

# The Outlook Gap

*“The most reliable way to forecast the future is to try to understand the present.”*

– John Naisbitt, *New York Times* best-selling author

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## Introduction

This Wednesday, Fed-head Jerome Powell announced the Federal Reserve’s third rate cut of 2019. On the same day, economic data reports signaled continued (but slowing) GDP expansion, buoyed by strong consumer spending and a resilient labor market. The impact of the news? After markets started the day sluggish, all three major US indexes rallied to close in the black.

But those laser-focused on the market’s immediate reaction to the well-received economic updates might have missed – or ignored – some of the less rosy news. Economic data released Wednesday also pointed to downward-trending business fixed investments and sputtering exports. On Thursday, a US manufacturing survey came in much weaker than expected. And, on top of that, Mr. Powell signaled that the Fed would likely pause cutting rates in the near-term as it seeks an ever-elusive “soft landing”.

It should come as no surprise to loyal readers of this newsletter that we believe the Fed has played a central (no pun intended) role in sustaining the longest market expansion in US history. Wednesday’s rate cut is another example of the symbiotic relationship between central banks and markets – which has become ever more intertwined over the past decade. But, as we have contended, the “Great Levitation” that has fueled this epically long bull run will likely take an equally central role in the eventual deflation of what we have dubbed “Bubble 3.0”.

In this week’s Guest EVA, we present an article from a widely admired friend, Danielle DiMartino Booth. Danielle likely needs no introduction for many readers, but for those unfamiliar with her illustrious career, she is the former senior adviser to Dallas Fed President Dick Fisher, a frequent CNBC commentator, and author of *Fed Up: An Insider’s Take on Why the Federal Reserve is Bad for America*, *Money Strong*, and *The Daily Feather* (which starts at just \$50 per month through [this link](#).)

In *The Outlook Gap*, Danielle provides some very relevant examples that underscore the growing divide between several economic indicators. One of those indicators is Consumer vs. CEO confidence, the latter of which has been a very reliable predictor of market swings. That, along with the recent persistent inversion of the yield curve, are powerful recession alerts that has Evergreen and Danielle, among others, minding the gap.

## Summary

- In the United States, there is a battle between the “worker bees”, who owe their livelihoods largely to the resilience of the NYSE and other U.S. stock markets, and the growing masses losing their faith in the ability of the U.S. economy to generate a quality of life worth embracing.
- There has always been a partisan divide when it comes to perceptions of economic performance; however, there is something deeper than politics at work here.

- Starting points matter all the more when there are as many fissures as we have dividing our country. Latitude to weather a U.S. recession, regardless of how brief or shallow, has been gravely compromised.
- Never in the history of the country has the economy's prospects been so closely tethered to that of the stock market – and share buybacks are the only thing maintaining stocks at their current levels.
- Of late, though, confidence among executives has taken a turn for the worse—much worse.
- In past episodes of plummeting CEO Confidence, stocks have followed their downbeat views. But the follow-through timing has never afforded insiders the luxury of ample time to get their ducks in a row.
- The best proxy of households' perception of their present situation is the unemployment rate, which is not coincidentally the most lagging of all economic indicators.
- It stands to reason that once the economy hits its outer capacity limits, when efficiency gains begin to dissipate, joblessness starts to rise. The slowing profit growth that results necessitates cost cutting which leads to headcount reduction.
- Companies are also guarded about the Fed's ability to engineer a soft landing, and rightfully so.
- Surprisingly, households are more jazzed up about spending than they've ever been. Here, once again, a disconnect emerges between managers and worker bees. How households can be this enthusiastic in the face of firms slamming on the brakes is nothing short of stunning.
- And yet, the Fed and our government refuse to allow the economy to rise and fall of its own volition, and to let cycles cycle through.

## **The Outlook Gap by Danielle DiMartino Booth**

Before they could Unite, they had to Man Up. Talk about inauspicious beginnings, that would certainly describe the Newton Heath LYR Football Club. Founded in 1878 by the Carriage and Wagon Department of the Lancashire and Yorkshire Railroad (LYR), the team's first recorded match was nothing short of underwhelming. Uniformed in the green and gold of the railway, the startup was defeated 6-0 by Bolton Wanderers' reserve team, equivalent to a U.S. baseball farm team. The young club's fortunes rose and fell in the ensuing years as it matured and recast itself amidst a sport looking for a home. The search ended in 1892 with the founding of the Football League, where Newton found itself favorably ensconced in the First Division only to be shortly relegated to the Second Division, gearing up as it went. By January 1902, with £2,670 in debts, or some £300,000 today, the club was served by the courts with a winding-down order. Refusing to accept such a fate, Captain Harry Stafford manned up, soliciting four local businessmen who contributed £500 each in return for control of the club they promptly renamed Manchester United.

Famed for its rise during the Industrial Revolution, Manchester's will to fight is rooted centuries earlier, in its 1620 foray into commerce, with the advent of fustian weaving. The rapid development of the city's textile industry forged close ties to the City of London and in so doing, infused Manchester's culture with puritanism. In 1625, closely following this new age of industrialization, 24-year-old Charles I acceded to the throne, and found himself pitted against a Parliament determined to check his royal ways. Funny thing, a large contingency of Charles' constituents took offense to levying taxes without Parliamentary approval and denying

Protestants aid in the Thirty Years' War. Such was the tension that by 1642, the act of one Lord Strange, in exploiting his royal privileges, set off a chain of events. The haughty Lord's attempted abscondment of Manchester's militia magazine culminated in the death of Richard Percival, a hard-working linen weaver, and the English Civil War's first casualty.

Assiduity, unity and fortitude would continue to shape Manchester's future. The importing of cotton and 1764's Spinning Jenny fully mechanized textile production sending the city's population soaring from 25,000 with no mills in 1763 to 95,000 with 52 mills in 1802. So renowned was the Mancunian work ethic, the city adopted the motif of the worker bee symbolizing the 'hive of activity' the city had become in the 19th century. In 1842, the worker bee was officially added to the Manchester coat of arms as the city grew its way to one million by the turn of the century. It was through the labors of its worker bees that this formidable city became a great European metropolis.

Unfortunately, even a swarm of determined bees couldn't save the city from the same malady that had slain so many other manufacturing hubs. Fortunately, its can-do legacy has allowed it to largely reinvent itself into a diversified economy that's a magnet to millennials returning to the city of their studies seeking a more affordable life that London denies. Bees remain on full display throughout the city and have even enjoyed a revival in the aftermath of the recent bombing of Manchester Arena as a sign of stalwart unity. Sports has, if anything, gained the most stature as Manchester United, listed on the NYSE, boasts status as one of the most valuable franchises in the world.

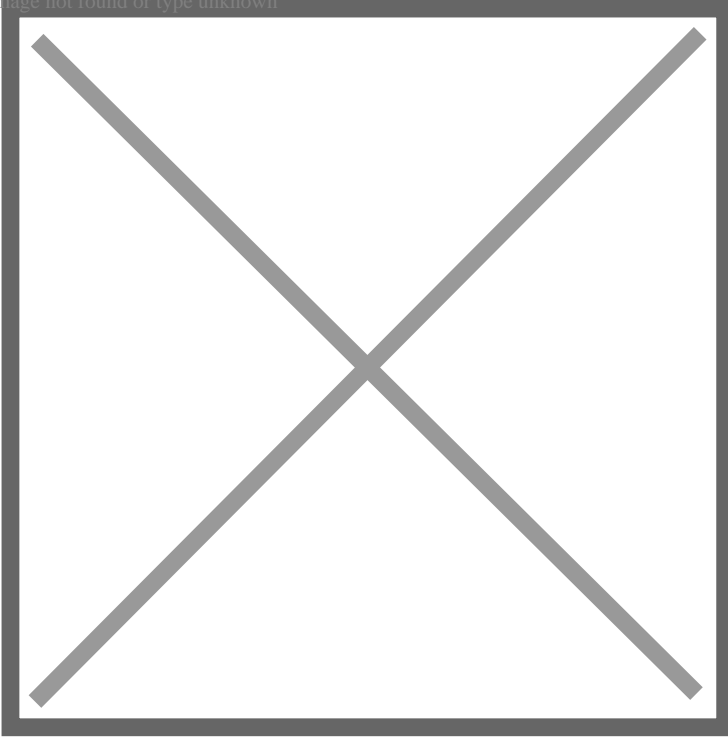
Closer to home, it's come down to a battle between the worker bees, who owe their livelihoods largely to the resilience of the NYSE and other U.S. stock markets, and the growing masses losing their faith in the ability of the U.S. economy to generate a quality of life worth embracing. Several of the facets of Mancunian history are at play from the threat of indebtedness to the scourge of a corrupt ruling class. Some would venture that what's missing is a zeal for contributing to the greater good through industriousness and the drive to create a sense of community.

But a recent *Wall Street Journal*/NBC poll found that just over 80% of millennials considered hard work to be a 'very important value.' The Baby Boomers/Silent Majority generations were not far off in their level of conviction while Generation X-ers were closer to 95%. Patriotism, however, polled night and day with just north of 40% of millennials ranking it as 'very important' followed by Gen-Xers at 65% and the two older generations at nearly 80%.

Politics, of course, has its own influence. A September Quinnipiac University poll found that 88% of Republicans viewed the economy favorably while just 39% of Democrats shared their view. The 49-point differential is the second widest of President Trump's presidency trailing only the depths of January's government shutdown.

That said, there has always been a partisan divide when it comes to perceptions of economic performance. There is something deeper than politics at work. We've read and heard evidence of the inequality divide to the point we've become immune to the statistics. If you're blessedly among the uninitiated, this next chart spectacles the wealth degradation that took place in the 17 years through 2016. The rich got richer to lean on that tired cliché. As for those who could sorely afford it at the opposite end of the spectrum, they lost ground.

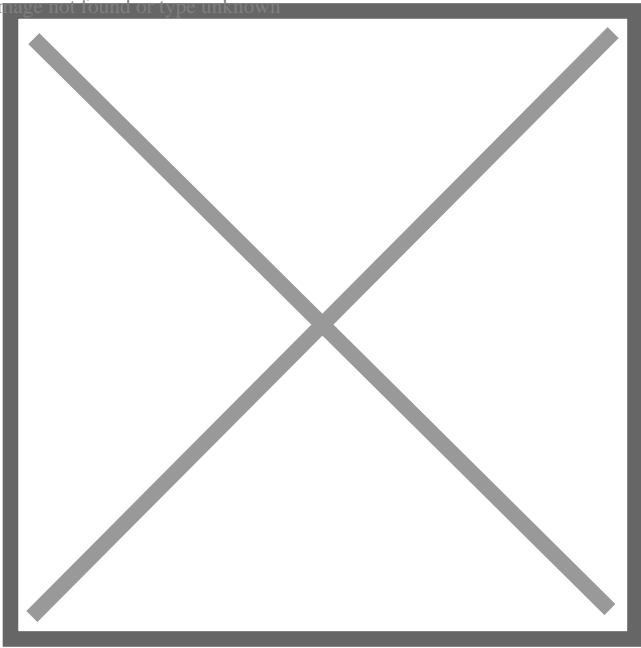
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Collective numbness doesn't render the data any less damning. In a ranking of the world's 20 largest economies, mean (average) U.S. wealth comes in the No. 3 spot, at \$403,974 just behind Switzerland and Australia. But the similarities with the other two countries stop there given they too are the top 2 ranked in terms of median wealth. That same midpoint on the distribution for the U.S. drops the country to No. 18 with average wealth almost seven times that of the \$61,667 median wealth.

Go back to the deep disparity in views on patriotism, add the wealth disparity, and with that as context, consider this next image. This is a Pew Research Center survey conducted at the end of 2018. All you need to know is that the younger you are, the less you trust others in this country, at best. At worst, seven-in-ten young Americans see their fellow countrymen and women as self-serving and exploitative – and this is a time of economic expansion.

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With this week's longer than normal preamble, you may be wondering if you've somehow stumbled upon a political blog or that of the Manchester Chamber of Commerce. Nothing could be further from the truth. Economic dynamism and the state of the economy have everything to do with my near-term outlook. Starting points matter all the more when there are as many fissures as we have dividing our country. Latitude to weather a U.S. recession, regardless of how brief or shallow, has been gravely compromised.

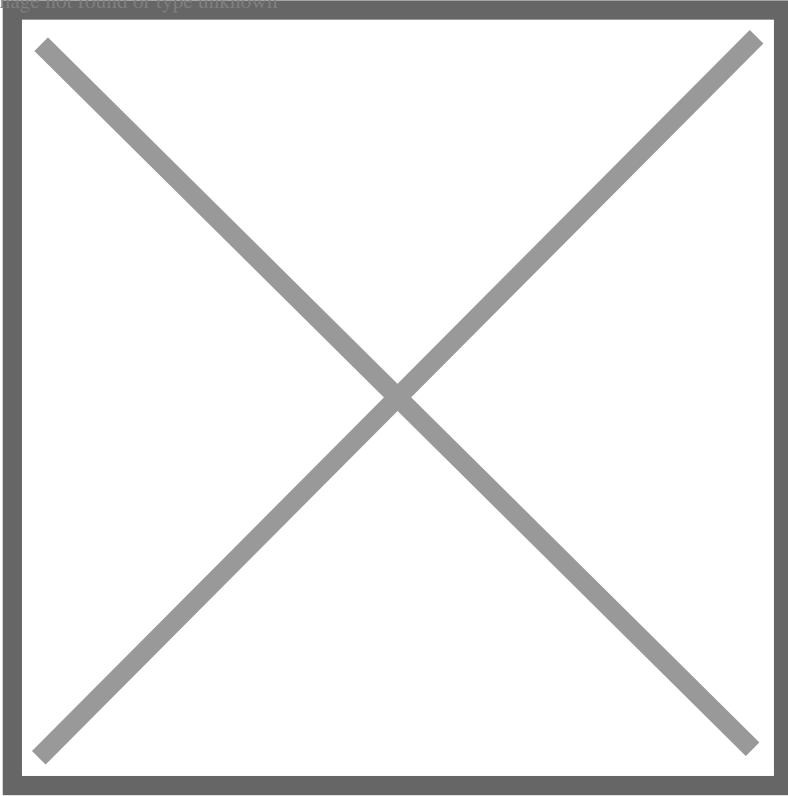
In the spirit of contradiction, the worker bees of the economy have never been happier. Average working U.S. consumers' outlook for the future have rarely been as bright as they are today. There's an abundance of data to back up this statement but the groundwork must first be laid.

While it's true that stock market holdings are concentrated in the hands of so few, this is a red herring in the context of the macroeconomic outlook. As I've written extensively, never in the history of the country has the economy's prospects been so closely tethered to that of the stock market – household net worth attributable to the stock market is greater than that associated with residential real estate, an occurrence only seen, to a slightly lesser extent, in the late 1960s and the late 1990s. If the stock market remains near its all-time highs, the foundations of the current economic cycle remain intact.

It follows that share buybacks are the only thing maintaining stocks at their current levels. This next graph illustrates how share buybacks have played an increasingly outsized role in how publicly traded Corporate America deploys its free cash flow, at the expense of long-term capital investment. 2018's tax bill allowed the repatriation of profits that had been overseas at a lowered tax rate pushing annual buyback volumes past the \$800 billion mark, a record.

Looking back to the post-crisis era, our friend Jim Bianco recently tallied share buybacks since 2009 through this year's second quarter and arrived at \$5.04 trillion. Compare this to the \$0.23 billion in cumulative positive inflows from households and foreign investors and negative outflows of \$0.36 billion on the part of exchange traded funds and open-ended mutual funds. It's damning math.

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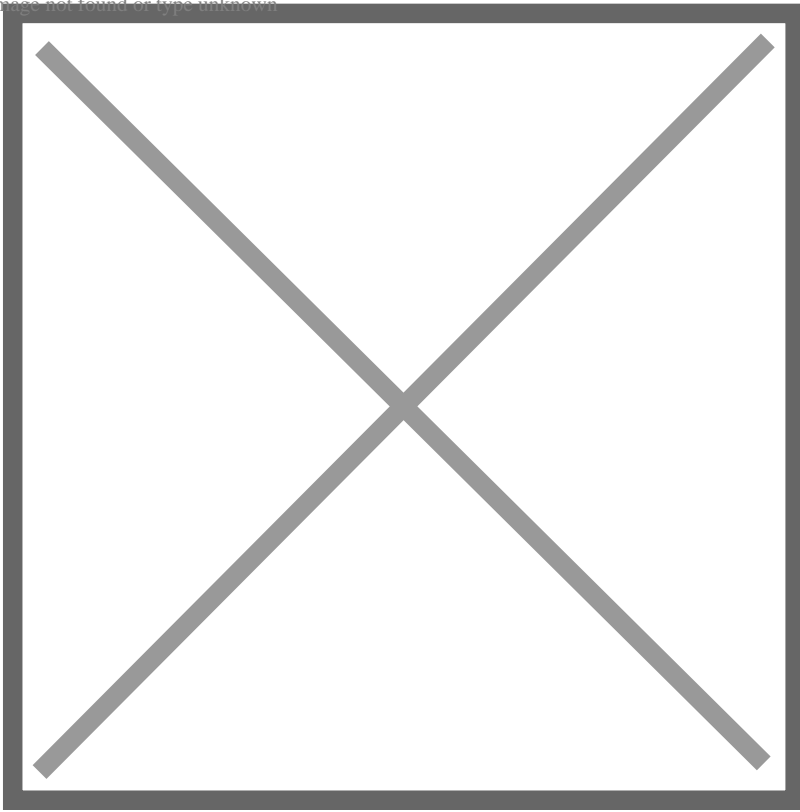


Of late, though, confidence among executives has taken a turn. Goldman Sachs forecasts share buybacks will decline for the full year 2019 to \$710 billion and then to \$675 billion in 2020. As I tweeted out, predictions of this ilk are tantamount to a sell-side firm forecasting recession. This reason alone, has Federal Reserve officials scrambling to ensure liquidity in the aggregate keeps a floor under share prices.

But let's stay on the subject of confidence among those who occupy the C-Suite. In the month through September 26, Trimtabs tracked \$14.2 billion of corporate executives' insider share sales, the highest for any September in the past decade. But persistence is what counts even more. September also marked the sixth consecutive month that insiders unloaded \$10 billion or more of their shares on a monthly basis, the longest stretch since 2006.

You could ask what it is they know that we don't. But that question barely scratches the surface. There are many ways to paint what's to come. At a minimum, there's a sense among executives that this – where we are today, with stocks climbing an unprecedently tall wall of worry – is as good as it gets. In past episodes of plummeting CEO Confidence, stocks have followed their downbeat views. But the follow-through timing has never afforded insiders the luxury of ample time to get their ducks in a row. So, executives sell first and ask questions later knowing they've left a few chips on the table.

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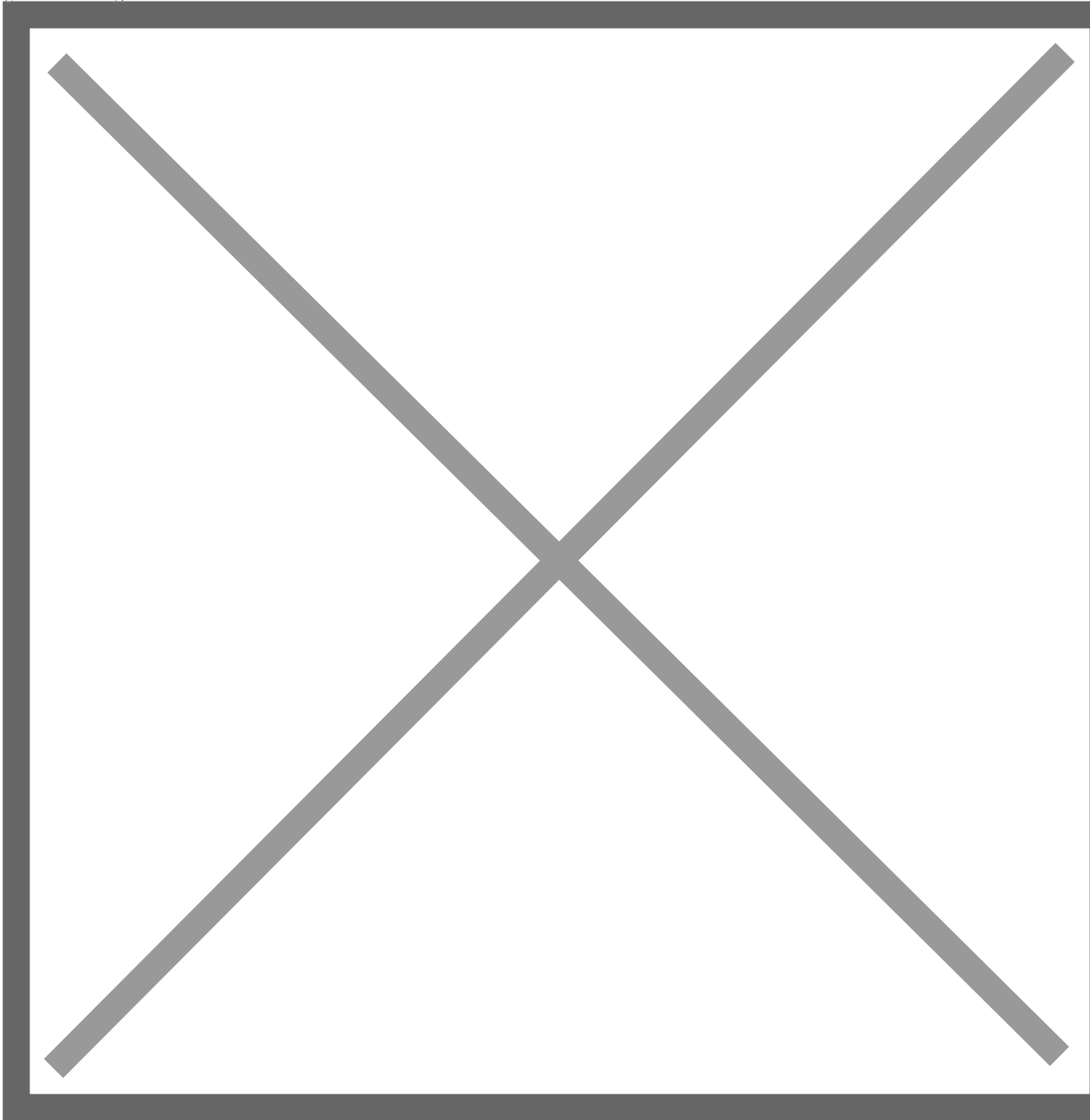
You may rightly be cynical in seeing yet another chart predicting stocks' demise. That's understandable given how many historic co-relationships have been conceived and drawn in recent years. In defense of market historians, we've never had central banks with unfettered access to printing presses. This is the first post-Quantitative Easing (QE) era ever encountered. That said, it really has been a U.S.-centric rally and, as detailed last week, propped up by a handful of idiosyncratic events -- Hurricane Harvey, a late-cycle tax cut and panic-buying among U.S manufacturers that pulled supply forward.

Jerome Powell may have no choice but to feign ignorance at the jig being up with a hope and a prayer that housing offsets the damage already inflicted on the economy. C-Suite occupants know they'll be penalized if they knowingly disregard the deteriorating operating environment.

As for gainfully employed consumers, they're largely basking in the afterglow of the economic stimulants blended beautifully with a skills shortage that's propelled employers to hold onto their employees for dear life even as they see demand dissipating over the horizon. Z-scoring confidence gauges demonstrate how disparate the views have become. Think of a z-score as how far removed from the norm any metric is in standard deviation increments.

With that, you can see CEO confidence is deep in recessionary territory while consumer confidence was only more relatively stretched during the dotcom years that convinced every American they were Rockefeller reincarnated. The gap is a touch wider yet vis-à-vis CEO confidence and consumers' assessment of their present situation (aggregate confidence combines current and future expectations). It's as if the CEOs know a storm is barreling down on them because their weather apps work and consumers are blissfully unaware, marveling at how very calm the air is outside.

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The best proxy of households' perception of their present situation is the unemployment rate, which is not coincidentally the most lagging of all economic indicators. To appreciate how tight the relationship is between perceptions of reality and what's truly taking place, look back to the cycles through the late 1970s. The unemployment rate troughs just as the last ounce of growth potential is wrung out of the economy. To best depict this relationship, invert the Output Gap and contrast it with unemployment.

It stands to reason that once the economy hits its outer capacity limits, when efficiency gains begin to dissipate, joblessness starts to rise. The slowing profit growth that results necessitates

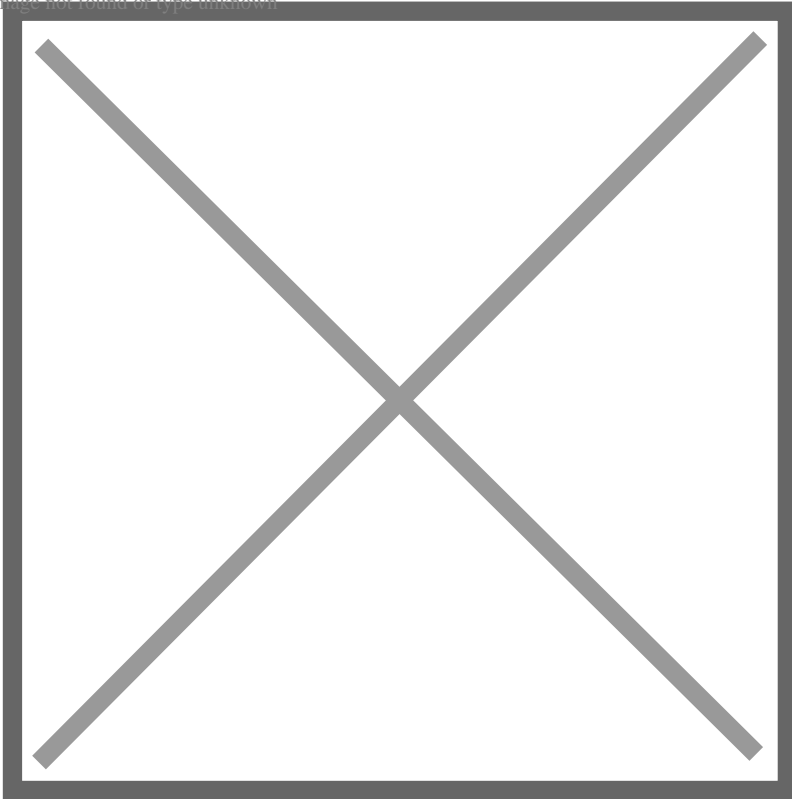


cost cutting which leads to headcount reduction.

Now, overlay QI's Outlook Gap on top of these familiar cyclical bedfellows and behold this next chart. Not only do the relationships hold, they corroborate. Both the Outlook and Output Gaps portend a rising unemployment rate. But here's where things get interesting, at least to this former central banker.

As I've written extensively over the past 15 years, the more the Fed meddles in the economy's functionality thereby stunting price discovery and market clearing, the more secular productivity is sacrificed. Think about how wasteful the housing boom and the post-crisis financialization have been for the U.S. economy. The best evidence of this is in the Output Gap bottoming at higher and higher levels these past two cycles. We're watching our country's economic potential wither away before our very eyes.

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Let's be realistic though. Brilliant managers have not gone brain dead just because there are fewer opportunities to grow their companies, or because they've chosen to go the financial engineering route in lieu of long-term capital investments (these captains of industry do, after all, work for their shareholders). They are, however, aware of the productivity atrophy suffered over the years.

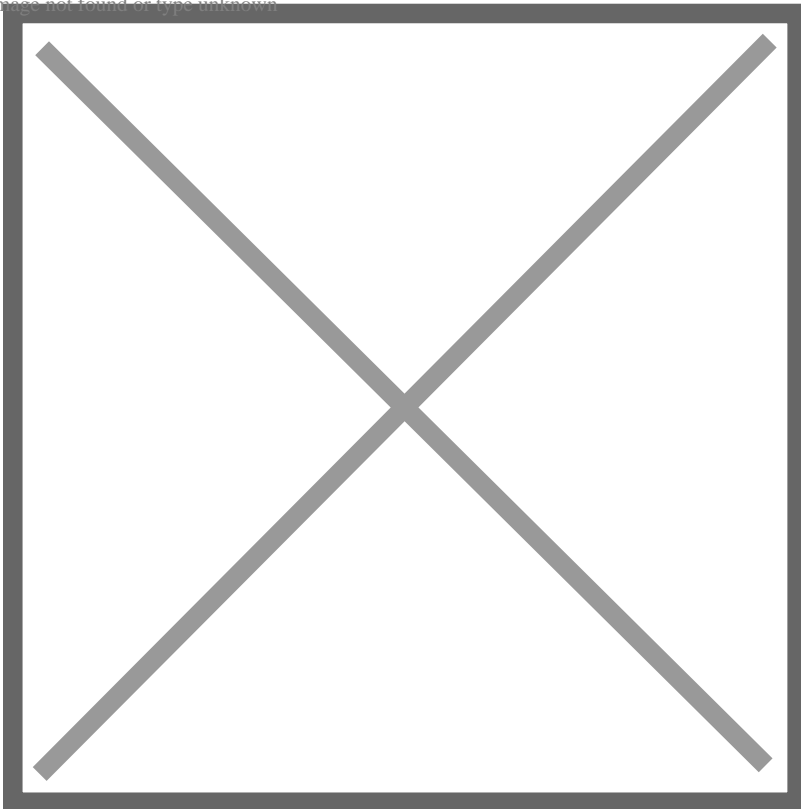
In the immediate term, they're also guarded about the Fed's ability to engineer a soft landing, as they should be. CEOs are equally aware that the most contentious election year in modern U.S. history is upon us and with it, scant hope for fiscal relief to temper the economy's slowing. In fact, as of this year's third quarter, the Outlook Gap is the widest on record. Never have CEOs been so far removed from the workers they lead. This unprecedented disconnect could result in a more violent than typical reversal in the unemployment rate.

A data detractor might suggest that CEOs are so downtrodden because their own jobs are on

the line. In 2002, Challenger, Gray and Christmas began tracking CEO turnover, an event that could be a good or bad turn of events. If CEOs are exiting to better positions, it could be a sign of economic vibrancy. But what if they are vacating positions to get out while the getting is good, which backs the persistent run in insiders selling their stock holdings? We can generously hope that's not the case. That said, the running tally through this year's first nine months is the highest on record. A less salubrious explanation might be warranted.

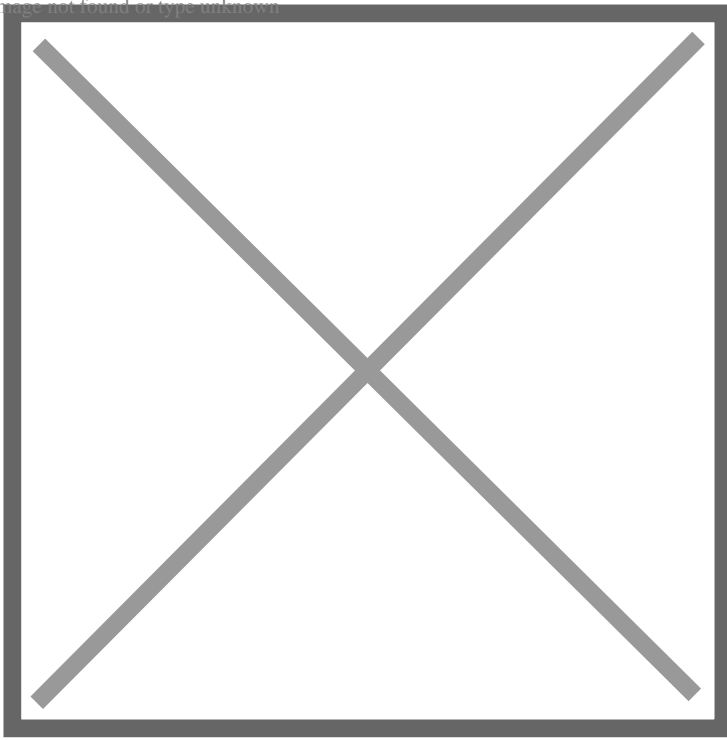
What if CEOs are being fired, for lack of a more genteel term? What if boards see fit to bring in new blood to view their newly adopted workforces as far removed as possible? Slashing headcount would be a less guilt-ridden task if connections have yet to be forged. Peering through the lens of cyclical industries, job growth among workers was abruptly interrupted earlier this year after a solid 18 months of continuous expansion. It has yet to recover in a consistent manner. Conversely, managers have enjoyed undisrupted job creation throughout.

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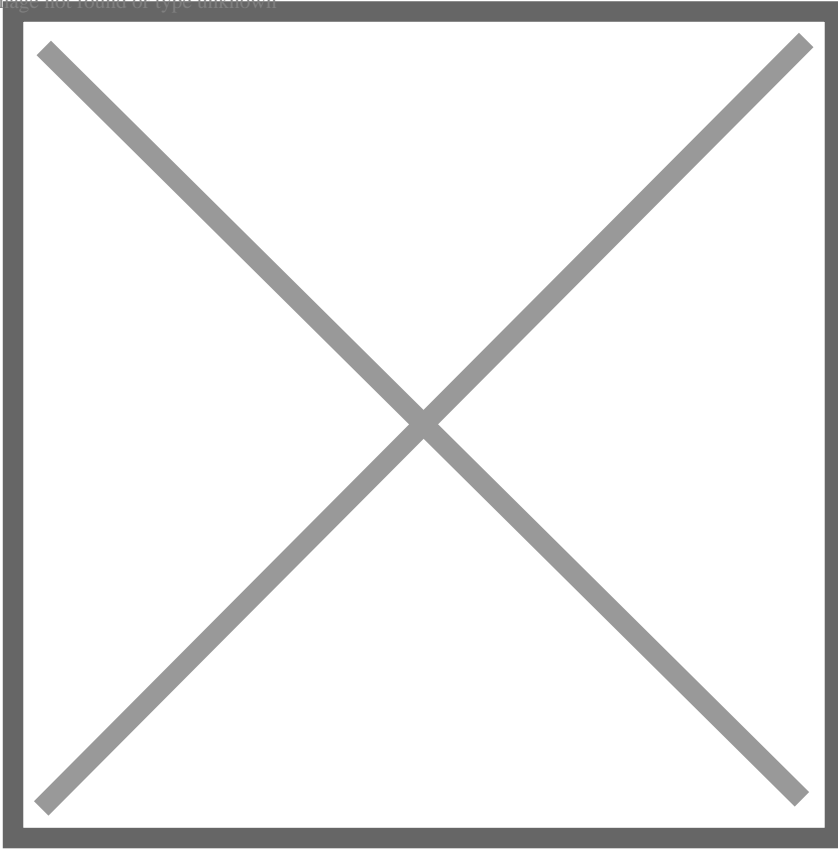
Has this indicator rung false alarm bells in the past? The answer is no with respect to its persistence. Cost cutting in cyclical industries has been underway in five of the last six months, the longest stretch since the economy was in recession. Increasing layoffs help explain this next chart of chain store sales that peaked first late last year and have since rolled over again. But sales growth has yet to even slow to 2018 rates and remains relatively robust. There is some intuition at work – average weekly wage growth may not be running at its annualized June 4.0% peak, but the rate was still a positive 2.6% as of September.

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If anything, households are more jazzed up about spending than they've ever been, at least gauged through Bloomberg's Weekly Buying Climate Index. Once again, a disconnect emerges between managers and worker bees. As highlighted in a recent Feather, commercial and industrial loan growth contracted by 1% on a two-month rate in October, the worst showing since June 2010. How households can be this enthusiastic in the face of firms slamming on the brakes is nothing short of stunning.

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Be that as it may, several clarifications present themselves. The first is self-evident – the worker bee is the last to be looped in on the recession conversation. Helpfully, credit card lines have yet to be cut. We have, however, seen the beginning of tighter credit card lending standards and a decided downturn in the growth of credit card spending at major banks, yellow flags that speak to the beginning of the end of the remarkable run in U.S. household spending.

Discerning trends in household finances is, nonetheless, nearly impossible. There was a time you could take the pulse of the health of consumer balance sheets with cursory glances at debt-to-income ratios and delinquency rates. Though mortgage debt remains 70% of household debt, it's not the same caliber of debt it was 15 years ago. As a recent analysis by Morgan Stanley noted, the post-crisis clampdown on mortgage availability has pushed up median FICO scores to over 750 from around 700 before the crisis. Separately, the five-percentage-point decline in the homeownership rate to 64.1% means that the pool of mortgage holders has shrunk as a percentage of the population. Call that reason No. 2 that distills the efficacy of delinquency rates.

To Chief Economist Ellen Zentner's credit, she recognizes the landscape has been altered. She's got the common sense to recognize that a period of record low interest rates does not simplistically equate to record low debt servicing costs. In fact, growing a rentership nation has pushed the pendulum in the opposite direction.

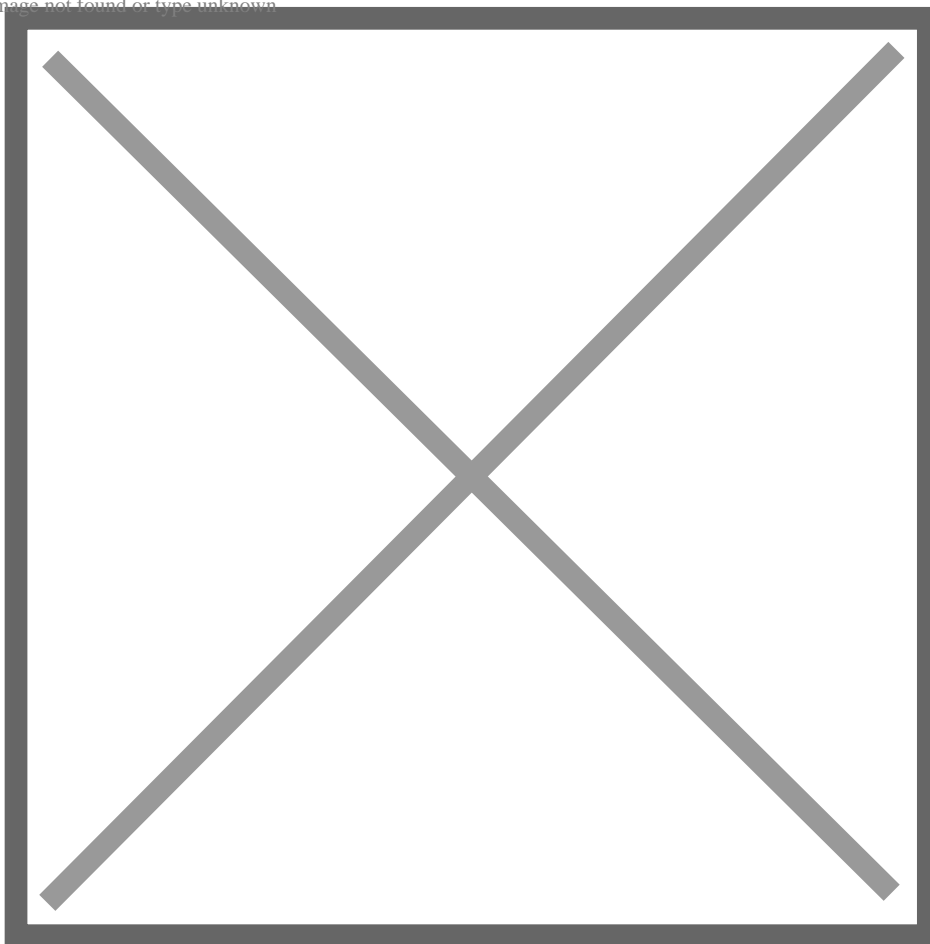
To derive what households are truly shouldering, she prefers the New York Fed's financial obligations ratio which incorporates payments towards rent, auto leases, homeowners' insurance and property tax payments. "Looking at this ratio together with debt-to-income, we can tease out the impact that increasing numbers of rental households paying progressively higher rent is having on the health of the consumer," Zentner explained.

What she found was that the differential between what we think of as traditional debt servicing and the financial obligations ratio was at the widest level since 1980.

Recall that about 85% of the apartments constructed in the current cycle have been luxury units making renting more expensive than it's ever been against a backdrop of so-so income growth. That being the case, a better gauge of strapped younger renter households is auto loan delinquencies given the share of lower-credit borrowers getting auto loans has risen to record levels in recent years. Set aside delinquencies for prime borrowers and you find that non-prime delinquencies are running north of their crisis era peaks.

Zentner's bottom line: "While the U.S. consumer's balance sheet is in fine shape overall, mainly because levels of debt and debt-servicing costs remain low, there's a segment whose income statements are under stress — rental households with lower income and lower credit scores. How big are they? Not small, at least on one metric: borrowers with FICO scores below 650 account for about 28% of the population." The sole factor separating these households from financial disaster is a paycheck. All bets are off if and when the unemployment rate begins to increase.

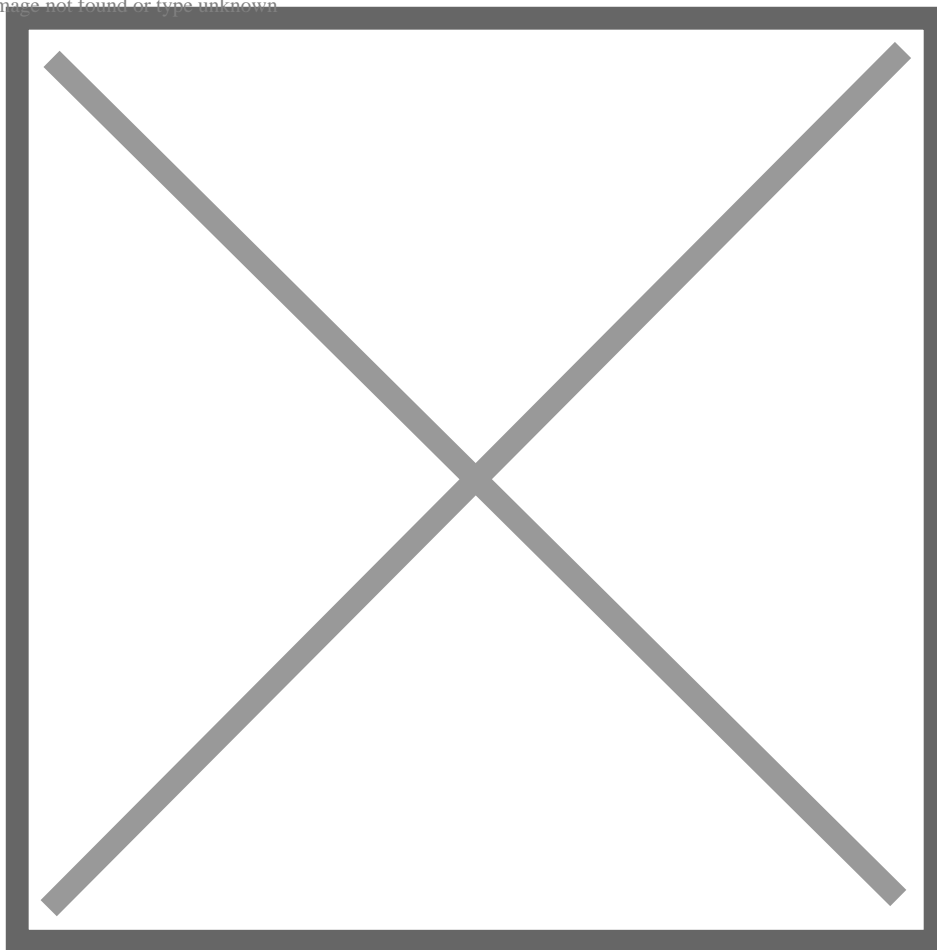
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Can you imagine the anger that will coarse through the veins of the younger cohorts who already feel their country has abandoned them when they are once again dragged to their knees by financial hardship? More importantly, should we judge so harshly that they've not the reverence for their country given less than half of those born into America's middle-income classes after 1980 can hope to earn more than their parents? Forty years of economic

immobility?

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The saddest reflection is that eight-in-ten millennials want to contribute to this country what Manchester's worker bees contributed to establish it an Industrial Revolution-era economic powerhouse. Most prize a strong work ethic and have the desire to succeed and meaningfully contribute to America's future. The vast majority of the country's up and coming generations know that there is no pride in hand-outs.

And yet, the Fed and our government refuse to allow the economy to rise and fall of its own volition, to let cycles cycle through, to let the weak fall and the strong prevail and in doing so open the economy to all who strive to share in her riches. Postponing the inevitable is the path taken by cowards who would sooner serve the untouchable few rather than the ambitious masses. And yet, here we find ourselves, usurped to those no better than traitors who cannot grasp that divided we will never stand.

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