Growth Conditions Less Robust

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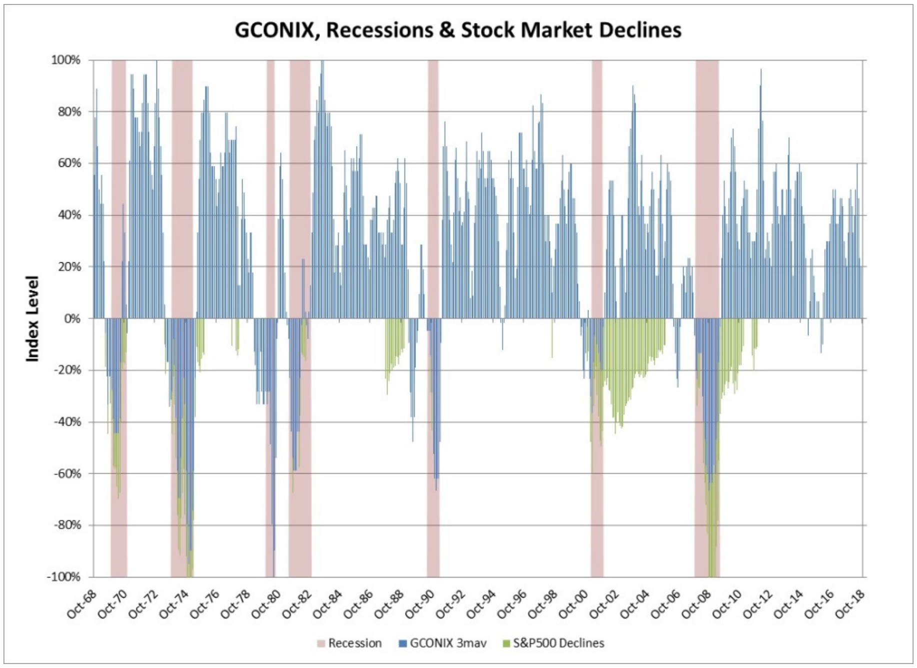
While growth conditions deteriorated over the third quarter, they remain favorable. Our Growth Conditions Index (GCONIX[1]) fell from a strong 60% favorable level at the end of June to 20% favorable as of the end of September. Three of the four sub-indexes fell, **with Real Estate falling from a positive 33% to a negative 67%** -a drop of 100 percentage points.

Wealthcare's Growth Conditions Index (GCONIX)				
Sub-Index	Weight	Jun-18	Sep-18	Change
Production	35%	62%	14%	-48%
Demand	30%	89%	78%	-11%
Real Estate	20%	33%	-67%	-100%
Macro Policy	15%	33%	33%	0%
Summary	100%	60%	20%	-40%

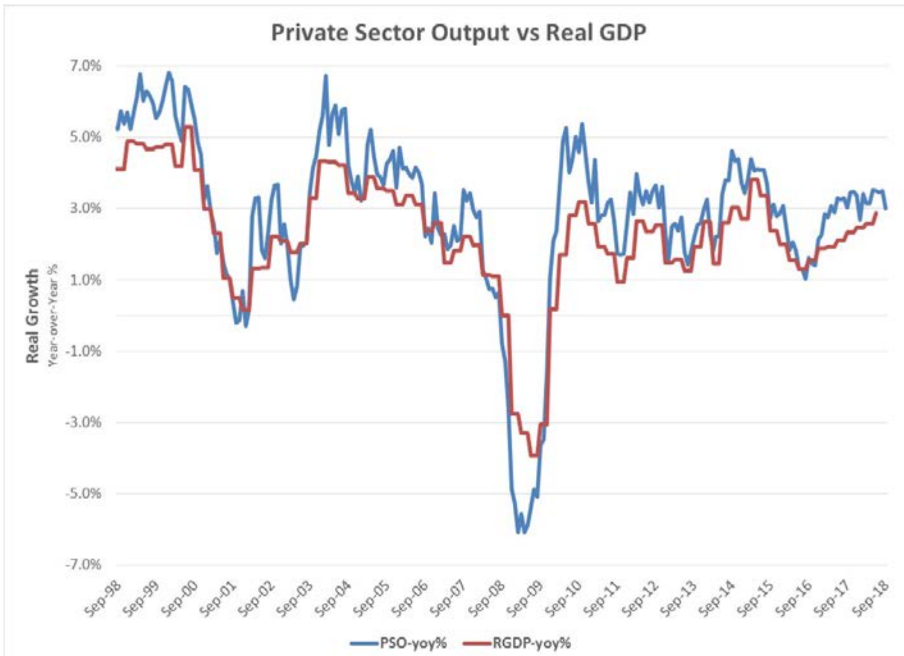
Still, GCONIX ended August at 20% positive, which based on our research, remains favorable for the economy and stocks and is illustrated in the chart below.



A decline in GCONIX to -20% or less has led every recession since 1970, albeit with a couple brief false positives. GCONIX has also led every major stock market decline except for the 1987 "one-day" crash. It's important to note that GCONIX does not measure the level of economic activity. It measures economic breadth and momentum. So, the decline in GCONIX in Q3 indicates economic breadth and momentum have declined from what was a strong prior quarter.

[1] For reference, a summary of how GCONIX is constructed is provided at the end of this article.

We measure the overall level of economic activity in the private sector using our Private Sector Output Index (PSO). It is a simple calculation. Take the number of workers for the month, multiply it by the hours worked per worker and the output per hour, and you get an estimate of the total output from the private sector. According to PSO, **private sector output grew at 3% year over year ending September, down from 3.5% as of June.** According to the Bureau of Economic Analysis (BEA), **real GDP grew at 2.9% year over year ending June**. The chart below shows the relationship between PSO and real GDP.

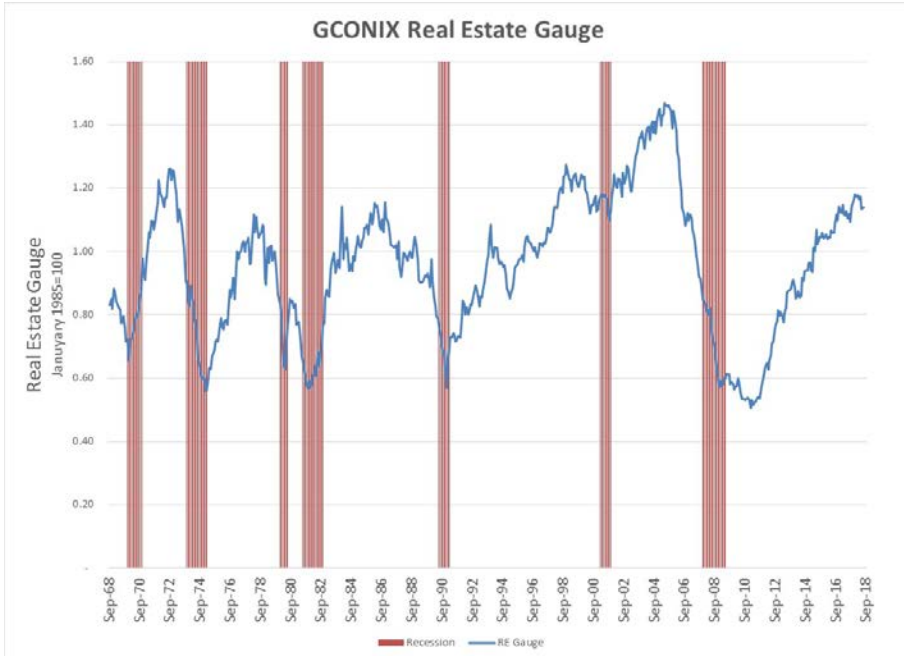


Not surprisingly, private sector output has higher highs and lower lows than real GDP, as the public sector tends to be a stabilizer. Over the past 50 years, the private sector has grown faster than overall GDP by about 0.50% per year. This is primarily due to private employment growing faster than public employment. Also note that private sector output tends to lead overall GDP. So, **given both the decline in GCONIX and PSO, it is reasonable to expect real GDP growth for Q3 to be lower than the prior quarter.**

The Real Estate sub-index has the feel of a canary in the coal mine. Housing and construction create jobs and lead to other spending – new furniture, appliances, landscaping etc. – that also leads to more jobs and more spending. The next chart shows the Real Estate Gauge, which combines the economic series for real estate that goes into GCONIX, plotted with recession indicators.

As you can see, the Real Estate Gauge tends to decline substantially leading into a recession. **The good news is that, while the gauge is now declining, thus far the decline is modest and comparable in size to prior temporary declines in the uptrend since 2011/2012.**

However, **30-year mortgage rates have risen by about 100 basis points since the beginning of the year and almost 40 basis points since the end of August** according to Bankrate.com. The GCONIX Real Estate sub-index turned negative in July. So higher rates are beginning to bite, and the economic data does not yet reflect the latest increases in mortgage rates. One of the indicators in our Demand sub-index is Personal Income. Personal Income, as published by the BEA and includes all forms of income (wages & salaries, investment income, rents, transfer payments etc.), has been rising at a 4.5% annual rate since the beginning of the year. However, a more narrow measure, **Average Hourly Earnings, has been rising at just 3.0%, while home prices, as measured by Case-Shiller, have been rising at an 8.2% annual rate. Potential homebuyers are getting squeezed by both higher prices and higher interest costs relative to income.**



It is worth revisiting the occurrence where GCONIX was positive yet we still had a major stock market decline – October of 1987. There are a number of explanations for Black Monday's 22.6% decline in 1987, but impending recession was not one of them. The next recession was more than two and half years away. The 22.6% decline on October 19th, 1987 was followed by the S&P 500 returning more than 57% over the next two years. The challenge is the ride. How do investors stomach an almost 23% loss in one day and then buy more stocks? With 20/20 hindsight, that is exactly what investors should have done.

Today, equity markets are having trouble digesting the rise in 10-Year Treasury yields to new highs last week, and yields continue to rise. The rising inflation, rising bond yields backdrop that preceded the sharp drop in stocks on Black Monday is also occurring today, but on a much smaller scale.

1. CPI headline inflation rose from 1.1% at the end of 1986 to 4.4 % by September of 1987, a rise of 3.3%. So far this year, CPI inflation has risen from 2.1% at the end of last year to 2.7%, a rise of just 0.6% and less than one-fifth the rise in 1987.

2. From low to high in 1987, the 10-year Treasury yield was up by 2.9%. The same measure for 2018? Just a rise of 0.8%, less than one-third the rise in 1987.

So, **we are in in a similar situation to 1987 in terms of direction of yields and inflation but nowhere close in terms of magnitude.** The markets still have to adjust to the new inflation and interest rate regime. While we may be in the early stages of a stock market correction, absent a surprise or shock (likely political) that drives negative market sentiment, based on current fundamentals, the magnitude of the decline should not reach bear market proportions.

GCONIX: Wealthcare's Growth Conditions Index

The Wealthcare Growth Conditions Index, "GCONIX" for short, is a composite of 20 key economic indicators that have had a tendency to lead or coincide with changes in economic activity. The components of GCONIX are published no less frequently than monthly. It is intended to measure the breadth of economic strength/weakness, not the level of growth. As such, the selected indicators span the major elements of economic activity and actors (e.g. the Federal Reserve) that influence it. Below is a list of the indicators (source in parenthesis):

Production

1. New Orders (National Association of Purchasing Managers Survey)
2. Backlog Orders (NAPM)
3. Business Activity (NAPM)
4. Industrial Production (Federal Reserve)
5. Manufacturers' New Orders (U.S. Census Bureau)
6. Durable Goods New Orders (U.S. Census Bureau)
7. Capital Goods Orders (U.S. Census Bureau)

Demand

8. Personal Income (Bureau of Economic Analysis)
9. Personal Consumption Expenditures (BEA)
10. Retail Sales (U.S. Census Bureau)
11. Initial Jobless Claims (Department of Labor)
12. Average Work Week (Conference Board)
13. Exports (U.S. Census Bureau)

Real Estate

14. Home Builders Market Activity (National Association of Home Builders)
15. Housing Starts (U.S. Census Bureau)
16. Building Permits (U.S. Census Bureau)
17. Construction Spending (Census Bureau)

Macro Policy

18. Government Debt (U.S. Treasury)
19. M2 Money Supply (Federal Reserve)
20. The Monetary Base (Federal Reserve)

The Production indicators focus on orders as they lead actual production. Likewise, Real Estate (housing and construction) has downstream impacts on economic activity – buy a new home and you also buy appliances, employ construction workers, painters, etc. The Demand indicators focuses consumption spending related indicators. Domestic consumption spending represents about two-thirds of GDP. Jobless Claims and the average work week tend to lead consumer spending. The Macro Policy indicators provide a measure of policy support for economic activity.

Of note, there is no financial market data used in GCONIX. The raw Index can range from 100% positive to 100% negative based on whether each component of the Index is rising or falling in real terms. Data is smoothed to reduce noise. If 10 of the GCONIX components are rising and 10 are falling, the Index has a reading of zero, which is a neutral reading meaning neither positive nor negative net growth conditions.

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Sources in include Bloomberg, National Association of Purchasing Managers, Federal Reserve, U.S. Census Bureau, Bureau of Economic Analysis, Department of Labor, The Conference Board, National Association of Home Builders, U.S. Treasury, Wealthcare.

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