KAPUSTA FINANCIAL GROUP

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Economic Storm Clouds Ahead

Earlier this year we published our thoughts on the U.S. and global economic outlook for 2018. We expected U.S. economic growth to remain strong throughout the year.

While consumer confidence and business confidence are at high levels and the jobless rate continues to fall, cracks in the near-term outlook for our economy are beginning to develop.

Interest Rates:

Since the 1960s the U.S. has experienced 7 recessions and an inverted yield curve preceded them all. An inverted yield curve – in which short-term rates rise above long-term rates – has a strong record of being a leading indicator of a recession. Today the curve is flat -the gap between short- and long-term treasury yields is at its narrowest in more than a decade - and the probability of an inversion in 2019 is rapidly rising.

The Federal Reserve (Fed) remains committed to increasing interest rates. They have made three moves this year with a fourth planned in December and at least three more hikes are scheduled for calendar year 2019. The Fed will most likely continue to raise rates until the yield curve inverts.

A booming U.S. economy coupled with increasing interest rates stokes investors' desire to put their money into riskier assets. Recently, the higher interest rates have sent bond prices tumbling. That, in turn, makes a pull back from stocks a much more likely event.

U.S. Economy:

Consumer spending and business investment continue to boost the Gross Domestic Product (GDP) – the value of all goods and services produced across the economy. Consumer confidence hit a new 18-year high in September – a positive indicator for spending going into the holiday shopping season. American's expectation for continued growth in the future is high.

Many of our biggest companies report some of the strongest earnings growth since the recession boosted by lower tax rates in a robust U.S. economy.

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Recently the S&P index has set the record for the longest bull run eclipsing the record set between 1990 and 2000. Over the last two weeks, the U.S. stock markets have broken through their all-time highs, which were set in 2000.

That said, stocks are facing an earnings road block as the job market tightens and are pushing labor costs higher as well as making it harder for companies to find workers to meet demand. A tight job market is a precursor to higher inflation. While corporate earnings for 2018 will remain strong, far more companies are warning that future earnings may not be as robust as this year - prompting some economists to question how much further stocks can increase following a nine-year rally.

Global Picture:

The synchronized global growth narrative has turned upside down since early this year. Weaknesses from worldwide rising interest rates and potential trade wars are causing most developed countries negative GDP growth. This is true throughout all of Asia with the exception of Japan. In Europe, all countries year-to-date have also experienced negative growth with the exception of Germany, which just turned slightly positive at the end of July. Italy is of particular concern as investors fear panic beginning to set in the bond market. Italian banks have large portfolios of the country's bonds which has raised concerns of financial instability spreading throughout the Italian economy and possibly throughout Europe.

The most significant country to the U.S. is China, which is in the cross hairs of our trade tariffs. Higher tariffs are expected to raise prices for consumers and businesses and draw retaliation against U.S. exports. So far, these global events have left the U.S. equity markets unharmed.

Summary:

U.S. growth remains strong relative to the rest of the world, but leading economic indicators show that our macro economy has most likely peaked in late April or early May and that we are in the very beginnings of a slowdown. Half the economists surveyed last month by the National Association of Business Economics, foresee a recession starting in 2019 or early 2020.

The headwinds of a tight job market, higher inflation, increasing interest rates, global trade tariffs, and all-time high stock and bond valuations have become a major risk to future economic stability.