The US should avoid economic recession in the coming year, but the odds of an earnings recession—where US corporate profit growth turns negative while overall economic growth does not—are rising.

ROLLER COASTER

The good news from the first half of 2019 is that the S&P 500 stock index is up 18.5%. The bad news is that it's trading almost exactly where it was in mid-September of last year. In between, we've been on a roller coaster ride driven in large part by President Trump and his chaotic approach to trade negotiations.

One day he's slapping tariffs on Mexican imports, the next day he's not. If it's Tuesday, it must be tariffs on China, and Wednesday, maybe Canada. Who knows?

The net effect of Trump's mercurial trade policy has been threefold: First, it has put a dent in China's economic growth, which was already slowing. Second, it has disrupted complex global supply chains that feed US manufacturing. And, third, it has sown confusion and weakened business confidence both in the US and around the globe. And for all of that, Trump has gotten only token concessions from US trading partners.

LEADING INDICATORS

Played as farce, Trump's careening about might be mildly entertaining, in a slap-stick sort of way. But, rather, it plays as tragedy as the real-world consequences come bearing down upon the global economy, including the US.

When business confidence falters, so does job creation, wage growth, and capital investment. Each of those very good things is the result of long-term planning on the part of business managers. Trump's erratic behavior makes long-term planning all but impossible. So, planning gets tabled. And that's what we're seeing in the US.

In May, the US created just 75,000 new jobs vs. an average of 245,000 per month for the three months through January. Manufacturing employment in particular has weakened, a result of softening exports and capital investment. Wage growth in the US has also stalled.

Of greatest concern for investors, leading indicators of the US economy have swooned. As readers know, we carefully follow purchasing managers' indices (PMIs) from the US and around the world. Why? Because these monthly surveys of business managers' expectations serve as good indicators of what's ahead for each of their businesses. When you aggregate these expectations, they give you a fairly good view of what's ahead in the coming months for the economy of a given region or country. As the stock market itself anticipates future economic conditions, PMIs give investors a glimpse of what stocks will soon be pricing in.

SLOWDOWN OR RECESSION

One such PMI is the known as the Markit US Manufacturing PMI (and that's not a misspelling of Markit). It's reading for June came in at its second-lowest reading in nearly a decade, the lowest having been May's. That takes us back to September of 2009 when a very weak US economy was just emerging from the Great Recession. Readings above 50 for this PMI indicate expansion while readings below 50 indicate contraction. The June reading was 50.6. May's was 50.5. We suspect it's heading lower.

At this point it's fairly clear that the pace of economic growth in the US is slowing. This, unfortunately, raises the question of whether a recession is coming to the US sooner rather than later. As bear markets in stocks occur in anticipation of recession, we have to wonder about how much longer the current bull market in stocks will last.

While an economic slowdown is at hand, it's not clear that a recession is on the horizon. We've actually had three prior slowdowns in the expansion since 2009: in 2011, in 2013, and in 2015. In each case, the US economy recovered, recession was averted, and the stock market continued upward after a brief hiccup.

WHAT'S DIFFERENT

A key difference in the current slowdown is that today the Federal Reserve has been raising rates in earnest since 2016 while in the prior slowdowns the Fed was holding short-term rates very near 0%. As interest rates are just the price of money, rising rates make money more expensive and so harder to borrow. This has a dampening effect on economic activity as the price of borrowing for everything from car loans to mortgages goes up.

As interest rate increases register in the US economy with a lag of 12-18 months, and as the Fed's final rate hike was last December, their dampening effects will be with us for a while yet. So, in addition to the headwinds caused by Trump's trade policies, the US economy also has to contend with the headwind of higher interest rates—as wasn't the case in the prior three slowdowns.

Investors have taken heart recently from indications that the Fed is likely to lower interest rates later this year and, indeed, the global trend in interest rates is lower. This is in response to a slowing global economy, including China, and is rightly welcome as lower rates will stimulate the US and foreign economies—eventually. The problem is that these interest rate cuts will register as stimulus in the US and abroad with a lag of many months. So, while the cavalry may be on the way, it's still a ways off.

SPLITTING THE DIFFERENCE

Ever since Trump was elected, we've voiced a very intentionally equivocal outlook on the markets. We've said with increasing conviction that the underlying fundamentals of the US economy were sound, indeed, remarkably so with fairly steady growth, unemployment now at 50-year lows, and inflation well-contained. These are Goldilocks conditions. And yet we've also said that with Trump in the White House, the risk of trade-policy errors posed a material threat to the economy and to the stock market.

Those risks have now come home to roost, as it were. Trump's wounding of the US and global economies through his trade policies doesn't entirely negate the positive fundamentals, but it does offset them to an extent. And while the recent, likely temporary, cooling of trade hostilities with China is welcome, the damage has been done. Our best reading of the tea leaves leads us to believe the US may avoid economic recession in the near term, but we think the probability of an *earnings* recession—where US corporate profit growth turns negative while overall economic growth does not—are rising. And this the stock market will not take kindly.

In September of last year, Wall Street estimated that corporate earnings would grow 23% over the coming 12 months. Now, that estimate has shrunk to just 5% for the next 12 months. Historically, when that forward earnings estimate hits 0%, the stock market stumbles. We think forward earnings estimates and stocks are headed there.

That said, we do think economic recession will be avoided and the earnings pullback fairly short-lived. We expect to see wind back in the US economy's sails by the middle of next year. This should, in theory, contain any stock market decline to something in the range of a correction, that is 10% to 20%.

Farnum Brown, Chief Strategist