THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – OCTOBER

U.S. Economy:

The evidence for an economic slowdown in the U.S. is clear: the first estimate of third-quarter real economic growth came in at 1.9%—well below several quarters in 2018 when the economy was boosted by large corporate and personal tax cuts, yet above consensus expectations of 1.6%. *But growth of 2% is **not** a recession, and it should be sustainable without a pickup in inflation*. In fact, with the labor market near "full" employment, many economists believe that the U.S. economy may not be able to grow much faster than 2% in the long run. The arithmetic is simple: if the labor force is only growing by 0.9% per year and worker productivity is improving by 1.1% per year, output will grow by 2% per year. The U.S. economy continues to resemble a "healthy tortoise," slowing but still growing after a brief "sprint" in 2018.

And the U.S. is close to "full" employment: the official unemployment rate for October was 3.6%, near the lowest in 50 years, and the labor-force participation rate of prime-age workers (25-54) has risen to a 10-year high (about equal to the rate before the 2007–2009 recession). The number of officially unemployed workers is equal to the number of unfilled job openings—a ratio that is one of the lowest on record (the ratio was more than 6-to-1 at the peak of the Great Recession). Some of the tightness in labor markets shows up in the form of rising wages, which are now increasing faster than inflation. This means that the average American worker is now fully participating in the longest business expansion in U.S. history. Although corporate profits, another key driver of stock prices, have been rising only slowly, Wall Street projects faster growth over the next 12 months.

The Federal Reserve's monetary policy-making committee (the FOMC) helped keep the Wall Street party going with another Federal Funds rate cut of 0.25 percent at the end of the month—its third in a row after changing gears from short-term rate increases. The Fed's reasoning is that these cuts are insurance against economic weakness (one of the Fed's two main jobs is to keep the economy growing at a sustainable rate). The Fed is also not worried about stoking inflation (its other main job is to keep inflation low), as its preferred measure of price increases remains below its announced target of 2%. The potential economic weakness could come from America's trade battles with China and Europe and from the fact that both Europe and Japan (two of our main trading partners) are growing very weakly, while China's breakneck growth continues to decelerate. For now though, the Fed is clearly on hold.

The slow pace of expansion is preventing the emergence of excesses that typically bring about the end of expansions. With interest rates low (near zero in real terms) and the U.S. economy growing at a sustainable rate with low inflation, what could go wrong? Investors still worry about the economic damage caused by trade wars, which almost all economists agree tend to hurt all countries. And with international trade data showing that the U.S. trade deficit is rising rather than falling, the White House may remain bellicose on trade even if a "Phase 1" agreement is signed with the Chinese. Domestic political considerations could also sway stocks, as public impeachment hearings begin and the 2020 elections approach.

International Markets:

Americans who bemoan the state of American politics need only to look at Britain to see what dysfunction really looks like. The British will now have a snap election on December 12, with no one able to predict what the results of that election will be or whether the Brits will leave the EU at all! The country is hopelessly divided and confused, and the Scots now favor leaving Great Britain altogether in order to stay in the EU. This political uncertainty has hurt British stocks, which have badly underperformed for several years. The FTSE fell more than 1% for the month and has made no gain at all since the beginning of 2017. The rest of Europe must deal with a potential Brexit plus very slow economic growth, but the postponement of a possible Brexit buoyed stocks on the continent in October. Both French and German stocks gained for the month, even though Germany has been teetering on the brink of recession.

Japanese stocks had a terrific October, rising almost 5% for the month to a 2019 high. The economy has grown surprisingly fast in 2019 so far, even though the government has finally raised the consumption tax to 10% (from 8%). The Japanese also expect an economic boost in 2020 from the Olympics. Chinese stocks, as measured by the Shenzhen 300 Index, rose slightly in October. Optimism over a possible trade deal with the U.S. has been helpful, and the Chinese monetary authorities have been easing policy to contain economic damage from the U.S.-China trade war.

Financial Markets & Outlook:

With the Fed's latest move to cut short-term interest rates to 1.50%, and the 10-year and 30-year Treasury yields hovering around 1.75% and 2.25%, respectively, the yield curve has returned to its more normal upwardly sloping shape, staving off fears of an impending recession.

U.S. stocks remain in a bull market. In October, after a brief sell-off at the beginning of the month, the large-cap S&P 500 Index broke through the 3,000 barrier to new all-time highs. The NASDAQ surged back to 8,300 (it then set a new all-time high on November 1). The Dow Jones is not far behind, having retaken the 27,000 mark late in October.

In summary, U.S. stocks have already had a tremendous year, with the S&P 500 up 20%. And stocks are entering the seasonally strong months of November–January. The economic outlook is sunny, but the political outlook is clouding up as we approach 2020. Be ready for occasional storms of selling as nervous Wall Street traders jump in and out of stocks based on daily headlines. Long-term investors will not be swayed by the inevitable short-term gyrations. The bull market can continue, but worries about trade, impeachment, and the 2020 election could always lead to the short but sharp sell-offs that have characterized this bull market since it started back in the dark days of 2009 when the Dow was below 6,500.