FRONT BARNETT ASSOCIATES LLC

I N V E S T M E N T   C O U N S E L

Marshall B. Front
Chairman

Direct Line: (312) 641-9001
e-mail: mfront@front-barnett.com

November 3, 2017

THE ECONOMIC OUTLOOK: A QUICK LOOK AT THE INDICATORS

The US has experienced 12 recessions since the end of WWII, one every 6 years on average. At 8 years and 4 months and counting, some fear the current recovery may soon falter, the victim of old age. Given the importance of the economic cycle to the course of corporate profits and, in our view, stock prices, it is important to be aware of measures analysts track to assess the odds of an economic recession resulting in a significant stock market downturn.

In summary, trends in monetary policy, interest rates, inflation, employment, manufacturing, housing, credit performance, earnings quality, and valuation metrics for stocks are all sending positive signals. In addition, our firm's proprietary Economic Model (attached), designed to forecast by 6 to 9 months a *change* in the direction of the economy, and continues to signal expansion as does the Leading Economic Indicators (LEI).

Below are current readings of the measures many analysts use to assess the likelihood of an imminent recession.

1. *Both the ISM Manufacturing and Non-Manufacturing* indices, among the most useful forward-looking metrics, remain well above readings of 50, signaling expansion ahead.

2. *Yield Curve*: The most frequently cited warning signal of a recession is the steepness of the yield curve. Typically, the yield curve will invert (i.e. short term interest rates rise above long term rates) in advance of a downturn. While the steepness in the yield curve has moderated in recent months, it is far from flat today, let alone inverted.

3. *Inflation Trends*: The Fed's dual mandate is focused on inflation and employment. Historically, the Fed has removed

70 WEST MADISON STREET • SUITE 4920 • CHICAGO, ILLINOIS 60602-4208
(312) 641-9000 • FAX (312) 641-9009

accommodation most aggressively when wages are accelerating. Wage growth trends have been stable at about 2.5% over the past year.

4. *Labor Market*: Recessions are characterized by rising unemployment. Hiring trends, jobless claims and the workweek remain healthy.

5. *Credit Performance:* As the business cycle matures, reaching its late stages, corporate finances typically come under pressure, leading to rising loan delinquencies and defaults. Current credit performance indicates little stress in the economy.

6. Similar to credit performance, *Earnings Quality* is a useful measure of corporate health. The current pace of reported write-downs is typical of mid-cycle readings.

7. *Housing:* It is atypical for recessions to occur while housing volumes are increasing as they are.

8. While *Valuation Metrics* for stocks are above average, they are not excessive when adjusted for expected level interest rates.

9. *Earnings*: With stock valuations where they are, the sustainability of the bull market is dependent on earnings growth rather than further multiple expansion. But, there are risks to corporate earnings should real wages pick up.

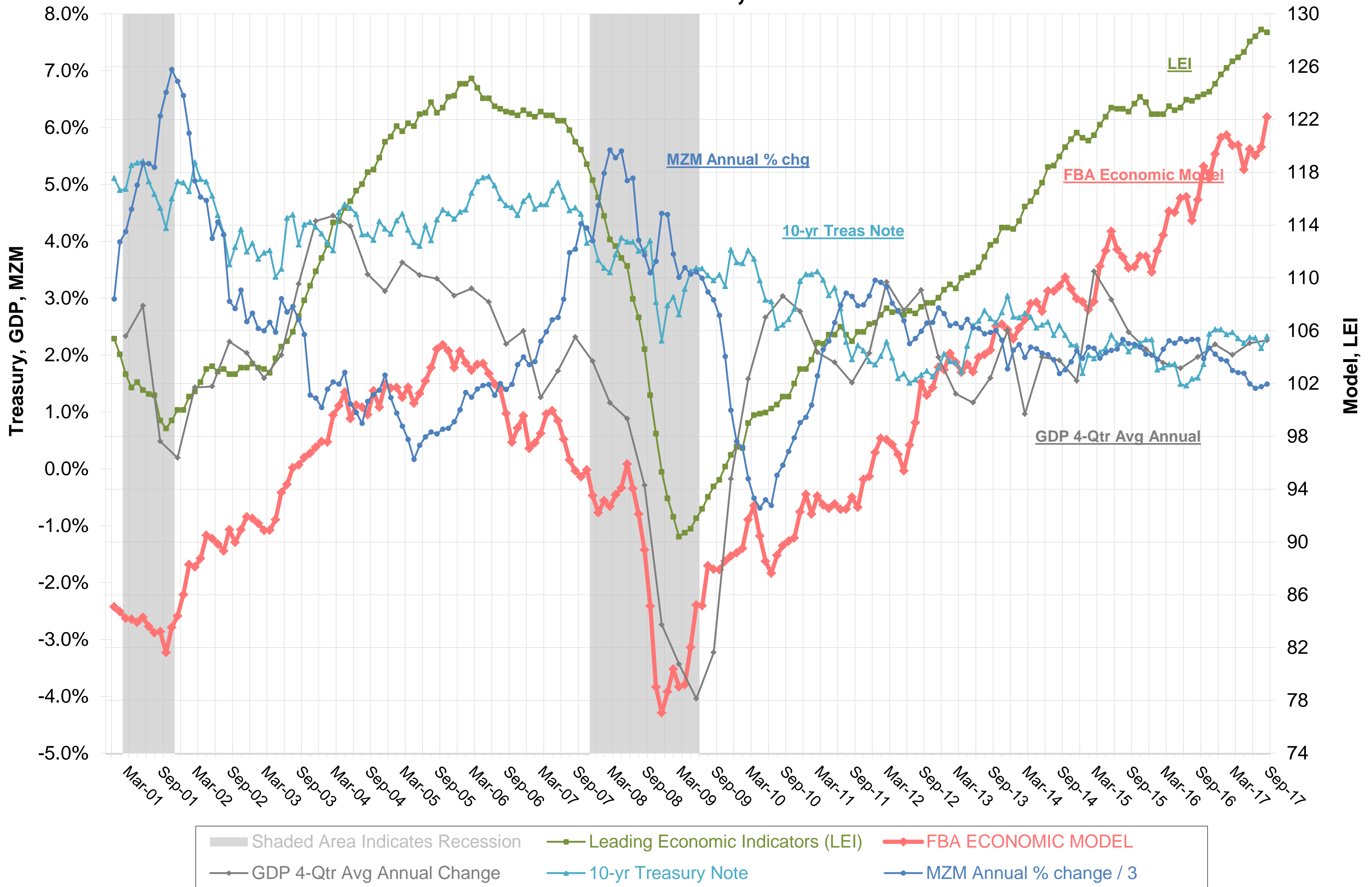
Interestingly, a current NY Fed analysis places only an 8% probability of a recession in the next 12 months.

Beyond the metrics, keep in mind recessions are generally caused by three circumstances: (1) growing inflation to the point at which the Fed believes it must step in to stop it; (2) a policy error, or (3) an exogenous event. When wage growth reaches a level of 4%, the economy is generally close to both a recession and an inverted yield curve. 2.5% wage growth today suggests we have a way to go in this expansion.

* * * * *

MBF

Front Barnett Associates LLC
Economic Model
October 30, 2017



Last updated 10/30/2017

There are inherent limitations in economic modeling. There can therefore be no assurance that our Economic Model will accurately predict future directional movements in the U.S. economy.