LPL RESEARCH
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FEELING CONFIDENT?

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KEY TAKEAWAYS

Consumer confidence has dropped sharply, primarily from what we see as temporary factors.

Economic fundamentals are still sound and could help stabilize sentiment.

We have yet to see the signs of excesses that have preceded past recessions.

Deteriorating confidence over the last several months has soured the economic landscape. About four months ago, the Conference Board's Consumer Confidence Index reached an 18-year high. Since then, the gauge has dropped about 18 points, its biggest three-month decline since 2011. Sentiment's swift decline has caused some to wonder if a drop in confidence could be self-fulfilling, as lower confidence could weigh on consumer spending, and consequently, on output. Historical data show that the U.S. economy has entered a recession an average of 19 months after a peak in consumer confidence, and a drop in sentiment has been a warning sign for past economic cycles [Figure 1].

While confidence shifts can be meaningful obstacles to economic activity, we think the severity of the current decline is due, in part, to temporary factors such as the government shutdown, and the fundamentals are still in place for sentiment to stabilize.

CHALLENGING HEADWINDS

Over the past several months, U.S. consumer sentiment has had to weather increasing trade risk, a 35-day government shutdown, unnerving headlines on geopolitical issues, a slowdown in global growth, and a near bear market in

1 CONFIDENCE SHIFTS COULD BE LATE-CYCLE RED FLAGS

Economic Cycle Trough	Economic Cycle Peak	Consumer Confidence Peak	Date of Max Confidence	Time from Peak Confidence to Start of Recession (Months)	Consumer Confidence at Start of Recession	Drop in Consumer Confidence from Peak to Start of Recession
03/1975	07/1981	110	04/1978	39	84	26
11/1982	07/1990	121	02/1989	17	102	19
03/1991	03/2001	145	01/2000	14	117	28
11/2001	12/ 2007	112	07/2007	5	91	21
06/2009	?	138	10/2018	?	?	?
Average (Before Current Cycle)		**122**		**19**	**99**	**23**

Source: LPL Research, Conference Board 02/07/19
Economic recessions noted are from the National Bureau of Economic Research, which defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."

the S&P 500 Index. Many of these headwinds have understandably chilled confidence, and their collective impact can be daunting.

However, we think many of these headwinds will subside in the near term, if they haven't already. Trade tensions have had a widespread effect on corporate sentiment and economic activity, but we expect meaningful progress toward a U.S.-China trade resolution soon. Government shutdowns, especially when prolonged, have historically dampened consumer sentiment. For example, consumer confidence fell an average of 9.3 points in the final month of the 1995 and 2013 shutdowns, which were both at least 17 days. However, confidence (and economic activity) typically has rebounded after shutdowns, and we expect the same outcome here.

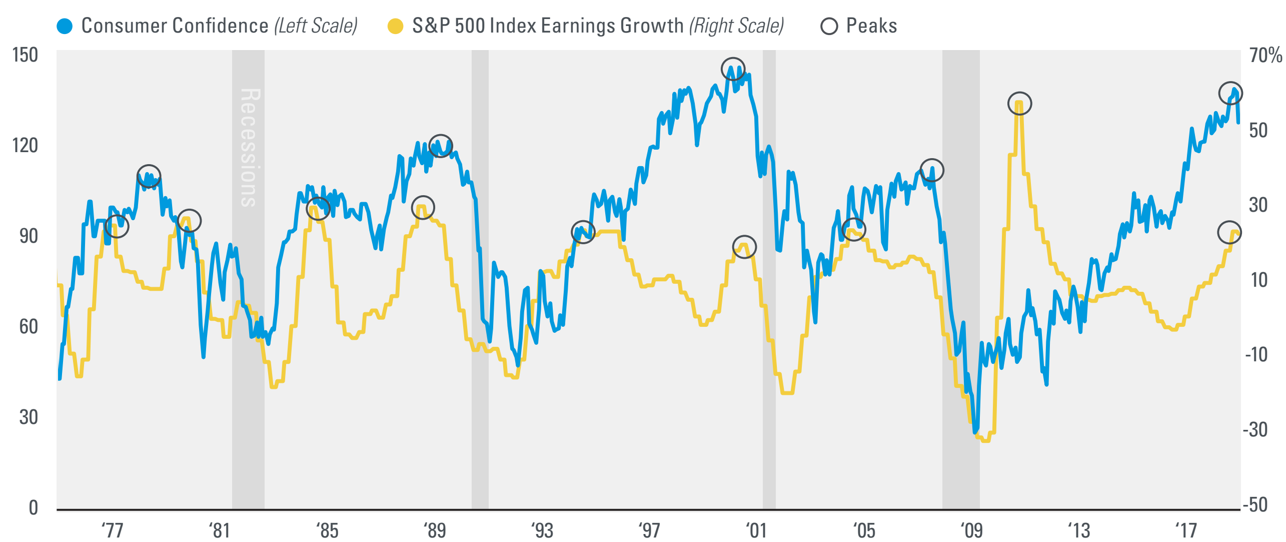
A downturn in major asset prices can also lead to consumers having a decreased sense of financial well-being, which can restrain spending and further reduce asset prices. The S&P 500 posted one of its worst slides of the current bull market in November and December 2018, but we believe stocks have bottomed, and may even make new highs in 2019. The S&P 500 has rebounded 14% since the late December lows, so we could see sentiment turn solely from stocks rallying.

SOLID FUNDAMENTALS

We believe solid fundamentals are especially important during a mature business cycle, a point we've emphasized frequently in today's volatile environment. The bulk of U.S. economic data we've seen lately remains sound. The labor market continues to show strength. Manufacturing gauges rebounded last month. Inflation has largely normalized, and it remains manageable. Most important, we still see reasonable potential for a resurgence in capital investment, which could drive higher productivity and help extend the cycle.

Corporate earnings have also signaled the possibility of a longer runway for economic growth. Profit growth for S&P 500 companies recently peaked at 23% in the third quarter of 2018, the quarter before consumer confidence's latest high. Since 1980, the U.S. economy has entered a recession an average of 28 months after the last earnings peak in the economic cycle [Figure 2].

2 SINCE 1976, RECESSIONS HAVE STARTED 23 MONTHS AFTER EARNINGS PEAKS



Source: LPL Research, Thomas Reuters, FactSet, Conference Board 02/07/19

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All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Fiscal policy remains supportive, and concerns about potentially restrictive monetary policy have settled down considerably. Following its most recent policy meeting in January, the Federal Reserve committed to patience when determining future interest rate adjustments and emphasized a commitment to flexibility until there is greater clarity on global economic conditions. At the same time, fiscal stimulus from the 2017 tax law, deregulation, and increased government spending remain in place, and it can take several years for the impact on economic output to fully play out, so we expect we'll continue to see benefits.

SIGNS OF EXCESSES?

Fiscal stimulus this late in the cycle does have some potential to contribute to a build-up in economic excesses, but we don't see any alarming signs of late-cycle excesses or "red flags" in the economy. Growth in wages, which makes up about 70% of business costs, has been healthy but subdued enough to not significantly weigh on profit margins. Average hourly earnings for non-supervisory workers has climbed as much as 3.5% year over year recently, but is still well below the 4% we've seen preceding recessions historically. Unit labor costs, or employers' compensation expenses per unit of output, grew 0.9% year over year through the third quarter of 2018, well below the 2% unit labor cost growth at historical consumer confidence peaks.

Valuations in financial markets are also under control and appropriate, given economic fundamentals. The S&P 500's price-earnings ratio is in line with its average for the bull market, and businesses' balance sheets remain healthy. While it's important to be mindful of where we are in the economic cycle, later-cycle economies can continue to exhibit stable growth for years, so the age of the expansion in itself isn't a red flag to us.

CONCLUSION

Global uncertainty is at its highest point in several years, but while the current environment is uncomfortable, we believe the steep drop in confidence has been exaggerated by some short-term factors, and we don't expect the recent decline in consumer confidence to have a meaningful impact on growth. Risks to economic fundamentals have increased, but the economy overall remains on solid footing, and, as discussed in our *Outlook 2019*, we expect GDP growth of 2.5–2.75% in 2019. ■