Made in Hollywood

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The news is filled with predictions of economic slowdown and a possible recession in 2019, or surely likely by 2020, but that's just the media filling the 24/7 news cycle with material to influence readers and viewers to supply more eyeballs. Yes, there are ebbs and flows in the data. That's normal. Underneath it all, the economy is performing well and there are no real signs of recession on the horizon. So it wouldn't take much to jumpstart a sharp rally in the stock market.

Economic growth is going to slow in 2019, simply because the 3% plus pace of recent quarters is unsustainable. It is also unnecessary and even undesirable. For several years, the economy grew at a 2% pace that was roundly criticized as weak, yet it was more than sufficient to bring the unemployment rate below 5% from 10%. So it was more than adequately strong. Nonetheless, policymakers wanted stronger growth and the fiscal stimulus package of 2017 contributed to that, along with the election of a President perceived to be more growth friendly and inclined to de-shackle the economy by reducing regulations. Growth accelerated above 3% in response, even though this pace was simply unsustainable. We expect a slowdown in 2019, likely back towards 2%. And such a slowdown would be a positive

development, despite suggestions of alarm by some over weaker growth prospects. There is no basis for a recession in the visible future and economists have no real ability to forecast 2020, as yet.

Growth of 2% will be sufficient to continue to increase corporate profits and reduce unemployment, even though we are already experiencing labor scarcity. A recent article in the WSJ reported that many retail firms have been hiring workers for the holiday shopping period on the basis of a phone call, no personal interview necessary. In other words, can they fog a mirror? Does this sound familiar? (Many mortgages were made in the 2004 – 2007 period on that basis and it didn't turn out well.) This hiring methodology is a clear indication of how desperate firms are to hire amid labor scarcity. This labor scarcity ensures that growth must slow.

A more moderate pace of growth is still sufficient for corporate profits to rise, and labor scarcity ensures that wages will also increase, both of which will sustain the expansion. Yet, this also suggests higher business costs and likely presages a somewhat higher inflation rate. That's one of the key downsides to running a hot economy.

So what will turn the stock market around? Actually, any of several possibilities will do, since people share several concerns. The very first potential trigger is any data that undermines the thesis that a recession is coming. Solid employment reports along with evidence of rising household incomes would point to continued growth, undermining the recession argument. So would strong holiday sales. Both are likely. Early reports on holiday shopping will emerge within days and the November jobs report will come at the end of next week.

A second concern is that the trade war with China will cause a global recession. Indeed, growth is slowing in China, and Japan and Germany reported a weak third quarter, providing some grist for the recession story mill. But as David Lieberman wrote last week, the negative quarters in Japan and Germany were due to unusual factors that are unlikely to be repeated, so it is more likely that both experience a rebound, likely sooner rather than later. Presidents Trump and Xi will meet shortly and they are likely to tone down the rhetoric even if they don't solve the world's problems in one meeting. That will be helpful, even if it falls short of the unrealistic

expectations of some people. And China does want a way out of this conflict, even if it is not yet ready to change its business practices. So they are likely to make some small concessions and the optics will improve.

Investors also fear that the Fed will continue to raise interest rates, which could precipitate further declines in the stock market and, possibly, also a recession. The decline in stock prices has stoked speculation that the Fed might pause in its march towards rate normalization. We disagree that the stock market decline seen so far will dissuade the Fed from hiking rates as planned. As Fed Chair Powell stated in early October, policy is still far away from neutral. Moreover, if the Fed continues to raise rates by the three 25 basis points hikes they have already penciled in for 2019, we also believe this pace of rate normalization will not damage the expansion. A slower pace of growth is coming regardless and is actually needed given the low level of unemployment. But if we're wrong, if the Fed blinks in any way, stocks would rally.

Another fear of investors is that stock prices are high after rising over the past several years, which surely contributed to investors bailing out at the first hints of weakness in stock prices. In fact, stock prices were actually cheap before the recent sharp slide, which was most visible when one adjusts price-earnings multiples to exclude the FANG stocks. It was commonplace even weeks ago to find quality companies trading at 12 to 14 times 2019 expected earnings. The decline has rendered stocks very cheap with the entire market, including FANG stocks, now trading at less than 15 times expected 2019 profits. This suggests that any good news could trigger a sharp rally. All of our portfolios sport an average price-earnings multiple of around 13 or less. We consider prevailing stock prices to be an attractive buying opportunity.

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