Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

Investment Outlook, November 2019

The U.S. equity market continues to advance to new highs despite the headwinds of declining earnings, decelerating economic growth, uncertain trade outcomes and other geopolitical concerns. Some on Wall Street have taken to calling this the most hated bull market in history. We're not entirely sure what that means, but you do have to ask what is causing stock prices to go higher.

Investors are reacting positively to the steepening of the yield curve since late August, driven in almost equal measure by a combination of falling short term rates and rising long term rates. The Federal Reserve has cut short term interest rates by 50 basis points since the yield curve inverted for a sustained period last summer. From its August nadir of minus 50 basis points (10-year Treasury Bond minus 3-month Treasury Bill), the yield curve has *dis-inverted* by almost a full percentage point, and has now moved well into positive territory at plus 40 basis points. The Fed's reductions in interest rates at the short end of the curve have been matched by an almost equal rise in the 10-year yield, reflecting the bond market's lowered assessment of recession risk as a result of the Fed's actions.

We have repeatedly pointed out that the yield curve has inverted prior to the onset of every recession of the last fifty years, and, reciprocally, no recession has occurred during that time absent such an inversion. It is understandable that investors would point to a now positively sloped curve as evidence that we have dodged the recession bullet, and that the odds of a "soft landing" have increased. To this, we would respond that, while a dis-inversion of the yield curve is a necessary criterion to avoid a recession, it has also been an insufficient event in and of itself. In fact, the last three recessions (1990-91, 2001, and 2007-09) have followed multi-month inversions of the yield curve that reversed prior to the subsequent economic downturn. Inverted yield curves have historically dis-inverted as short term rates declined, but too late to extend the economic cycle.

An inversion of the yield curve is a long leading indicator, having preceded economic downturns by as much as two years. The Fed's own forward 12-month recession probability model peaked in late-August / early September and has eased since then. It is simply too soon to know whether the soft landing scenario will play out, or whether the inversion indicator will maintain its perfect track record. As someone once said, the thing about long leading indicators is that they are long.

The key things to look for in the meantime are employment data and credit spreads. Continued strength in the jobs market, particularly maintaining the current low level of jobless claims, would give added support to the "no recession" thesis. At the same time, a widening of credit spreads between Treasuries and lower rated debt securities would be cause for concern, as the weakest credit areas are often the first to experience the strain of a recession. The reports thus far in regards to both jobs and credit are neither discouraging nor conclusive.

The indicators elsewhere are largely positive. To date, 89% of the companies in the S&P 500 have reported earnings results for the third quarter, and 75% of those reports have exceeded estimates. It must be noted that earnings are still below year ago results, but by a lesser amount than had been forecast. Equally encouraging is the fact that companies that report disappointing results are being penalized to a far lesser extent than in prior quarters, with a less than 1% hit to their stock price, on average, indicating that lower earnings estimates are being increasingly discounted in stock prices.

Non-farm payrolls for October advanced by a greater than expected 128,000, with another 95,000 in upward revisions to the prior two months. The unemployment rate, which is derived from a separate survey of households, ticked up 0.1% to 3.6%, still very near a 50-year low, and wages continue to grow at a moderate but steady pace.

The third quarter advanced estimate of GDP came in just ahead of expectations at an annualized 1.9%, driven as usual by strength in consumer spending offsetting continued weakness in manufacturing and investment and the ongoing drag from trade. The corporate tax cut of 2017 has fulfilled virtually none of its promise, possibly undone by trade uncertainty and the lagged effects of Fed tightening. We are now in a capital spending recession after two consecutive quarters of lower fixed investment spending, and the question is whether lower business investment eventually spills over into the jobs market. As we said earlier in this piece, it is too soon to know, but we will be watching.

Joseph J. Tascone
Senior Vice President &
Senior Investment Officer

Michael D. Blatt, CFA
Vice President &
Senior Investment Officer

Peter M. Capozzola, CFA
Vice President &
Senior Investment Officer

John E. Shea
Vice President &
Investment Officer

Kevin W. Brimmer
Portfolio Manager

Shelby M. Fay
Portfolio Manager

Chemung Canal Trust Company

CAPITAL BANK
A division of Chemung Canal Trust Company