Zacks INVESTMENT MANAGEMENT

Portfolio Manager Investing Insights

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Are U.S. Cities Telling Us a Recession is Fast Approaching?

A report this week from the National League of Cities caught my attention. In it, 63% of finance officers from major U.S. cities predicted a recession as soon as 2020.1 A perfect storm of falling city revenues, rising expenditures, softening business investment, and a housing market that feels like it's plateauing. The question is – could this be a basis for a recession on the horizon?

The report, known as City Fiscal Conditions Report,1 looks at responses from finance officers in 554 cities with populations over 10,000, so I'd characterize it as offering a comprehensive view into economic conditions throughout America. For the data wonks out there, the Fed's Beige Book is another example of a report that offers a glimpse into how cities and regions are performing, and I'd consider it equally insightful in helping us understand economic conditions 'on the ground.'

The findings in the City Fiscal Conditions Report for 2019[1] undoubtedly show softening across the board. A summary of the findings includes:

- In fiscal year 2018, total constant-dollar general fund revenue growth slowed to 0.6%.
- Property tax revenues increased by +1.8%, compared to +2.6% growth in 2017.
- Sales tax revenues grew by +1.9%, compared to +1.8% in 2017.
- Income tax revenues rose +0.6%, compared to +1.3% in 2017.
- Expenditures are rising: +1.8% in 2018, which is slower growth than previous years but less than what's expected in 2019.

Cities do fiscal reporting on a yearly basis, meaning that there's about an 18 to 24-month lag for economic shifts to show up on city ledgers. In other words, the softening trend could be a signal of a slowdown that is already well underway, which is what I think has finance officers worried.

A report on U.S. cities' fiscal conditions can help us take the pulse of the U.S. economy, but it does not help us forecast corporate earnings looking out over the next six to twelve months. In terms of portfolio management, it is not enough to determine what is happening from an economic standpoint – we need to determine what the

market expects to happen and whether those expectations are being met.

The City Fiscal Conditions Report gives an indication the economy is slowing, but this simply confirms something we already know. I would argue that it's already being reflected in the market, too, with downward revisions to earnings estimates of cyclical companies over the past few months. Given the negative expectations around corporate earnings coming into the third quarter, what we're seeing today are earnings surprising to the upside – which is helping push the market to new highs.

But there's another side to the story that few people are telling: year-over-year growth is slowing, but it is not yet contracting. Looking at the figures above from the City Fiscal Conditions Report, it is clear to see that revenues are still growing, even if they're growing at a slower rate than previous years. In the previous recession, revenues were declining for almost two years before the recession took hold. I think we need more data before making any recession declarations.

As I've mentioned in previous columns, I also believe some of the softer economic data we're seeing across the board – but particularly in business spending – is tied to policy uncertainty (particularly in the realm of trade). If some of the pressure gets released over time with movement towards a deal, or perhaps even the eventual signing of a deal, I could see most of these trends reversing.

Bottom Line for Investors

Amid stories and data points of weakening economic growth, I believe it's important to remember that the market is a discounting mechanism of future earnings expectations. Only two factors drive stock prices, in my view: expectations for future earnings and interest rates. Expectations for future interest rates are essentially determined by the yield curve, so the key issue is how earnings expectations change in response to changing economic expectations. In my view, it's times when the economic outlook is completely positive – and stocks are discounting strong earnings growth – that the market is more likely to come under pressure. When the economic outlook turns more negative and stocks discount weak earnings growth (like we're seeing today), surprises to the upside can drive prices higher. This is why I'd argue the market is hitting new highs at the same time economic signals, like the fiscal condition of U.S. cities, are showing weakness.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] National League of Cities, City Fiscal Conditions 2019. https://www.nlc.org/sites/default/files/2019-10/CS_Fiscal%20Conditions%202019Web%20final.pdf

IN FOCUS THIS WEEK

- U.S. GDP falls below +2%
- The Federal Reserve cut interest rates for the third time in 2019
- The Brexit deal failed to pass through Parliament by October 31
- Big tech companies like Google, Amazon, and Facebook are facing more scrutiny about regulation

Third Quarter U.S. GDP Falls Below +2%

In the "advance" estimate for U.S. third quarter GDP, the Bureau of Economic Analysis (BEA) found that the U.S. economy expanded at a +1.9% annual rate. This marks a slight decline from the 2% GDP growth notched in Q2, but perhaps more importantly relays the signal that the U.S. economy may be back to "muddle-through" growth. According to the BEA, the uptick in GDP growth reflected positive contributions from personal consumption expenditures (PCE), federal government spending, residential fixed investment, state and local government spending, and exports. The main – and arguably most important – detractor from GDP was business investment. U.S. economic growth going forward is likely to be a tug-of-war between the U.S. consumer and virtually everything else. Business investment, manufacturing, credit, and other leading indicators have been trending weaker for some time now, as uncertainty over the trade war and the longevity of the economic cycle wears on corporate America.[1] Orders for durable goods fell in September in the U.S., and business activity across the world from Europe to Japan were flat and negative, respectively.[2] Meanwhile, China posted sub-7% GDP growth in Q3, its lowest rate of expansion since 1990.[3]

The Federal Reserve Cuts Interest Rates, Signals Pause

As expected, the Federal Reserve cut interest rates for the third time in 2019, but in doing so made clear to the market that it would hold off on further cuts unless the economy decelerated sharply from here. The Fed sees the U.S. economy expanding modestly and believes that a healthy consumer – fueled by a strong labor market – should be enough to continue growth moving along for the balance of the year and into next. The fed funds rate now sits at a range between 1.5% and 1.75%, and the Fed reiterated that it would step in for further stimulus if warranted. In our view, this rate cut is unlikely to help reaccelerate cyclical growth, but may offer additional support to equities as investors search for yield. The committee voted 8-2 to lower interest rates, with the two dissenters preferring to keep rates steady.[4]

Brexit Stakes Just Got Higher

The effort to pass a Brexit deal through Parliament by October 31 failed, and the European Union extended the deadline to January 31. But there was a victory secured in the brutal process, and it went to Prime Minister Boris Johnson. The Prime Minister was able to secure a general election set for December 12, the consequences of which will be immense for Britain. Should Prime Minister Boris Johnson emerge victorious, he will earn five years in office and surely have the mandate needed to pass Brexit through Parliament. If Johnson loses, he will be the shortest-serving prime minister since 1827.[5] The opposition arguably faces an uphill battle, as Labour and Liberal Democrats both have support of 'Remain' voters but risk splitting the vote.

The Biggest Names in Tech Double Down on Lobbying Efforts

Big tech companies like Google, Amazon, and Facebook had their heyday of lax regulation for the better part of the entire economic expansion. But those days may be nearing an end. As the biggest names in tech come under the triple-threat scrutiny of the Federal Trade Commission, the Justice Department and state attorneys, they are responding by upping the ante on lobbying dollars spent in Washington. Lobbying expenditures by Facebook, Amazon, and Apple are set to hit records in 2019, with Amazon's $12.4 million making it the top spender.[6] Amazon and Facebook are now the top corporate lobbyists in the United States, outstripping even defense contractors.

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[1] BEA, October 30, 2019. https://www.bea.gov/news/2019/gross-domestic-product-3rd-quarter-2019-advance-estimate

[2] Reuters, September 26, 2019. https://www.reuters.com/article/us-usa-economy/us-business-investment-downturn-could-pressure-slowing-economy-idUSKBN1WB1PV

[3] Financial Times, January 19, 2016. https://www.ft.com/content/e6b04734-bdbb-11e5-a8c6-deeeb63d6d4b

[4] The Wall Street Journal, October 30, 2019. https://www.wsj.com/articles/fed-cuts-rates-by-quarter-point-11572458556?mod=article_inline&mod=hp_lead_pos5

[5] The Wall Street Journal, October 29., 2019. https://www.wsj.com/articles/u-k-opposition-to-back-boris-johnsons-call-for-election-11572347134?mod=article_inline

[6] The Wall Street Journal, October 28, 2019. https://www.wsj.com/articles/tech-firms-ramp-up-lobbying-as-antitrust-scrutiny-grows-11572255000?mod=djem10point

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