Recession Risk Recedes as Jobs Grow

After a difficult winter, the U.S. economy avoided the worst fears of investors and remains on a positive trajectory. The risk of recession has receded, consumer confidence remains strong and financial markets rebounded into positive territory for the year. The impressive jobs recovery continues and is nearing what economists consider “full employment.” However, U.S. growth remains slow (as evidenced by meager GDP growth in the first quarter) and conditions are even weaker abroad (as evidenced by the recent downward revision of global economic growth by the International Monetary Fund). The U.S. election cycle is another restraining factor for the markets. We believe this year will continue to be a challenging one for investors, but expect corporate profits and equities to rebound next year as headwinds from a stronger U.S. dollar and low energy prices wane.

STAYING ON A GROWTH PATH

U.S. economic growth fell to just 0.5% in the first quarter (as initially reported by the Bureau of Economic Analysis), sparked by disappointing industrial production and retail sales. However, this seems to be a momentary blip largely due to reduced inventory growth. The dollar has pulled back from its highs, oil has bounced back nearly 70% from its lows earlier this year (as of this writing) and job creation remains strong. All of these factors calmed the markets—which rebounded strongly from their February lows and are nearing their all-time highs set last spring—and suggest the economy will avoid a recession.
Perhaps most importantly, the U.S. Federal Reserve opted to follow the “First, do no harm” dictum. After signaling in December it would raise rates four times in 2016, signs of a slowdown early this year caused the Fed to ease the pace of monetary tightening. While the Fed is still concerned about inflation, which has shown signs of coming back to life, it does not want to jeopardize what is still one of the weakest economic recoveries on record. Most economists now expect the Fed to raise rates no more than one or two times this year. Similar easing from the European Central Bank and Bank of Japan, which moved Japanese rates into negative territory, should also help keep the U.S. economy from falling into recession.

**BATTLING POLITICAL HEADWINDS**

In addition to weak economic growth, the U.S. election cycle is likely to act as a damper on the markets this year. Presidential election years are typically marked by harsh, negative rhetoric. No matter which party holds power, the other party inevitably tries to make the economy look bad.

Historically, the eighth year of a President’s time in office has seen the worst equity performance of any in a presidency. Going back to 1929, when President Hoover was in office, the S&P 500 has fallen an average of -3.2% in the last year of a two-term presidency. (Of course, that doesn’t mean history will repeat itself.) But the first year of a new President’s term typically sees the stock market gain a healthy +8.9%, which gives investors something positive to look forward to.

On average, the U.S. stock market has risen most sharply during the third and sixth years of a president’s time in office, and declined in the second and eighth years.

![S&P 500 in the Presidential Cycle Diagram](image)
EMPLOYMENT GROWTH IS REAL

The drumbeat of negative rhetoric has actually made people skeptical of good news when it occurs. One such case is the persistent decline in unemployment. While some may believe the political world is focused on our country’s problems, the U.S. economy is experiencing the most consistent job growth in a generation. Civilian unemployment has fallen from 10.0% at the height of the financial crisis to 5.0% and even lower in the early part of this year. There has been a 2.4 million net addition to the U.S. labor force in the last six months alone—pouring cold water on the theory that the low unemployment rate represents individuals dropping out of the labor force.

Yet many people have trouble believing these numbers. They are so convinced that the economy is poor that they look beyond the headline unemployment figure to other measures showing larger numbers of discouraged or underemployed workers, declining labor force participation, or the plight of the long-term unemployed. Yet no matter which of these statistics you look at, they all show the same thing: the massive surge in unemployment during the financial crisis was followed by a consistent and unabated pattern of improvement. There are fewer discouraged job seekers, fewer underemployed workers and fewer long-term unemployed. Most of the so-called discouraged workers are actually retired or disabled, are full-time students, or don’t want a job for some other reason. Many older people who had put off retiring when the financial crisis devastated their stock portfolios are now choosing to retire after the run-up in equity markets.

![10-Year Unemployment Rates](image)

10-YEAR UNEMPLOYMENT RATES (percent, monthly, seasonally adjusted)
All these measures of U.S. unemployment have declined steadily since the financial crisis and are close to their pre-crisis lows:

- Civilian Unemployment Rate
- Total Unemployed, plus all marginally attached workers plus total employed part time for economic reasons
- Persons Unemployed 15 weeks or longer, as a percent of the civilian labor force

Source: FRED (Federal Reserve Economic Data) from the St. Louis Federal Reserve Bank.
In fact, we are nearly back to the low unemployment rates last seen in April 2008 prior to experiencing the full effects of the global financial crisis. While it is difficult to precisely define what would constitute full employment in the economic sense, Fed Chair Janet Yellen recently spoke of “coming close” to the Fed’s congressional mandate of maximizing U.S. employment. Not that we don't still have problems in the labor market—such as the troubling low rate of wage growth or the 45 million Americans still collecting food stamps despite the run-up in employment—but no matter how you measure it, job creation has been a bright spot in the post-crisis U.S. economy.

**NO BUBBLES ON THE HORIZON**

Another common source of skepticism is whether we paid too high a price to stabilize the economy with historically low interest rates and quantitative easing. Are these loose monetary policies causing financial bubbles that could pop at some moment and leave us worse off than before?

At the present time, no bubbles appear to be forming. National housing prices are approaching levels last seen in 2007, but are rising at an unexceptional rate of 5.4% per year according to the 20-city Case-Shiller Index (long considered to be one of the most accurate barometers of housing prices). Similarly, while the U.S. stock market has gone up about 215% from its lows in 2009, that reflects its recovery from a 55% loss during the last recession. Today's price-earnings ratios of about 17.0 are still only slightly above the 15-year historical average of 16.2—far below the dot-com era when P/E ratios based on forward earnings were approaching 30. These are well short of bubble territory and reflect the low earnings expectations at the moment. Future earnings expectations should start moving higher, which will lower these forward P/E ratios, as soon as the current headwinds due to stronger U.S. dollar and low energy prices dissipate.

As for the long-term impact, history has little to tell us. Today’s stimulative monetary policies are unprecedented. What we have learned so far is that low interest rates and quantitative easing appear to do a better job of preventing a recession than of generating growth. While this is the fourth-longest economic expansion since 1900, it is the most sluggish in the post-war era. But in the absence of any fiscal stimulus since the immediate post-crisis years, monetary policy has been the only tool available to global policymakers who are hesitant to increase public debt any further. While central bankers have been saying for years that more fiscal stimulus is needed to put the world’s economy back on a healthier path, there is little political appetite for debt-funded stimulus programs.
FINE-TUNING THE PORTFOLIO

J.P. Morgan has made some adjustments in its portfolios by lowering our exposure to equities to reflect the weak economic growth and aging economic expansion. We also modestly increased our exposure to corporate and high-yield bonds. The U.S. stock market has already achieved our modest expectations for this year, so we are seeking outperformance from favored sectors like healthcare and technology rather than the market as a whole. We also like the consumer discretionary sector because employment is growing and consumer confidence remains high. We are positive on Europe and Japan, particularly with their aggressive stimulus programs. Our research shows that when the ECB is loosening at the same time the Fed is tightening or remaining neutral, European equities tend to outperform U.S. markets over a 6–12 month time frame. But we are continuing to shy away from emerging markets, where we still see too much risk. While this year’s stock market volatility may continue, we do not expect any major upward or downward breakouts, and we are looking forward to 2017 when corporate profits and the equity markets could experience more substantial growth.