Signs Point to Volatile Markets, But Not Yet to Recession

The U.S. and global equity markets got shaken up a bit last week, with weak manufacturing numbers in the U.S. and globally indicating pronounced slowdowns in factory activity, employment, and trade. The manufacturing sector is very globally interconnected, with very few sophisticated products being assembled in a single country, so the synchronized slowdown comes as no surprise. There are cyclical forces at work here, in my view, but the adverse impact of the trade war is also starting to show up in the numbers.

With the impeachment inquiry also flooding the airwaves last week, it may feel as though we're due for a reckoning. I'd agree that in the short-term, all this ongoing noise is likely to contribute to higher levels of volatility. But does that mean we need to fundamentally to shift our long-term strategy or turn fully defensive? I don't think so.

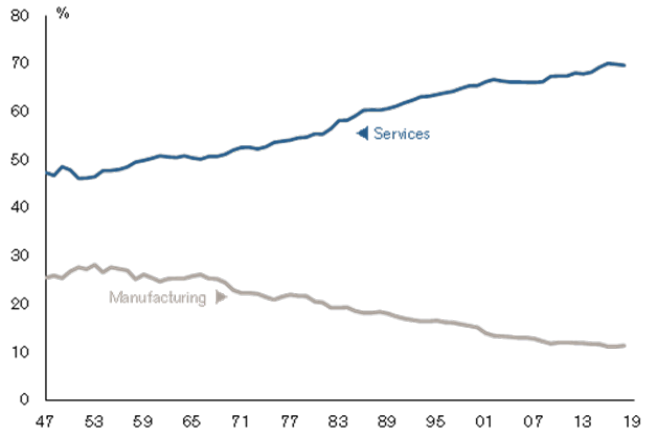
If you ignore the noise and consider the broad range of fundamentals, the picture for markets and the U.S. economy does not look so bleak.

Manufacturing versus The U.S. Consumer, Labor Markets, and Services

Manufacturing is an important component of the U.S. economy and has historically been a leading indicator. But news last week made it appear as though factory activity is a bellwether for the U.S. economy. It isn't. The manufacturing sector only accounts for around 10% of the U.S. economy, and that number has been shrinking progressively over the years.[1]

I believe this shrinking trend does not signal any kind of economic downfall and should not be viewed in a negative light – it is simply part of a longer-term transition, where the U.S. has moved from being an industrial economy to now being a services and consumption-based economy. In the modern economy, skilled labor has more value and pays higher wages than unskilled labor, which has led to overall increases in wealth over time (though creating winners and losers in the process).

Services Account for a Growing Share of the U.S. Economy



Source: Credit Suisse[2]

To be fair, if the ISM services data last week had indicated contracting activity in the U.S. economy, my tone here might be a bit different. But the ISM Non-Manufacturing PMI, which measures services, remained comfortably in expansion territory and relatively healthy. Many news reports noted that services data was less expansionary than expected, and that it surprised to the downside, but at the end of the day growth is growth.[3]

Macroeconomic data in the labor market and retail sales (the all-important U.S. consumer) also offer evidence that it is not all doom-and-gloom in the U.S. economy. Job growth as measured by non-farm payrolls remains strong, with reports last week showing that the U.S. added 136,000 jobs in September, bringing the jobless rate (3.5%) to its lowest level in 50 years.[4]

Small businesses, which are often considered a key growth engine for the U.S. economy, have been increasingly reporting labor *shortages*, where 57% of owners have said they're hiring or trying to hire new workers. A majority of these business owners have reported finding few, if any, qualified applicants for open positions, which might at once point to strength in economic activity but also a skilled labor shortage in the U.S. A key takeaway from the NFIB Small Business Jobs Report was that "hiring has slowed down, but it's due to the inability to find qualified workers, not because of a lack of customers."[5]

The U.S. consumer is another proxy for the health of the U.S. economy, and signs for now point to solid spending as we enter the holiday shopping season. Total retail sales for the June 2019 through August 2019 period were up 3.7% from the same period a year ago, with a particularly strong showing in July. In the latest ISM Non-Manufacturing report, the statement from the Retail Trade sector was that "business continues to pick up as we quickly approach Q4. Week by week, we inch closer to a much-anticipated holiday retail season, which requires not only last-minute buys, but a push to fill open positions."[6] Again, not all doom-and-gloom.

Bottom Line for Investors

Recession risks are clearly rising, and growth across the global economy is slowing. U.S. corporate earnings are also expected to post their third straight quarter of negative growth in Q3, which hasn't happened since 2015 – 2016. We should probably expect any bit of bad news to invoke a volatile response in the stock market.

But it's not all doom-and-gloom out there, and the base case is that the U.S. economy is still growing. The all-important services sector remains in expansionary territory, the U.S. consumer is still spending at a nice clip, the jobs market is quite healthy, and interest rates are falling. Recessions don't tend to happen when these factors are all working in the positive, and I do not think that changes now.

ABOUT MITCH ZACKS

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[1] National Association of Manufacturers, 2019. https://www.nam.org/state-manufacturing-data/2019-united-states-manufacturing-facts/

[2] Federal Reserve Board, Haver Analytics®, Credit Suisse. October 2, 2019.

[3] Institute for Supply Management, October 3, 2019. https://www.instituteforsupplymanagement.org/ISMReport/NonMfgROB.cfm?SSO=1

[4] The Wall Street Journal, October 4, 2019. https://www.wsj.com/articles/u-s-september-nonfarm-payrolls-grew-steadily-11570192288?mod=article_inline&mod=hp_lead_pos1

[5] NFIB Small Business Jobs Report, September 2019. https://www.nfib.com/foundations/research-center/monthly-reports/jobs-report/

[6] Institute for Supply Management, October 3, 2019. https://www.instituteforsupplymanagement.org/ISMReport/NonMfgROB.cfm?SSO=1

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- Retail purchases increase in spite of the trade war
- Minutes from the Federal Reserve's September meeting offered 2 revelations
- The U.S. and China resumed trade talks. Is a "Mini-Deal" next?

U.S. – China Trade Talks to Resume: "Mini-Deal" in the Works?

We would argue that a trade breakthrough between the United States and China could be a bullish event, supporting another leg of this already long-in-the-tooth bull market. But we also don't want to get anyone's hopes up – a grand trade deal between the two largest economies in the world does not seem likely this year. If anything, the two sides seem only to be drifting further apart. Trade talks resumed this week, and many market watchers (us included) are hoping that the two sides might embrace smaller concessions – a "mini-deal" – to at least postpone the tariff rate increases set to go into effect on October 15 and the new tariffs scheduled for December 15. These latest rounds of tariffs are the ones many expect to hit the U.S. consumer the hardest, which could ultimately deal a blow to the main lifeline of the U.S. economic expansion. Expect the equity markets to be hyper-sensitive to announcements/developments that take place in the coming days as negotiations continue.[1]

Retail Purchases Rise Ahead of Tariffs

As the December 15 tariffs loom, retailers are not taking their chances that a deal will be reached this week. Instead, imports at the U.S.'s major retail container ports are expected to reach their highest level of the year in November, which will eclipse the record reached last year. Interestingly, this data suggests that the trade war is actually increasing imports from China and other foreign countries, rather than decreasing them as the Trump administration has been eager to do. Trade deficits have grown over the last year as a result, with retailers hedging against uncertainty by upping purchases and stockpiling inventory.[2]

Mortgage Rates Remain Steady Even as Interest Rates Plummet

The 10-year U.S. Treasury bond yield has fallen sharply, from 2.66% at the beginning of the year to 1.65% as of October 1. Since mortgage rates are closely linked to rates on the 10-year, many homeowners and first-time buyers have been eager to take advantage of the falling rate environment. But many bankers and mortgage lenders have had to temper that excitement, as mortgage rates have not been falling as fast as interest rates this year. Since the end of June, for instance, the 10-year Treasury yield has fallen about 40 basis points (bps), while the average mortgage rate has only fallen 10 bps. According to research from Dow Jones Market Data, the gap between average mortgage rates and the 10-year is the highest it's been in more than seven years.[3]

Fed Pushes Ahead with Monetary Support, Even as Economy Appears Stable

Minutes from the Federal Reserve's September meeting offered two revelations: 1) there appeared to be more dissent about the September rate cut than previously indicated; and 2) Chairman Jerome Powell thinks the economy is in pretty good shape. Minutes showed that "several" Fed governors wanted to keep rates on hold instead of cutting by 25 bps, and a "few" officials believed the market was pricing in too many future rate cuts by the Fed. Even as the Federal Reserve cut interest rates, Chairman Jerome Powell said that "households are in good shape," and that the economy "just feels very sustainable." He added that "there's no aspect of the economy that is booming. You've got a solid consumer sector where wages are going up at the level of productivity plus inflation, job creation is healthy, there's no one sector like a housing bubble, there's nothing like that."[5] It sounds an awful lot like a 'goldilocks' assessment of the U.S. economy, but then again, the Federal Reserve has rarely been right about forecasting recession.

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[1] The Wall Street Journal, October 9, 2019. https://www.wsj.com/articles/trade-talks-resume-at-pivotal-moment-in-u-s-china-relations-11570644975?mod=djem10point

[2] Axios October 10, 2019. https://www.axios.com/us-retail-imports-surge-new-tariffs-28650941-16c5-4853-8b7a-b92208bc610c.html

[3] The Wall Street Journal, October 10, 2019. https://www.wsj.com/articles/mortgage-costs-outpaced-by-drop-in-interest-rates-11570699801

[4] Federal Open Market Committee, October 9, 2019. https://www.federalreserve.gov/monetarypolicy/fomcminutes20190918.htm?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosmarkets&stream=business

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