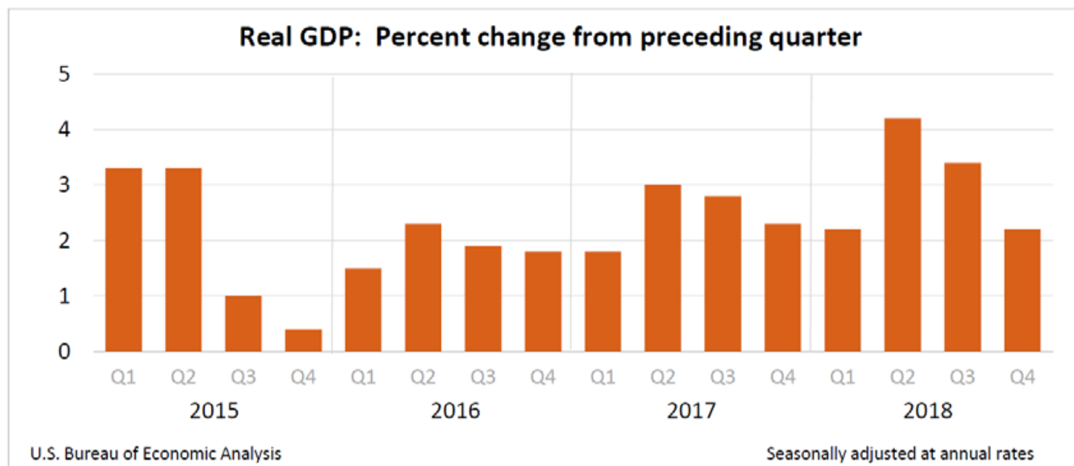
# Alley Company Quarterly Letter
## Battleship

April 15, 2019

The S&P 500 Index rallied sharply in the first quarter of 2019, completing a V-shaped recovery from the worst December for the stock market since 1931. It appears that the market was spooked by a "growth scare" in late 2018, but now is focusing on the likelihood of continued economic expansion.[1]

The U.S. economy has indeed been downshifting in recent months. For example, fourth quarter 2018 real gross domestic product (GDP) growth was 2.2 percent compared with growth rates comfortably above 3 percent in the middle quarters of last year (see exhibit below). In addition, growth estimates for the first quarter of 2019 have slid to below 2 percent according to Bloomberg consensus forecasts.




The recent decline in the *rate of growth*, however, shouldn't be confused with an unhealthy economy or one that is *contracting*; nor should it be used to support a narrative about an economy that is reaching "stall speed," which some pundits have incorrectly put forth in the recent past.

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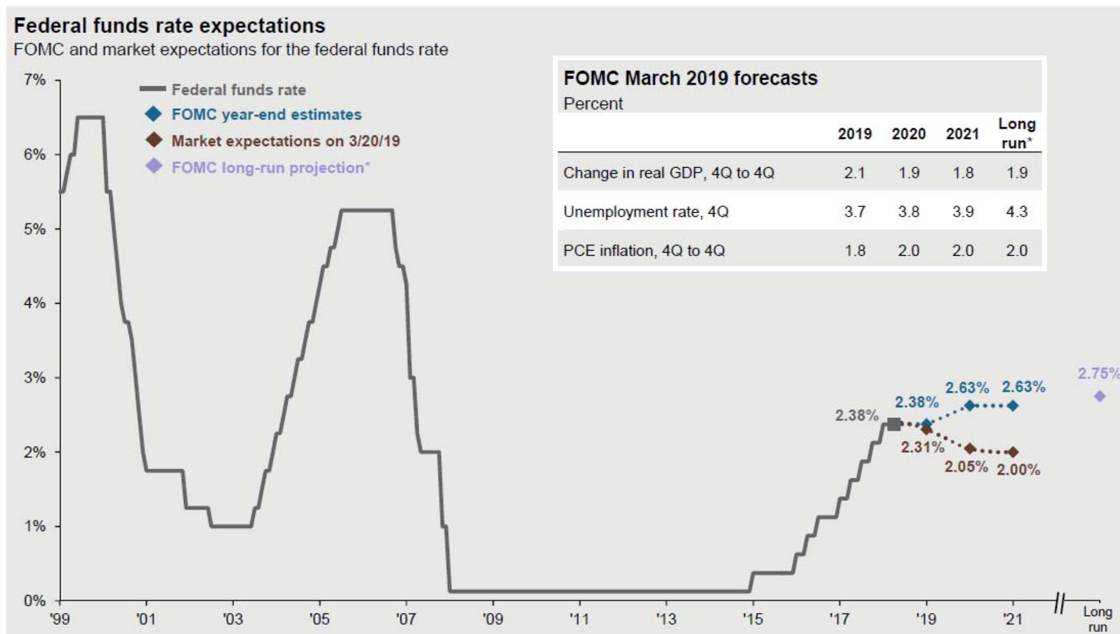
The reality is that the U.S. economy is the largest and most diversified in the world and expanding at a moderate pace over and above the rate of inflation is actually a recipe for success. More rapid growth could potentially prove to be unsustainable (boom-bust cycles) or promote overheating (creating excesses or too much inflation).

Since the end of the Great Recession in 2009, the U.S. economy has been **functioning like a battleship** – moving slowly at times, but heavily armored and hard to knock off course. In fact, the economy has now been expanding for 117 months, making this the 2nd longest business cycle on record dating back to the 1850s.[2]

For its part, the Federal Open Market Committee (FOMC)[3] believes the economy is strong and well positioned for continued growth.

> "The U.S. economy is in a good place, and we will continue to use our monetary policy tools to help keep it there. My colleagues and I have one overarching goal: to sustain the economic expansion, with a strong job market and stable prices, for the benefit of the American people."
>
> - Fed Chair Jerome Powell

Over the last three years, the FOMC has raised the target range for the Fed Funds rate by 25 basis points on nine separate occasions (see exhibit below). Rather than a concerted effort to fight inflationary pressures or slow an overheating economy, this action has primarily been to return the Fed Funds rate to a more "normal" level after a period of crisis-level policy. But now, with growth slowing at the margin and inflation considered to be well-anchored on a global basis, a pause in the normalization process is warranted. Many economists believe this, along with a U.S.-China trade deal, could refresh economic growth.




| | 2019 | 2020 | 2021 | Long run* |
|---|---|---|---|---|
| Change in real GDP, 4Q to 4Q | 2.1 | 1.9 | 1.8 | 1.9 |
| Unemployment rate, 4Q | 3.7 | 3.8 | 3.9 | 4.3 |
| PCE inflation, 4Q to 4Q | 1.8 | 2.0 | 2.0 | 2.0 |

Source: JPM Guide to the Markets; Federal Reserve.

On the corporate earnings front, expectations for growth in 2019 have been declining on the heels of robust 20 percent-plus growth in 2018. After a bump from corporate tax reform (Tax Cuts and Jobs Act of 2017) last year, growth could settle out closer to the long-term average of approximately 6 percent.

Like a heavily armored battleship, the U.S. economy has been hard to knock off course. While recessionary periods are normal and will come and go in the future, it appears that the near-term headwinds of unwinding crisis-level monetary policy and U.S.-China trade tensions have calmed for now which should lead to a continuation of economic momentum and a positive backdrop for corporate earnings performance.

With market volatility and economic crosscurrents the norm, investors should adopt a battleship mentality and embrace an **investment philosophy** and **asset-allocation structure** that can stand the test of time, even when the waters get a little choppy.

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[1] The "growth scare" in late 2018 was primarily caused by concerns over monetary policy and U.S.-China trade tensions. In January, Federal Reserve (Fed) Chair Jerome Powell communicated that future monetary policy action would be "data dependent," acknowledging that crosscurrents in the global economy had emerged that made a more patient approach appropriate. As the first quarter came to a close, signals were sent to the market that the U.S.-China trade negotiations were making progress.

[2] Source: National Bureau of Economic Research (NBER). Assumes current expansion started in July 2009 and continued through March 2019, lasting 117 months so far. Data for length of economic expansions and recessions can be found at www.nber.org/cycles/

[3] The FOMC is the body of the Federal Reserve System that sets national monetary policy. It consists of twelve members – the seven members of the Board of Governors; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis.