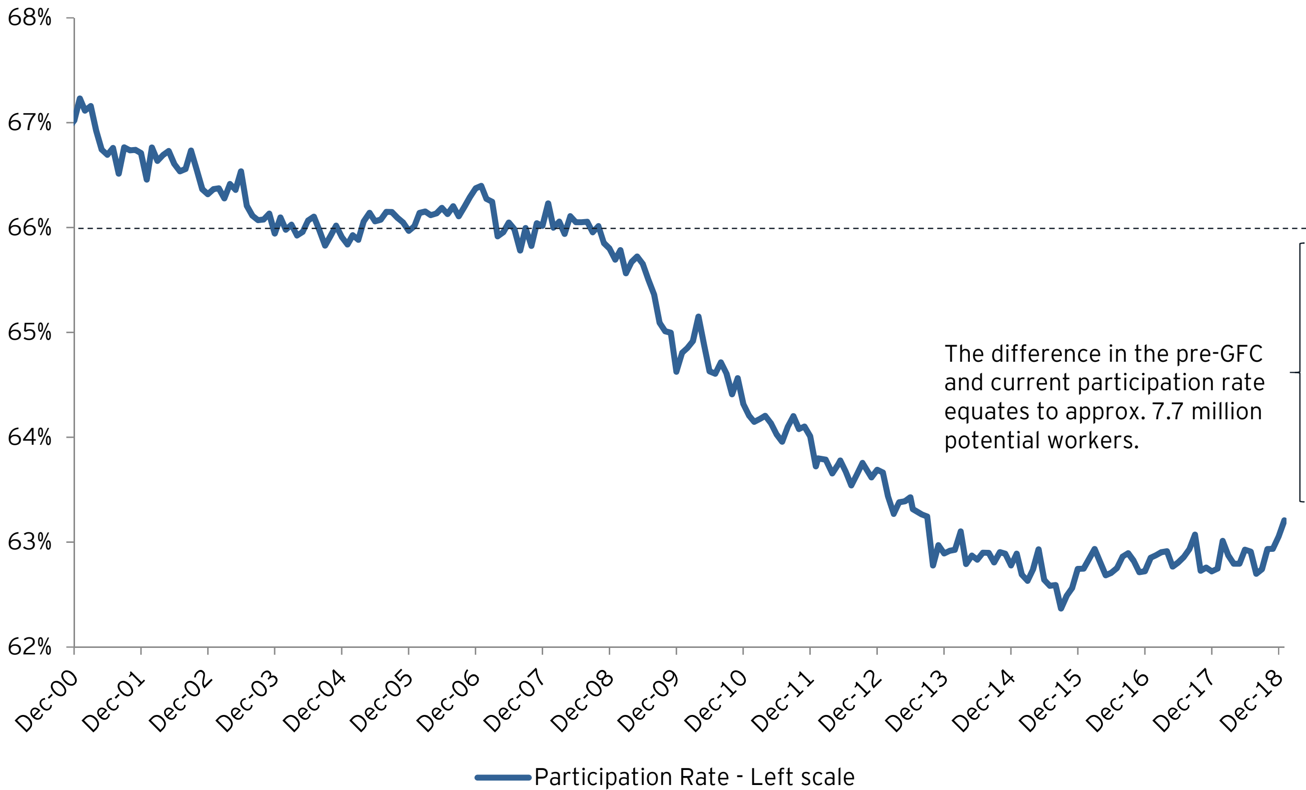
Labor Force Participation Rate



Sources: Bureau of Labor Statistics, Foleynomics, and Covenant Investment Research.

Even at this improved level, the participation rate remains well below the pre-Financial Crisis average of approximately 66%. With an eligible population base of roughly 258 million, each percentage point of participation equates to roughly 2.6 million workers. For a variety of reasons, an aging labor force demographic being the most significant, the participation rate is unlikely to recover to pre-Financial Crisis levels. Still, improving labor market participation is a tailwind for economic growth, something Chairman Powell underscored in his recent Congressional testimony.

Another good indicator of the health of the labor market is consumer confidence. Based on the Conference Board's survey, the number of people reporting that jobs are easy to get vs. hard to get remains in a solid upward trend. This situation augurs for the labor force participation rate to grind higher since jobs are available for those wanting work. We also note that confidence in the labor market is essential in maintaining healthy consumption levels as households are more likely to spend a larger portion of their income if concerns for future employment are low.

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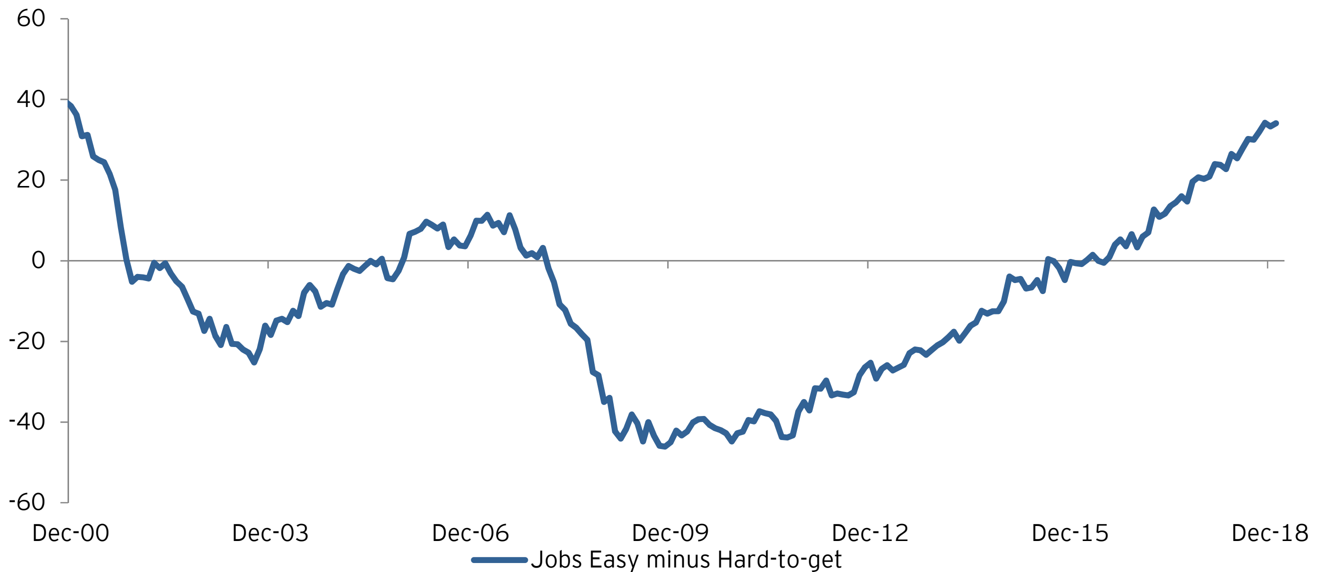
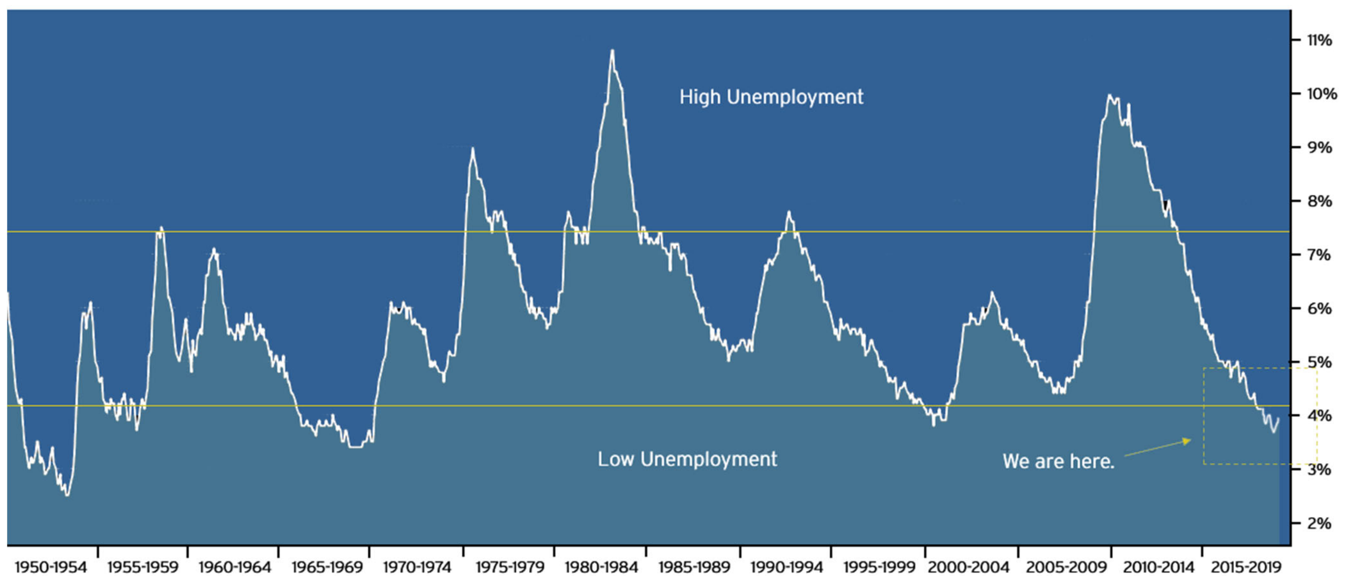
Job Market Stress



Sources: Conference Board and Foleynomics.

Outlook: Consumer Confidence in the labor market hasn't been this high since mid-2000, the headline unemployment rate is 3.8%, and the broader U-6 unemployment rate is 7.3%. All these measures indicate robust labor market conditions, but there are some early indications of deterioration on the margins. Weekly unemployment claims recently ticked higher, and the U-3 unemployment rate is off its November low of 3.7%.

Headline Unemployment Rate (U-3)



Sources: Bloomberg Finance L.P. and Covenant Investment Research.

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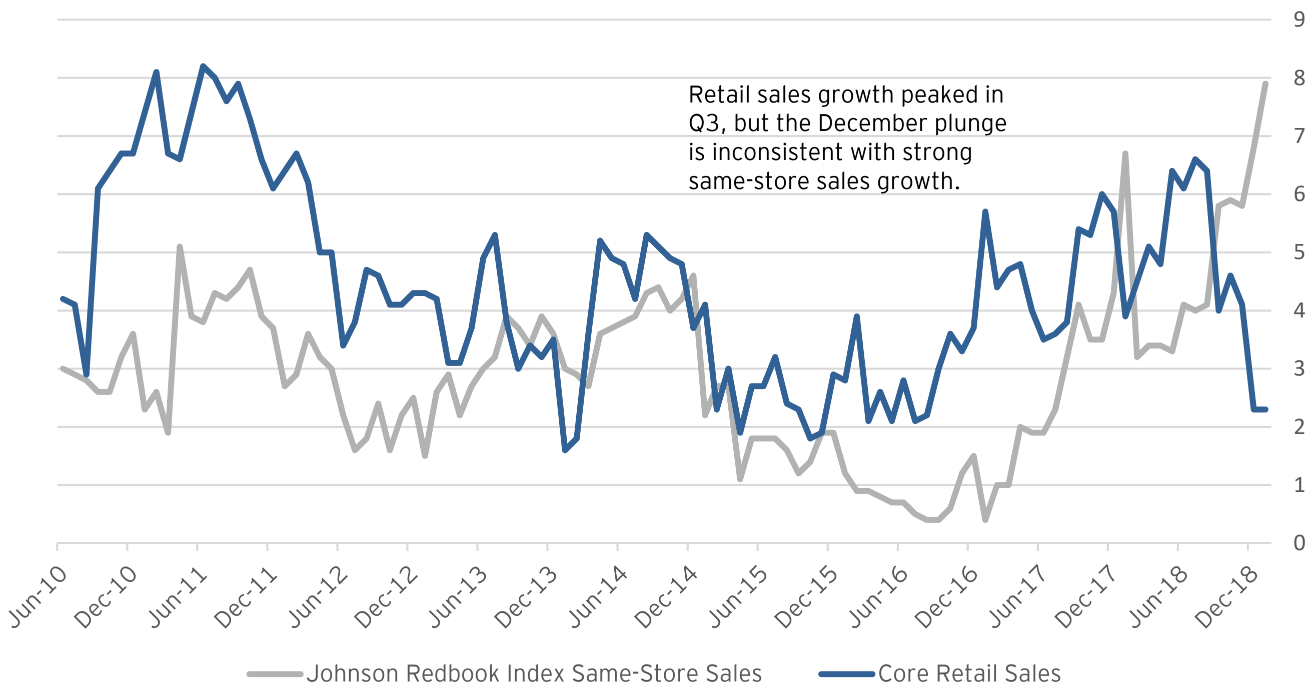
Though low by historical standards, the recent changes in some of the labor trends are worth watching because when unemployment begins rising, it typically continues to climb into a recession. According to data from BCA Research, in the postwar era, each time the three-month average unemployment rate has risen by more than 0.33%, a recession has followed (see chart on previous page). The next few months will reveal if the government shutdown negatively skewed recent unemployment numbers, or if the labor market is signaling slower growth ahead.

CONSUMER SPENDING & CONFIDENCE

Despite a December retail sales report that was, in a word, dreadful and sent a chill through financial markets, consumer spending contributed 1.9% to Q4 GDP. Ultimately, we expect the weak retail sales report was related to the government shutdown or some other reporting anomaly as related data points don't support a nearly 50% decline in monthly sales compared to a year earlier. For example, the Johnson Redbook Index, which covers a sample of large general merchandise retailers representing about 9,000 stores showed strong year-over-year sales growth in December. Having said that, we also don't believe a breakout in consumption is at hand as, like several sectors of the economy, consumption peaked in the third quarter when tax cuts and fiscal stimulus exerted the greatest growth impulse on the economy.



Sources: Bloomberg Finance L.P. and Covenant Investment Research.

Importantly, U.S. consumer fundamentals remain solid:

- Household debt ratios have fallen dramatically since 2007 and remain below long-term averages (see chart below).
- Total household debt as a percentage of disposable income has declined to 2002 levels.

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- Homeowner's equity is recovering toward pre-Great Financial Crisis levels.
- The savings rate as a percent of disposable income is running at about 6%, giving households the ability to increase spending.
- The tight labor market is leading to a modest acceleration in wage growth, which is currently running well above its 5-year average.

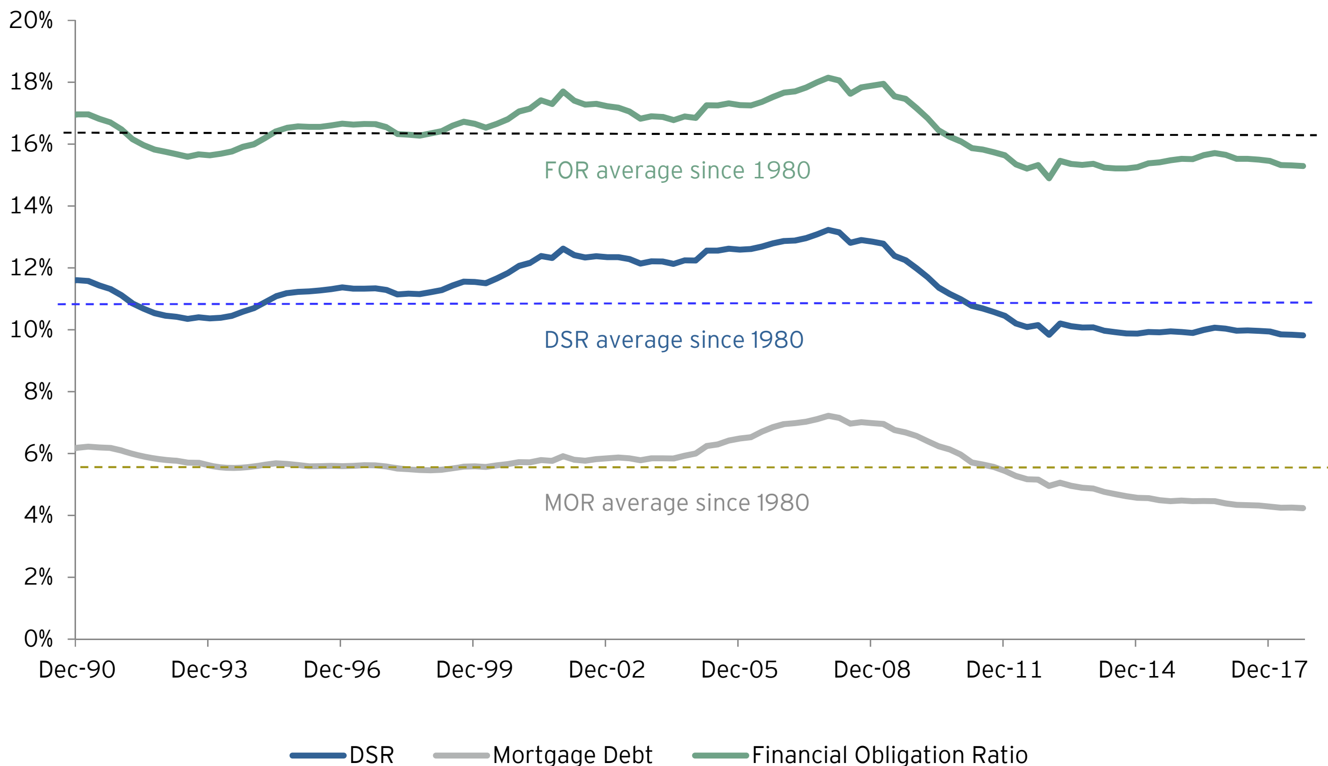

Chart Legend:
MOR – Mortgage debt
DSR – Debt Service Ratio includes mortgage and consumer debt payments divided by disposable income.
FOR – Financial Obligation Ratio adds auto leases, rental payments on tenant-occupied properties, property taxes and homeowner's insurance to DSR.

Sources: Federal Reserve and Foleynomics.

Outlook: Consumer confidence took a hit following the partial government closure, and the yawning gap between confidence in current conditions vs. future expectations (discussed in the Covenant Weekly Synopsis here) bears watching. However, the former is likely to recover and the difference between the two, while concerning, can remain wide for extended periods. Although consumption levels peaked in Q3, we expect the all-important consumer to stay "in the game" in 2019 and to keep the economy on track for full-year growth of 2.0% - 2.5% growth.

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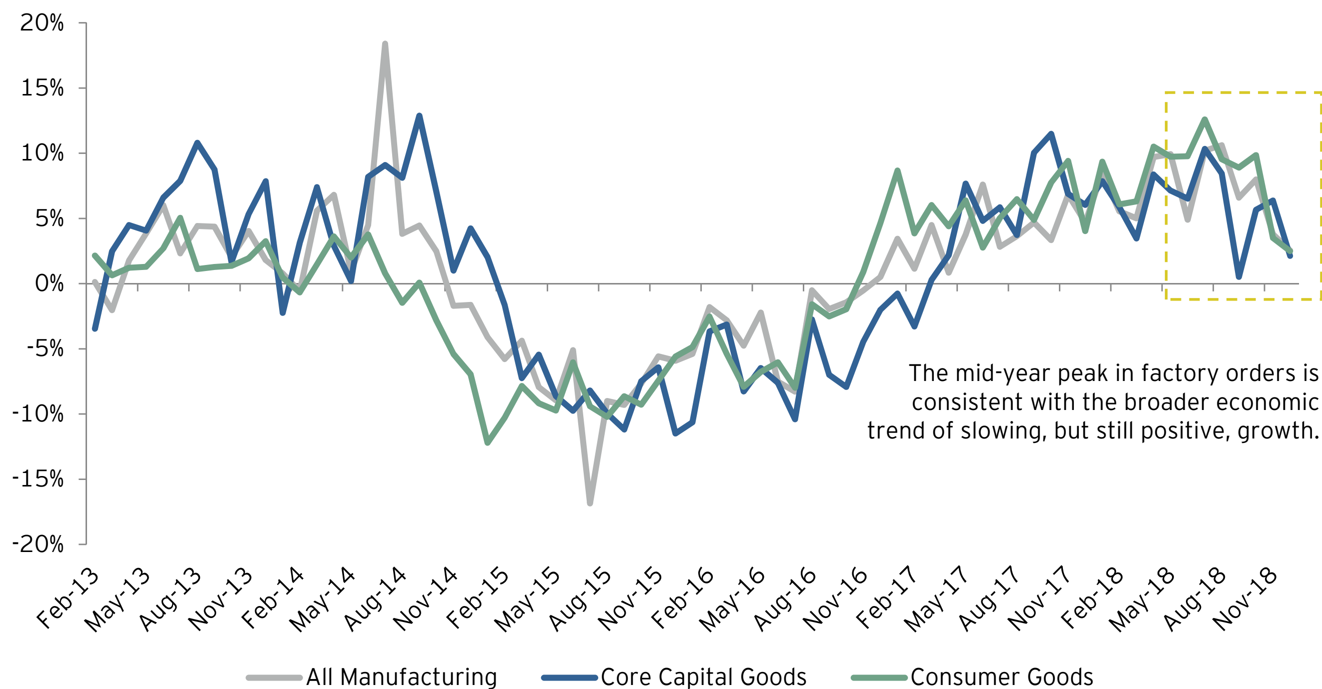
MANUFACTURING

Like many economic sectors, manufacturing output peaked in the third quarter and is slowing. A portion of the growth in the second and third quarters is attributable to orders intended to beat tariff deadlines, but that effect waned in Q4, exemplified by the following data points:

- Factory orders for consumer goods and core capital goods are trending lower.
- The ratio of business inventories to sales is moving higher, indicating slower turnover in inventory.
- Factory shipments fell from 9.5% year-over-year growth in August 2018 to 4.25% by December.
- Capacity utilization is showing signs of rolling over.
- The ISM Manufacturing Index peaked at 61.3 mid-2018 but has since fallen to 54.2. The overall index level is still healthy, but the downward trend implies slower growth ahead.

Factory Orders

(Non-seasonally adjusted year-over-year % change)



Sources: Census Bureau, Foleynomics, and Covenant Investment Research.

Outlook: Overall activity levels in the manufacturing sector are stable, albeit less robust than in mid-2018. The trade conflict with China pulled orders forward, particularly in Q3 and the resulting inventory overhang will require time to work off. A weaker US Dollar would make domestic manufacturing more competitive in the global market, but absent a full-blown trade war, the manufacturing sector should continue to support our broader theme of "good, but not great growth" for the economy.

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CONSTRUCTION

The construction sector of the economy is flagging, dragging on the broader GDP growth measure. The current pace of total construction expenditure growth (approx. 2.5%) is barely above inflation and would be far worse absent the boost from fiscal-stimulus-fueled government investment in 2018.

Nominal Year-Over-Year Construction Spending

Sources: Census Bureau, Foleynomics, and Covenant Investment Research.

Within the bellwether residential housing sector of the economy, existing home sales declined from an annualized rate of 4.9 million a year ago to a current pace of 4.6 million. Higher mortgage rates, tighter bank underwriting standards, and rapidly appreciating home prices are negatively impacting the housing sector. Indeed, residential investment has been slowing since late 2017 and recorded four consecutive quarters of negative real growth through December 31, 2018.

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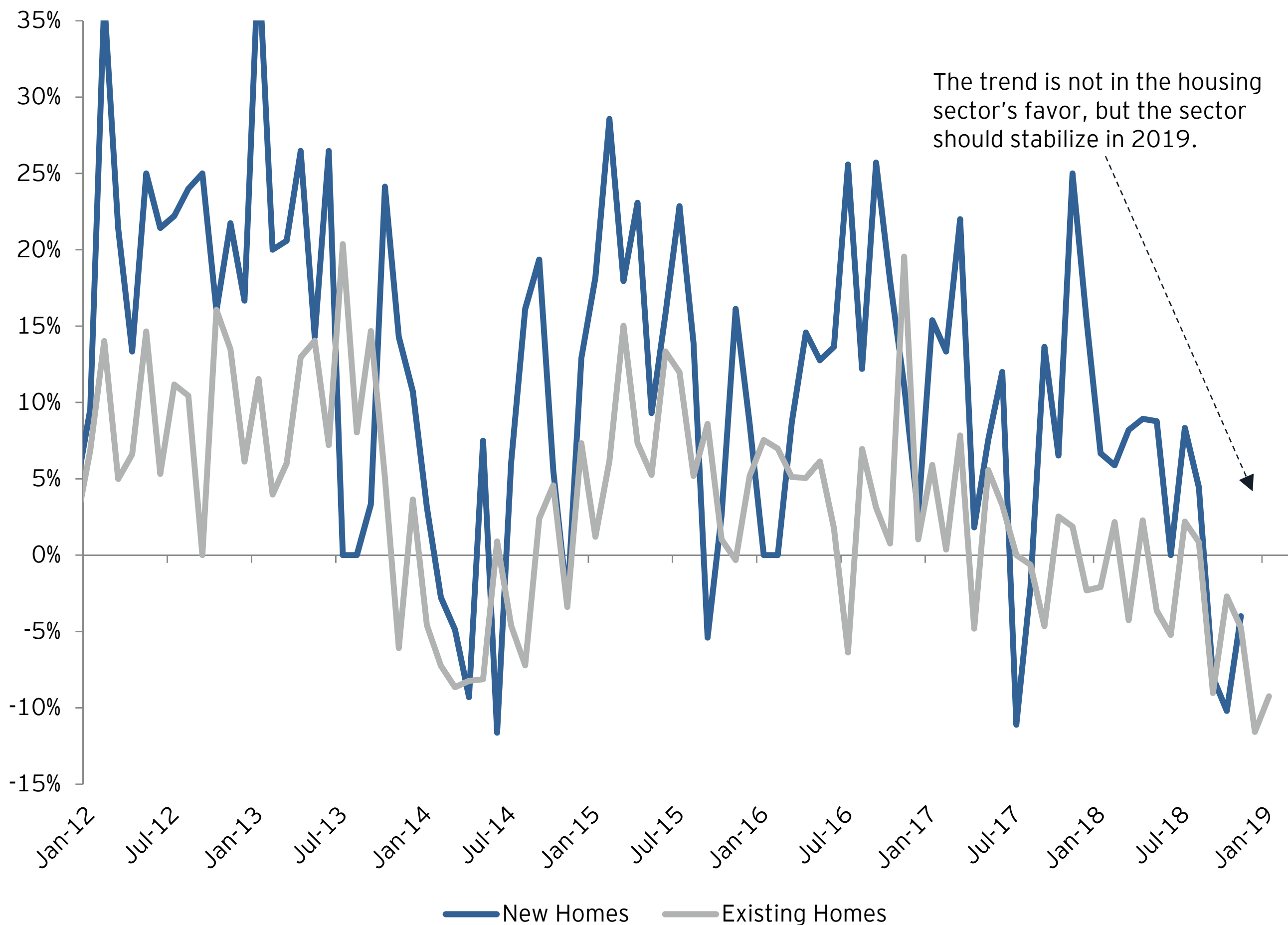

Sources: Census Bureau, Foleynomics, and Covenant Investment Research.

Outlook: The trend in home sales is concerning, but the overall level of activity is steady, and there are several reasons for optimism that the housing sector will stabilize in 2019. First, mortgage rates have declined from their recent peak in December. The average 30-year mortgage was 4.8% in December but has fallen to 4.3% today, according to Bankrate.com. Second, the rate of home price appreciation has slowed in most major metropolitan areas. Third, wages continue to rise and, combined with lower mortgage rates and slower price appreciation, owning a home is becoming more affordable.

Conclusion

As Q4 GDP data confirmed, growth peaked in most major economic sectors in the middle of 2018 and is now slowing from the unsustainable rates afforded by tax-cuts and fiscal stimulus earlier in the year. Whether the economy can avoid a recession late this year or in 2020 depends, in no small degree, on the Fed's actions going

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forward and the margin for error is thin. Will the Fed remain patient enough to determine if the recent spate of weak economic data is temporary allowing for additional rate hikes later this year? Alternatively, if the data shows a more pernicious trend will the Fed act quickly to cut rates like the 1995 Fed?

In some ways the Fed finds itself trying to achieve two goals that are at odds with one another. On the one hand, the Federal Reserve is motivated to raise interest rates to prepare for the next recession. In the last 60 years, the Fed cut interest rates by an average of 4% during recessions to stimulate growth. Yet, with the Fed Funds rate at 2.5%, the Fed doesn't have enough room to cut rates by that much unless they embrace negative interest rates, a monetary policy that has shown little success (witness Japan and Europe). On the other hand, the Fed does not have much room to raise rates currently because as we learned in Q4 and the beginning of 2019, they are likely approaching a level that curtails economic growth. The Fed's already difficult job is exacerbated by winding down a balance sheet bloated by QE, the effects of which nobody knows.

Recessions are a natural phase of the business cycle, and eventually, the U.S. economy will succumb to one. However, the Fed generally attempts to forestall recessions for as long as possible and, when they do occur, to help the economy recover quickly to prevent lasting economic damage. In this regard, we are encouraged that Chairman Powell, outside of his December press conference (which we'll attribute to pushing back against President Trump's criticisms to maintain the Federal Reserve's political independence), appears willing to listen to the data…and to be patient.

Powell is not a trained economist, and though he is surrounded by them, he espouses a pragmatic approach to Fed monetary policy that incorporates, but does not rely exclusively upon, traditional Fed financial models. On this point, Powell's approach is similar to that of Alan Greenspan in 1995. And, like "The Maestro" in the mid-1990's, Powell has an opportunity to reverse a declining growth trend and extend the current expansion.

- The Covenant Investment Team

Disclosures

The principal sources used in the preparation of this Report include: Bloomberg L.P., Foleynomics, Congressional Budgetary Office, Wells Fargo Securities, and Covenant Multifamily Offices, LLC ("Covenant"). Some data included in this report including government reports and other data has been taken from secondary sources and were not derived from the primary sources. Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Covenant), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Covenant. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Covenant is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the Covenant's current written disclosure statement discussing our advisory services and fees is available upon request. If you are an Covenant client, please remember to contact Covenant, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services.

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