ECONOMIC AND FINANCIAL DIGEST

LANTERN INVESTMENTS, INC.

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Bubble Bubble Toil and Trouble

There's a time-honored adage that Wall Street likes to climb a wall of worry. As the curtain rang down on 2018, that wall kept getting higher, resulting in one of the most tumultuous market environments in years. The question is, will that wall come tumbling down or pose a formidable barrier for the economy to surmount in the coming year? As it is, the expansion is getting long in the tooth and showing distinct signs of fatigue. A recent Duke University poll revealed that 50 percent of Chief Financial Officers expect the economy to fall into a recession in 2019. That's more pessimistic than the view held by the majority of economists, but even they are upping the odds of a downturn this year. The latest poll puts the odds at over 20 percent, which is still low but up about five percentage points from a few months ago.

Paradoxically, the deepening sense of pessimism reflects a drumbeat of headline-grabbing "what-ifs" rather than what's actually happening. What if trade tensions with China escalate to the point of no return, resulting in onerous tariffs and other trade barriers that hammer global growth? What if the Federal Reserve makes a policy mistake that cuts short the expansion? What if corporations ran up too much debt and households filled their portfolios with too many risky stocks, making them vulnerable to higher interest rates or a steep market correction? These and other questions buffeted investor psychology in the waning months of 2018 and continue to linger as the curtain rises on 2019.

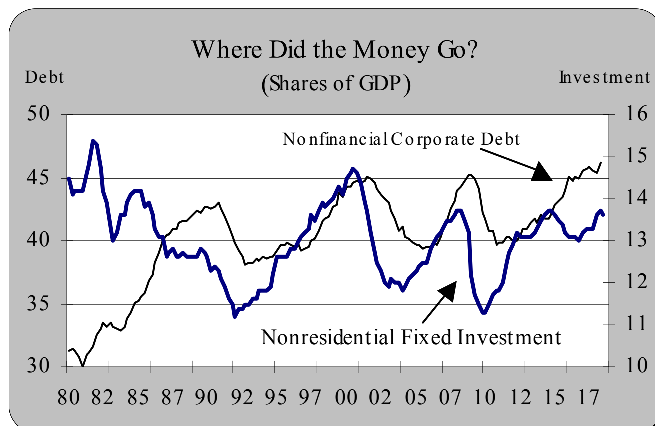
But the reality is that the economy continues to resemble more of a Goldilocks environment than the bearish sentiment in corporate boardrooms and on trading floors. Following sturdy growth rates in the second and third quarters, the economy appears to have delivered another solid performance in the fourth quarter, punctuating the strongest growth for a full year since 2005. Meanwhile, inflation ended the year on a tame note, erasing fears that the tightening labor market would stoke a surge in wage and price increases. Sturdy growth, full employment and tame inflation are not ingredients that would normally be associated with mounting pessimism. The question is, will the "what-ifs" that are spooking investors and corporate leaders come to pass and eradicate the Goldilocks environment?

Fact Versus Fiction

The divergence between perception and reality is not something new. For about three years through mid-2017, consumer and business confidence surged even as their actual spending lagged behind. Throughout the period, the so-called "soft data" portrayed a substantially brighter picture of an economy that was slogging along at a lackluster 2 percent pace. Since mid-2017, however, that gap has steadily closed as economic growth accelerated while surveys of households and business sentiment have leveled off, although at high levels.

More recently, the trend lines have been moving in the opposite direction. The economy has continued to forge ahead at a speedier pace than seen in earlier years of the recovery, but worries over global growth and rising trade tensions have taken a toll on sentiment reading, particularly among large corporations whose fortunes are deeply tied to global developments. So far, consumers are still upbeat and spending accordingly, as evidenced by the recent strength in retail sales. But even that reality is being contradicted on Wall Street. Despite a festive shopping season over the holidays, retail stocks suffered their biggest losses in the fourth quarter since the financial crisis.

To be sure, Wall Street is fretting over an array of potential trouble spots that underpinned a dramatic slide in stock prices over the last two months. Trade policy and political dysfunction, including a partial government shutdown, topped the list; but analysts that dig deeply into corporate balance sheets are finding some disturbing developments that could have potentially dire consequences. Most troublesome is the huge volume of debt that corporations have taken on during the expansion. Total non-financial corporate debt has grown by an impressive 58 percent since 2010, reaching a record, both in nominal terms ($9.3 trillion) and as a share of GDP (45 percent). The outsize increase has been encouraged by an extremely easy monetary policy, the increased risk appetite of investors and the strong desire to obtain the higher yields available on corporate bonds in a prevailing low-rate environment.



A Corporate Debt Bubble?

Unfortunately, the favorable backdrop encouraging the debt buildup is in the process of reversing. Monetary policy is tightening, interest rates are rising and investors are becoming more discerning, as evidenced by the recent sharp widening of yield spreads between lower and higher-rated bonds. If profits sag under the weight of a growth slowdown and rising cost pressures, debt-servicing issues will become a problem for a growing swath of borrowers.

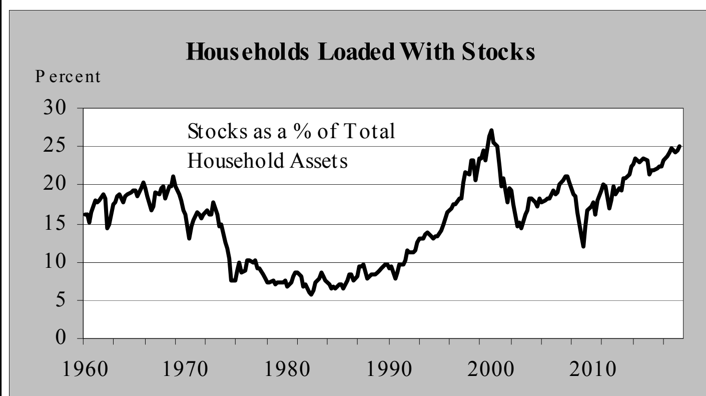
What's worse, the proceeds from borrowing have been mostly channeled into nonproductive uses, namely to finance mergers and acquisitions, stock buybacks and dividend payments to shareholders. Normally, corporations turn to the capital markets to finance capital spending, something that lifts productivity and enhances the long-run growth prospects for the economy. But business investment spending never exceeded the 13.7 percent share of GDP reached four years ago, and is not likely to in the near future.

Importantly, many analysts are becoming increasingly concerned about the financial health of the business sector and its vulnerability to rising interest rates. They fear that a corporate debt bubble has emerged before our eyes and could be the catalyst for the next recession. This threat should not be treated lightly, particularly as the proximate catalysts of the last two recessions were the bursting of the dot.com bubble in 2000 and the collapse of the speculative housing bubble in 2007. In fact, the Federal Reserve in its first-ever Financial Stability Report, highlighted worries about the elevated level of corporate debt, with special focus on the rapid growth of leveraged loans.

Household Vulnerability

Even as corporations have built up enormous amounts of debt, households have seen big gains on the opposite side of their balance sheets, as assets have enjoyed an astonishing appreciation since the end of the recession. On the surface, this should be a good thing. But equity holdings have accounted for 40 percent of the increase, thanks to the surge in stock prices, and they now account for 25.2 percent of total household assets, only a tad below the 27 percent record high seen at the height of the dot.com bubble in 2000. The good news for the economy is that when households feel wealthier they tend to spend more than otherwise.

The potential bad news, however, is that the outsize share of stocks on the balance sheets of households leaves them more vulnerable to a market correction. The 14 percent tumble in stock prices from early October to mid-December wiped out about $4 trillion of equity wealth. The period is probably too short to have a meaningful near-term impact on consumption — short-term market swings do not generally change consumption habits – but if the wealth destruction is not recovered over the next six months or so households will feel poorer and likely pull in their horns.



Indeed, there's some evidence that the negative reaction to a market downturn is greater than the positive reaction to a market upturn, reflecting the notion that people derive more pain from a loss than enjoyment from a gain. Time and the direction of stock prices will determine if that is the case in this cycle. But the more important trends to watch are the fundamental underpinnings that move the markets one way or the other. While not as solid as they were earlier in the year, our sense is that investors are sounding a more pessimistic note than is warranted by actual and prospective events.

Contained Risks

As noted, the expansion, now in its tenth year is getting long in the tooth and would become the longest on record if it lasts through the middle of 2019. However as economists are quick to note, expansions do not die of old age, but rather by some external event or a policy mistake. The shock from the bursting of a corporate debt bubble would certainly qualify as such an event. But unlike the mortgage-related bust that ushered in the financial crisis and Great Recession, the corporate debt build-up is not nearly as dire. For one, corporate balance sheets are in relatively good shape, as assets have increased faster than liabilities since 2008 and include a sizeable liquidity buffer available to repay short-term debt. For another, profits are still growing and bolstering cash flow to service debts, although the gain this year is expected to be smaller than in 2018.

Likewise, household balance sheets may have taken a hit from the recent slide in stock prices. But the damage to the economy would be greater if the wealth destruction occurred alongside weak job and income prospects. That's not the case now, as the labor market remains strong and wage growth is picking up. What's more, like corporations, households have a sizeable cushion of savings, which insulates them somewhat from a temporary setback in their stock portfolios. Thus far, the setback has not made a meaningful dent in consumer confidence, which remains near an all-time high. The risk is that a sustained market correction might undermine household confidence, causing a spending pullback that would morph into the very self-fulfilling recession feared by investors.

Perhaps the biggest concern, amplified by President Trump, is that the Federal Reserve will misjudge the strength of the economy and push interest up too far. That's always a nontrivial risk, as the Fed has a poor forecasting record and its rate hikes have tipped the economy into 7 of the last 10 recessions. However, despite Trump's criticisms, the central bank has moved much more gradually in this cycle than in past ones. Following the latest quarter-point increase, the Fed raised rates nine times over the past three years for a sum total of 2.25 percentage points. By contrast, in the two-year 2004 – 2006 cycle, the Fed lifted rates 17 times, for a cumulative rise of 4.25 percentage points. At the December policy meeting, the Fed scaled back the number of increases expected in 2019 from three to two in recognition of slower prospective growth and still-tame inflation, and seems ready to ease back further if justified by incoming data. That doesn't sound like a Fed about to make a policy mistake.

KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

								12-Month Range	
	December	November	October	September	August	July	June	High	Low
Prime Rate	5.35	5.25	5.25	5.03	5.00	5.00	4.89	5.35	4.50
3-Month Treasury Bill Rate	2.37	2.33	2.25	2.13	2.03	1.96	1.90	2.37	1.41
5-Year Treasury Note Rate	2.68	2.95	3.00	2.89	2.77	2.78	2.78	3.00	2.38
10-Year Treasury Note Rate	2.83	3.12	3.15	3.00	2.89	2.89	2.91	3.15	2.58
30-Year Treasury Bond Rate	3.10	3.36	3.34	3.15	3.04	3.01	3.05	3.36	2.88
Tax-Exempt Bond Yield	4.13	4.30	4.32	4.12	3.96	3.88	3.89	4.32	3.56
Corporate Bond Yield (AAA)	4.02	4.22	4.14	3.98	3.88	3.87	3.96	4.22	3.55
Conventional 30-Year Mortgage Rate	4.64	4.87	4.83	4.63	4.55	4.53	4.57	4.87	4.03
Dow Jones Industrial average	23806	25252	25569	26233	25630	24978	24790	26233	23806
S&P 500 Index	2567	2723	2785	2902	2858	2794	2754	2902	2567
Dividend Yield (S&P)	2.22	1.99	2.02	1.88	1.87	1.92	1.96	2.22	1.79
P/E Ratio (S&P)	17.1	18.9	18.7	20.1	21.0	20.5	19.8	22.8	17.1
Dollar Exchange Rate (vs. Major Currencies)	92.1	91.7	90.8	90.0	90.4	90.0	89.7	92.1	85.7

** Monthly Averages*

ECONOMIC INDICATORS

								12-Month Range	
	December	November	October	September	August	July	June	High	Low
Housing Starts (In Thousands)		1256	1217	1237	1280	1184	1177	1334	1177
New Home Sales (Thousands of Units)			544	597	591	606	612	672	544
New Home Prices (Thousands of Dollars)			310	321	324	328	311	340	310
Retail Sales (% Change Year Ago)		4.2	4.8	4.2	6.4	6.6	6.1	6.6	3.9
Industrial Production (% Change Year Ago)		3.9	3.8	5.6	5.4	4.1	3.6	5.6	2.8
Operating Rate (% of Capacity)		78.5	78.2	78.4	78.5	77.9	77.8	78.5	77.0
Inventory Sales Ratio (Months)			1.35	1.34	1.34	1.34	1.33	1.36	1.33
Real Gross Domestic Product (Annual % Change)				3.4			4.2	4.2	2.0
Unemployment Rate (Percent)	3.9	3.7	3.7	3.7	3.9	3.9	4.0	4.1	3.7
Payroll Employment (Change in Thousands)	312	176	274	119	286	165	208	324	119
Hourly Earnings (% Change Year Ago)	3.2	3.1	3.2	2.8	2.9	2.8	2.8	3.2	2.6
Personal Income (% Change Year Ago)		4.2	4.3	4.2	4.5	4.6	4.6	4.6	4.2
Savings Rate (Percent of Disposable Income)		6.2	6.3	6.3	6.3	6.3	6.5	7.4	6.2
Consumer Credit (Change in Blns. Of Dollars)		22.1	25	9.6	21.0	15.1	5.2	25.0	0.8
Consumer Prices (% Change Year Ago)	1.9	2.2	2.5	2.3	2.7	2.9	2.8	2.9	1.9
CPI Less Food & Energy (% Change Year Ago)	2.2	2.2	2.1	2.2	2.2	2.4	2.2	2.4	1.8
Wholesale Prices (% Change Year Ago)		2.5	2.9	2.7	2.8	3.2	3.3	3.3	2.5

LANTERN'S BOND OFFERINGS 800-860-1010

Rating Moody/S&P	Description	Coupon	Maturity	Yield to Maturity	Approx Price	Tax Equivalent Yield
MUNICIPAL BONDS:						
AA2/AA-	**California State University Rev** Callable 05/01/26 @ 100	3.000%	11/01/33	3.100%	98.817	5.70%
AA3/AA	**Miami FL Dade County Water & Sewer Rev** Callable 08/01/26 @100	3.000%	10/01/34	3.200%	97.542	5.30%
AA3/AA-	**Port Auth NY & NJ Consolidated Bonds** Callable 12/01/22 @ 100	3.000%	12/01/35	3.150%	98.043	5.79%
NR/AA+	**McAllen TX General Oblig Bonds** Callable 02/15/27 @ 100	3.500%	02/15/40	3.500%	100.000	5.79%
AA1+/AA+	**Rhode Island Hsg & Mortgage Rev** Callable 10/01/25 @ 100	3.350%	10/01/41	3.600%	96.140	6.62%
AA2/AA+	**New York City Housing Dev Corp** Callable 02/01/25 @ 100	3.400%	11/01/47	3.700%	94.709	6.80%

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The bonds listed above are just a sample of the bonds we own or offer. Consult your investment representative to determine suitability. The tax-equivalent yield is calculated using the lower of yield to call and yield to maturity and a 39.60% federal tax rate plus an estimated 6.00% state tax rate (45.6% total) where applicable. You will only receive the quoted tax equivalent yield if you are in this tax bracket. Additional tax equivalent yields can be calculated upon request. All municipal bonds listed are exempt from federal taxes unless described as "subject to AMT" or listed as taxable and may be subject to state and local taxes. Discount bonds may be subject to capital gains taxes and/or ordinary income. All bonds are subject to price change and availability. All prices are as of 01/11/2019. If bonds are sold prior to maturity or call date, they may be worth more or less than their original investment. Official statements and material events information for some municipal bonds may be found on www.emma.msrb.org