

THE REAL ECONOMY

VOLUME 55



**RECESSION WATCH:
WHAT'S THE
BOND MARKET
SAYING ABOUT
FUTURE GROWTH?**

JOBS REPORT CLUNKER
PUTS JULY RATE CUT ON THE TABLE

INDUSTRY SPOTLIGHT:
INVESTORS EYE HOSPITAL REVENUE BONDS
IN SEARCH OF YIELD

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RECESSION WATCH: WHAT'S THE BOND MARKET SAYING ABOUT FUTURE GROWTH?

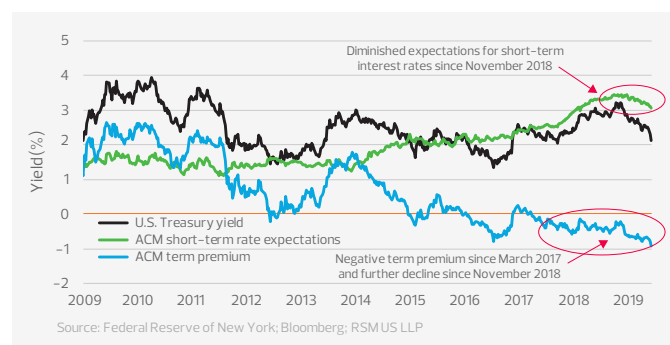
By Joseph Brusuelas

Despite a 3.2% gross domestic product growth rate (real private final demand 1.3%) in the first three months of 2019, we are beginning to see data that implies the current economic recovery likely peaked in the third quarter of 2018. While identifying the exact month(s) when a business cycle starts and ends is part science and part art, our estimation is that we have a near miss for a recession this year. The probability of an end to the current business cycle is rising due to trade policy and tight monetary policy. The bond market is clearly signaling that absent a cessation of trade hostilities or a shift in monetary policy, we are now late in the business cycle.

Financial markets—and the bond market, in particular, because of its direct dependence on monetary policy and expectations for inflation and economic growth—offer information to bridge the gap between the science and art of identifying the beginning and end of a business cycle.

Figure 1

Decomposition of 10-year Treasury yields
ACM/FEDERAL RESERVE MODEL



For example, the yield on 10-year Treasury bonds has been dropping steadily as anxiety over trade policy has increased in recent months, and dropped by 40 basis points from May 23 to June 3 as threats to the U.S.-Mexico supply chain increase. Movements in



RECESSIONS ARE SPARKED BY AN EVENT, AND WE SEEM TO BE GOING FROM ONE ECONOMIC OR GEOPOLITICAL SPARK TO ANOTHER OF LATE.

prices/yields along the maturity spectrum clearly imply that the policy rate is too tight given current economic activity and the proliferation of risks to the outlook. Thus, the Federal Reserve needs to shift its policy from monetary patience to easing as the outlook for global growth is further dampened at the end of a long recovery and by threats to the global supply chain. This is part of the reason why we recently changed our Federal Reserve call and now expect 25 basis point cuts from them in September and December.

Looking at the composition and behavior of long-term interest rates, we can see that the yield on 10-year Treasury bonds rose from August 2016 through October 2018 (see Figure 1). The economic recovery was continuing through its ninth year, and the Fed used the opportunity offered by extremely low unemployment rates and the prospect of rising wages to gradually push short-term interest rates higher toward what are deemed to be normal levels.

Recall that (1) Fed policy directly influences short-term interest rates (referred to as the money market) through its setting of the Fed funds rate, and (2) that investors should be indifferent about buying a series of risk-free, short-term securities or a single, long-term bond whose market price includes compensation for the risks of holding that bond until it matures. For instance, an investor could buy either a 10-year Treasury bond or a series of Treasury bills every three months over the next 10 years. But that 10-year bond would be priced to compensate the investor for the risk of holding that bond and not earning the returns guaranteed by the short-term securities if short-term interest rates were pushed up or down. The risk component of holding that bond for 10 years is called the term premium.

As shown in Figure 1, interest rates can therefore be decomposed into: (1) an expectations component, and (2) a risk component. In the case of 10-year Treasury bonds, the expectations component (the green line in Figure 1) consists of the path that short-term interest rates are

RECESSION WATCH continued

expected to take over the 10-year life of the bond. The risk component, the term premium shown as the red line in Figure 1, consists of perceptions of the probability that short-term rates might deviate from their expected path. The risk is that an event will occur sometime over the life of the 10-year bond (for instance, an oil shortage, a financial crisis or a trade war) and that the Fed will respond by raising or lowering the Fed funds rate. The sum of those two components equals the yield on the 10-year bond.

In the case of the expectations component built into 10-year bond yields, Figure 2 shows that expectations for the future path of short-term interest rates peaked during the first week of November 2018 at 3.4%, and have steadily dropped by about 50 basis points to less than 3%. The perception of the bond market appears to be that the Fed will abandon its monetary tightening program and will instead cut the Fed funds rate in response to lower growth.

In the case of the risk component, the bond market's judgment shows, in Figure 2, an increasing risk that Fed policy might have to become even more accommodative than expected. As it became clear that the Trump administration's trade policy had the potential to damage the economy, the bond market reacted by pricing in potential for an economic slowdown and deflation. As such, the estimate of the term premium on 10-year bonds has fallen by 50 basis points since November 2018. Note also that the term premium has been negative since March 2017, pricing in the risk of an economic, financial or geopolitical event that could trigger a recession.

Figure 2

	10-year Treasury yield (%)	Model-based 10-year yield (%)	Expectations for short-term rates (%)	Term premium (%)
Nov. 7, 2018	3.21	3.22	3.43	-0.22
June 4, 2019	2.14	2.16	3.06	-0.91
Change (basis points)	-107	-106	-37	-69

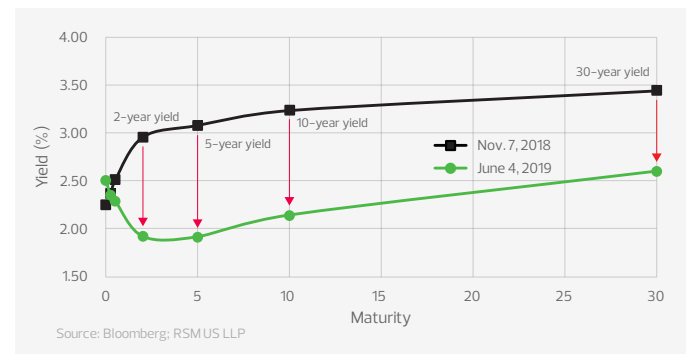
Figure 3 shows that since November 2018, yields have moved lower all along the yield curve and that the yield curve is now inverted from money market rates out to 10-year maturities. The market is now anticipating that growth and inflation in the near-term have the potential to be lower in coming months and that a revision in Fed policy will likely push short-term rates lower.

However, as with all human endeavors, that doesn't necessarily mean that the end is near. As we noted in an earlier report, a yield curve inversion suggests a climate conducive for slipping into a recession, rather than predicting a recession in coming months. Within that climate, though, recessions are sparked by an event, and we seem to be going from one economic or geopolitical spark to another of late.

Figure 3

Changes in the U.S. Treasury yield curve since Q4 2018

NOV. 7, 2018 AND JUNE 4, 2019



FINANCIAL MARKETS—AND THE BOND MARKET, IN PARTICULAR, BECAUSE OF ITS DIRECT DEPENDENCE ON MONETARY POLICY AND EXPECTATIONS FOR INFLATION AND ECONOMIC GROWTH—OFFER INFORMATION TO BRIDGE THE GAP BETWEEN THE SCIENCE AND ART OF IDENTIFYING THE BEGINNING AND END OF A BUSINESS CYCLE.

Must all good things come to an end?

The economic recovery that began during the June 2009 trough of the Great Recession is now on the eve of its 10th anniversary (see Figure 4). Should the National Bureau of Economic Research, the final arbiter of business cycle peaks and troughs, decide that the economy is still growing through the second quarter, the current recovery will have outlasted the Dot.com Boom of 1991–2001 (see Figure 5).

Figure 4

U.S. economic recoveries in the months after recessions

REBASED LEADING INDICATOR VALUES FROM BUSINESS CYCLE TROUGHS TO PEAKS

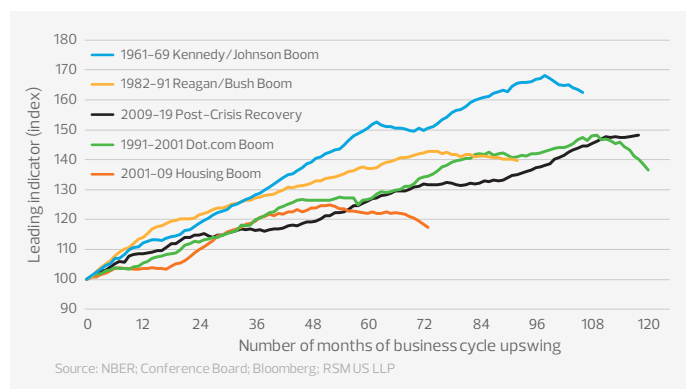
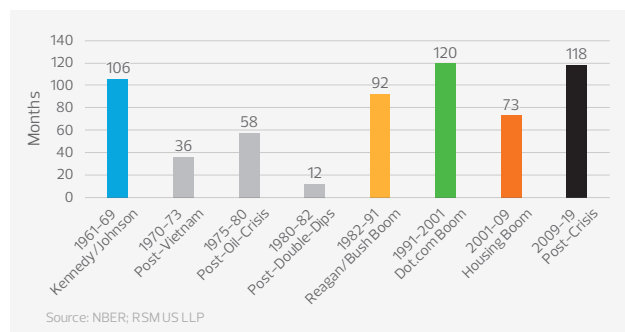


Figure 5

Duration of business cycle upswings



What are economic indicators suggesting?

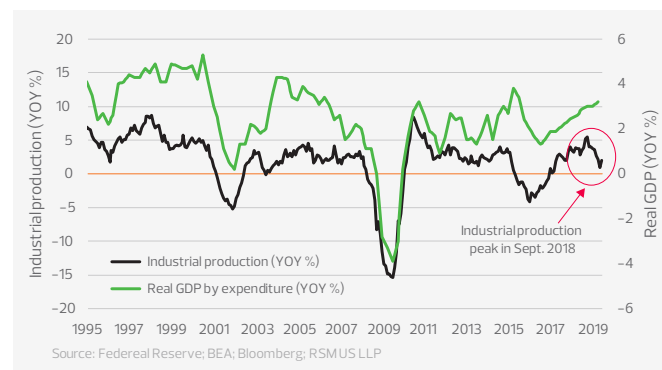
The NBER looks at various indicators and indices (including yield-curve models and monthly GDP estimates) to determine when the business cycle stopped growing and when the downturn began. The NBER's assessment is complex even after the fact, but the financial markets are operating in real time, or as close as possible to the release of indicators that are collected and reported in the weeks or months after the economic activity has occurred.

The following is a sample of monthly economic indicators that are listed as inputs to the NBER decision process and are conventionally followed by the bond market. In each case, the indicator shows a drop-off in economic activity since the third quarter of 2018, confirmation of what the bond market has been anticipating.

Industrial production—while real GDP grew by 3.2% in the first quarter of 2019, the downturn in industrial production is now seven months long (see Figure 6). Industrial production in September 2018 was 5.4%; in April 2019, industrial production growth slipped to 0.9% before correcting to 2% growth in May, all on a year-over-year basis.

Figure 6

Industrial production and real GDP growth

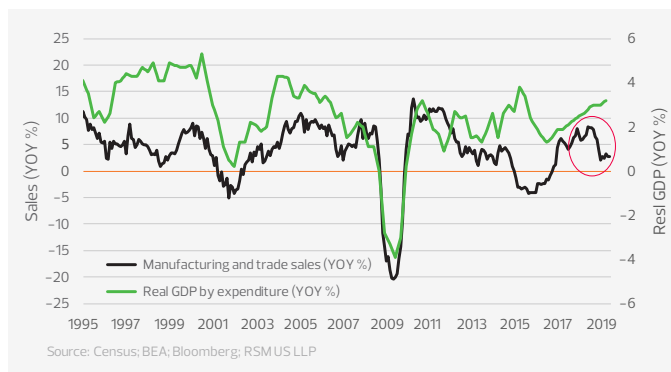


RECESSION WATCH continued

Manufacturing and trade sales—economic activity included in manufacturing shipments and retail and wholesale trade sales peaked at 8.4% in May 2018 and remained strong throughout the summer (see Figure 7). Since then, sales growth slumped to 2.1% in December before popping back up to around 3% in March and April 2019 on unexpectedly strong retail activity, all on a year-over-year basis.

Figure 7

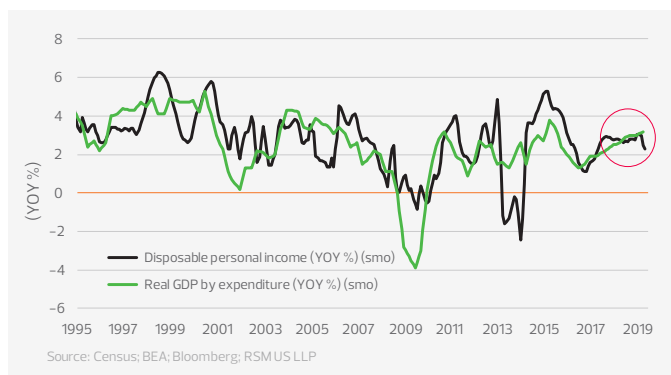
Manufacturing, trade sales and real GDP growth



Real disposable income—as the economy strengthened and employment opportunities and wages finally began to grow on what looked to be a sustained basis, households experienced an increase in real disposable income from the summer of 2016 through the end of 2018, peaking at a 3.9% growth rate. Since then, real disposable income slipped again to nearly a 2% growth rate in March and April 2019, all on a year-over-year basis.

Figure 8

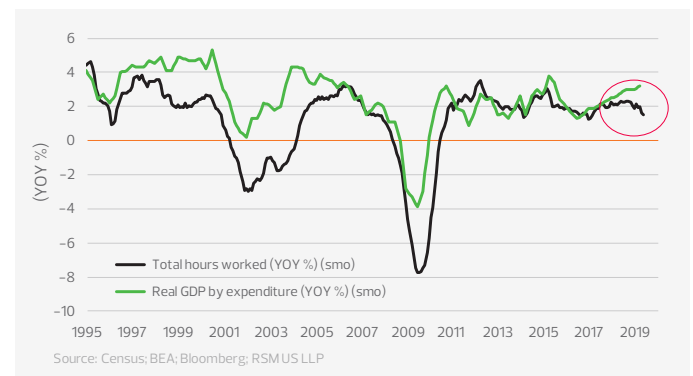
Real disposable income and real GDP growth



Total hours worked—the labor market generally lags the business cycle; it can take a while before employers are willing to add staff at the start of an upswing, and it can also take a while, because of contractual or personal obligations, to cut back on staff when an economic recovery reaches maturity. This could be the current situation. The upward trend in total hours worked appears to have peaked at a 2.5% growth rate in May 2018 and then cooled down to 1.5% growth by May 2019, all on a year-over-year basis.

Figure 9

Total hours worked and real GDP growth

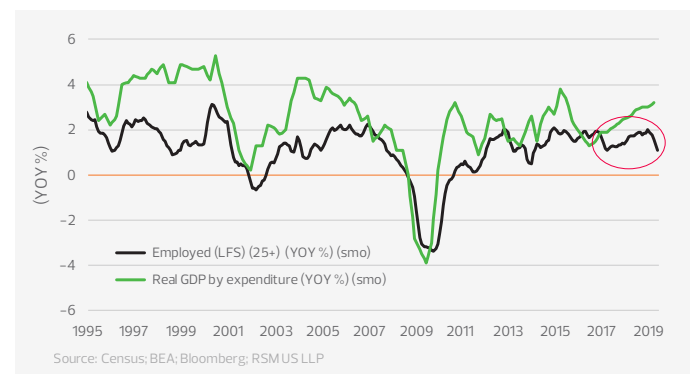


Employment growth—as with other labor statistics, you would expect employment growth to lag behind the trends in the business cycle—slow to increase as the recovery first gains momentum, and then slow to decrease as the recovery winds down.

Employment growth was moving higher from Q3 2016 through the last quarter of 2018 when it hit a 2% pace. That pace has not been sustained in 2019, however, slowing to a 1% rate in April, all on a year-over-year basis.

Figure 10

Payroll employment and real GDP growth





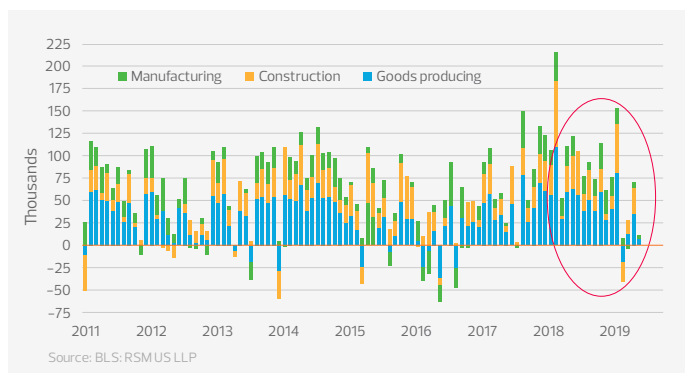
JOBS REPORT CLUNKER PUTS JULY RATE CUT ON THE TABLE

By Joseph Brusuelas

An interest rate cut at the July Federal Reserve meeting is now on the table as firms pulled back significantly on hiring in May. The recent weak hiring report is likely due to the uncertainty tax linked to the current trade policy, placing further burden on the economy.

While topline hiring showed a net gain of 75,000 jobs, there was noticeable weakness inside the higher-paying goods producing, manufacturing and construction numbers and downward revisions (minus 75,000) in hiring over the past two months. As a result, the gains in May were completely negated by the revisions and the three-month pace of hiring decelerated to 151,000 jobs.

Policymakers and investors should anticipate a broader deceleration in hiring in the second half of the year, likely toward the 80,000 new jobs necessary to stabilize the unemployment rate. While a rate cut at the July Fed meeting is not a certainty, policymakers should anticipate the market aggressively pricing in the likelihood of a 25 basis point cut.



The broad deceleration across service sector hiring, including the middle market, is of serious concern. This is the second time in four months that the economy has produced a jobs number that implies an increase in the unemployment rate in coming months as the pace

of hiring slows. The Fed now has a domestic economic component to add to its decision matrix and a narrative that consists of deteriorating global economic and financial conditions, an inverted yield curve and falling bond yields.

The three-month average annualized pace of hourly earnings declined for the third straight month to 2.73% from 3.31% in February. With hours worked flat on the month, this does not bode well for the spending outlook in the second half of the year. Given the elevated level of inventories in the manufacturing sector, which includes many middle market firms, this poses noticeable downside risk to growth in the current quarter and the second half of the year. On the month, average hourly earnings increased 0.2% and were up 3.11% from one year ago.

What's under the hood?

Lifting the hood on this clunker of a jobs report, the data inside is even bleaker. The softness that has recently defined employment in middle market manufacturing has now spilled over into the services sector. The evolution of job creation in the manufacturing sector is extremely troubling at this point with a net creation of 5,000 over the past three months.

The only signs of strength were in business services, which added 33,000 jobs. Education and health expanded by 27,000 jobs and leisure and hospitality contributed 26,000 new hires. The higher-paying goods producing, manufacturing and construction sectors added 15,000 jobs in May. Trade and transport hiring were flat, retail trade shed 8,000 jobs and is down 51,000 jobs over the past four months, while the financial sector added 2,000 jobs. There was an increase of 5,000 jobs in the temporary category.



HEALTH CARE

Industry SPOTLIGHT

INVESTORS EYE HOSPITAL REVENUE BONDS IN SEARCH OF YIELD

By Rick Kes

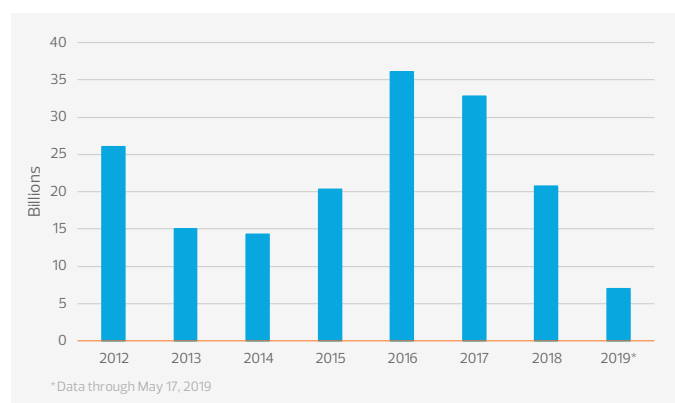
Investors are eyeing higher-yield hospital revenue bonds amid bargain prices underscored by the 10-year U.S. Treasury, which is priced at its lowest level since 2017. However, health care systems have not yet stepped up to issue more debt to meet demand.

Several bond deals issued in the first few months of 2019 have seen significant over-subscription, signaling more demand than supply. The bonds bought are also offered in the secondary market, which has seen appreciation in their value.

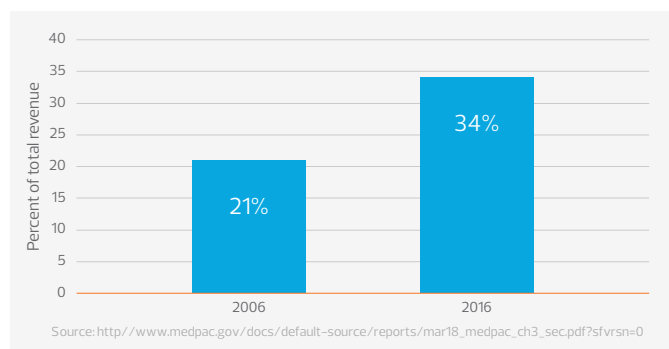
So why haven't health care systems issued more bonds? One possible reason could be that they are reevaluating construction activity typically funded by these types of debt instruments. Hospital systems are facing continued pressure to move service out of acute care hospitals into lower-cost settings such as outpatient clinics.

The chart below shows a slowing in hospital bond offerings so far in 2019.

Total long term hospital bond issuance (\$)



Medicare outpatient revenue as a percent of total revenue



KEY TAKEAWAY

If you are a middle market executive within a health care system considering going to the debt markets, you may want to move quickly as bond buyers are looking for places to put their money. Additionally, you could consider issuing debt for projects besides construction that you previously would have slated for other types of financing.

RESEARCH SHOWS MIDDLE MARKET CYBER RISK

Nearly 50 percent of midsize companies expect they will face unauthorized users attempting to breach their data or systems this year, according to executives RSM surveyed. Despite incidents of rising cybercrime, just half of the businesses surveyed carry cyber insurance policies to protect against internet-based risk. Our study shows that many of those policies may fall short of comprehensive coverage.

Meanwhile, the C-level executives we surveyed may be overly confident in their firms' internal abilities to thwart an attack. Some 93 percent of respondents were confident in their organizations' ability to safeguard customer data. The reality—based on actual incident reports—is proving that confidence may be misguided.

Learn more in the [full report](#).



MMBI REVERSES Q1 DECLINE AMID ROBUST REVENUE AND EARNINGS EXPECTATIONS

Middle market business sentiment staged an impressive recovery in the second quarter, as the proprietary RSM US Middle Market Business Index rose to 132.3 from 124.1 in the prior period. The positive outlook was bolstered by robust revenue and earnings expectations along with a modest economic upturn and strong rebound in equity prices.

However, MMBI findings also indicated businesses are in the process of adjusting to a deceleration in growth as the economy comes down from the high that followed 2018's federal tax cut. In the special questions portion of the MMBI survey, which focused on labor issues, companies denoted a reluctance to engage in aggressive hiring, in part due to the reduced supply of willing and available workers.

Learn more in the [full report](#).



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