Are Investors Pricing in Too Much Recession Risk?

October kicked off with some weak economic reports. The Institute for Supply Management released manufacturing data showing that U.S. factory activity continued its slump, with the manufacturing index falling to its lowest level (47.8) since June 2009. Global manufacturing activity also remained firmly in negative territory in September, posting its fifth consecutive month of contraction. Nearly every major economy took a hit, the report said.[1]

Markets were rattled by this data, and recession chatter followed.

I've seen this pattern more this year than perhaps any other year in this decade-long economic expansion: market watchers and prognosticators cling to the slightest whiff of economic weakness, then use it to declare imminent recession. Whether it's the trade war, the inverted yield curve, weak corporate earnings, negative interest rates, or some other concern, the refrain is that this economic cycle is doomed – soon.

There's also been a notable response in the equity markets to rising fear of recession. I've been observing a notable rotation away from cyclical sectors and towards defensive sectors. In the third quarter, Utilities was the top-performing sector (+9.3%), followed by Real Estate (+7.7%) and Consumer Staples (+6.1%).[2] Since September 30, 2018 (roughly over the last year), Consumer Staples and Utilities have been at the top of the performance chain, with Staples outperforming Information Technology by a margin of 2-to-1 and Utilities outperforming by a margin of 3-to-1.[3]

Investors have also been hedging in other ways. There are nearly 2.5 times the amount of put options on the S&P 500 Index as there are call options, and the cost of hedging has soared to one-year highs across several equity benchmarks.[4]

The demand in the market to go defensive is clearly high, but in my view, investors might be over-compensating – and over-paying – to defend portfolios against a recession that may not be as imminent as many believe.

As investors rotate – or consider rotating – into traditionally defensive sectors like Utilities and Consumer Staples, many may not realize that the Utilities sector's price to earnings ratio is at an all-time high. The Utilities sector's P/E has risen

ahead of previous recessions as investors have made similar moves, but never to this degree. It is now the most overvalued sector, in my view. Consumer Staples is not far behind, which has me convinced that investors are over-playing the defensive hand, and paying dearly for it.[5]

The Recession May Not Be as Near as Many Believe

Manufacturing data was quite weak, and there are clear signs that global growth is slowing, in my view. But few reports point out that manufacturing only makes up 10% of U.S. economic output, and that the U.S. and global economy are still expected to grow north of 2% in 2019. Services in most developed countries remain strong and expanding, and the U.S. consumer – which comprises some 70% to total U.S. GDP[6] – continues to spend at a healthy clip. Patches of weakness are being counterweighed by bigger patches of strength, in my view.

I'll give you a few more data points to support the argument. 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. A majority of these business owners have reported finding few, if any, qualified applicants for open positions. This points to strength in economic activity, and also points to a skilled labor shortage in the United States (a good problem to have, in my view). A key takeaway from the NFIB Small Business Jobs Report is that "hiring has slowed down, but it's due to the inability to find qualified workers, not because of a lack of customers."[7]

The U.S. consumer is another proxy for the health of the U.S. economy, and signs point to steady spending as we enter the holiday shopping season. Total retail sales for the June 2019 - August 2019 period was up 3.7% from the same period the previous year, with a particularly strong showing in July.[8] 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."[9]

Finally, data in the broad labor market also offers evidence of the U.S. economy's stability. Job growth as measured by non-farm payrolls remains strong, with reports last showing that the U.S. added 136,000 jobs in September, bringing the jobless rate (3.5%) – its lowest level in 50 years.[10]

Bottom Line for Investors

If the market delivers a positive turn of events – which we may already see early signs of with a potential trade "truce" – there could be an upside rally which effectively unwinds many of these defensive positions. We could see mean reversion in cyclicals.

Hopefully readers see the bigger takeaway here, however. In my view, ***owning a diversified portfolio means that regardless of whether defensive sectors or cyclical sectors outperform, you'll participate in the upside***. In my opinion, having a diversified portfolio, at the end of the day, is the optimal way to be on the defensive in uncertain economic times.

ABOUT MITCH ZACKS

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

[2] Strategas, Quarterly Review in Charts, October 1, 2019.

[3] Charles Schwab, October 10, 2019. https://www.schwab.com/resource-center/insights/content/sector-views

[4]Bloomberg, October 9, 2019. https://www.bloomberg.com/news/articles/2019-10-09/stock-investors-hedged-for-a-crisis-risk-a-new-pain-trade?srnd=premium

[5] Charles Schwab, October 10, 2019. https://www.schwab.com/resource-center/insights/content/sector-views

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

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

[8] U.S. Department of Commerce, September 13, 2019. https://www.census.gov/retail/marts/www/marts_current.pdf

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

[10] MarketWatch, October 4, 2019. https://www.marketwatch.com/story/us-adds-136000-jobs-in-september-unemployment-rate-hits-50-year-low-2019-10-04

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- U.S. corporate earnings are likely to report a soft Q3
- Is "Phase 1" of the U.S.-China Deal Already Falling Apart?
- Britain and European Union negotiators reached an agreement on Brexit
- Could weak September retail sales figures be a sign of recession?

Earnings Season Kicks Off on a Positive but Cautious Note

U.S. corporate earnings are likely to report a soft Q3, with total earnings for the quarter estimated to decline -5% on +4.2% higher revenues, according to Zacks estimates. We expect 11 of the 16 Zacks sectors to post lower earnings compared to the year-earlier period, including the high cash flow Technology sector.[1] While this may appear, at first glance, like negative news, there are a few factors to note. The first is that this particular patch of weaker earnings was largely expected, coming off high comparisons resulting from strong showings in 2018 (the tax cut still working its way through). The second is that we do not expect this weakness to span into the next couple of quarters, with positive year-over-year growth expected in 2020. Finally, Q3 earnings may not ultimately be as weak as expected. It's early days, but this week saw solid reports from some of the U.S.'s most key banks and health care companies. UnitedHealth Group, Johnson & Johnson, JPMorgan Chase, and Citigroup all reported strong earnings that added a shot of early optimism into earnings season.[2]

Is "Phase 1" of the U.S.-China Deal Already Falling Apart?

Just last week, markets were given a confidence booster with the announcement of "phase 1" of a trade deal between the U.S. and China. What was billed as the foundation for a broader trade deal, upon further scrutiny, revealed that there were only minor concessions and promises of delayed tariffs (U.S.) and additional agricultural purchases (China). It turns out that China's purported $50 billion of agricultural purchases – which is higher than China has historically spent – is based on conditions that the U.S. drops plans to add 15% on $156 billion of consumer goods starting on December 15. China also indicated that its agricultural spend would actually hinge on demand and market prices, which means they may have $50 billion to spend but may not ultimately go that high. Complicating matters further, the House of Representatives recently passed a bill supporting protestors in Hong Kong,[3] which could end up irritating China.

Is the Brexit Breakthrough Real?

Markets were pleasantly surprised on Thursday to learn that Britain and European Union negotiators had reached an agreement on Brexit. Early indications show that a resolution was reached on the border between Ireland and Northern Ireland, which to-date had been one of the thorniest issues in negotiations. But opposition leaders are already claiming that the new Brexit deal is worse than the deal Theresa May had reached months before, and the terms and text of the deal are still subject to British Parliamentary vote, which is all but assured. It was encouraging to see two sides that were seemingly very far apart – Boris Johnson vs. EU leaders – manage to arrive at a negotiated agreement.[4] Now the hard part begins.

Are Weak September Retail Sales Figures a Sign of Recession

As weak manufacturing data and negative corporate earnings in Q3 have alerted many investors to recession possibility, matters were made worse this week with softening retail sales. The Commerce Department stated on Wednesday that retail sales fell -0.3% in September as households cut spending on online purchases, cars, and building materials. The core figures correspond to overall consumer spending in the United States, which accounts for the largest share of the U.S. economy. But investors can temper their nervousness for two reasons: 1) monthly data are volatile, and we would want to see a pattern of weak spending before raising red flags; and, 2) the core figure does not include most services spending, which is where a majority of U.S. consumer dollars go.[5]

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[1] Zacks.com, October 11, 2019. https://www.zacks.com/commentary/559900/what-to-expect-from-q3-earnings-season-with-big-banks-set-to-report?

[2] The Wall Street Journal, October 15, 2019. https://www.wsj.com/articles/u-k-pound-posts-gains-on-brexit-optimism-11571130220?mod=djem10point

[3] The Wall Street Journal, October 16, 2019. https://www.wsj.com/articles/despite-trade-truce-u-s-china-cold-war-edges-closer-11571227090

[4] The Wall Street Journal, October 17, 2019. https://www.wsj.com/articles/brexit-talks-are-dealt-a-blow-as-northern-irish-party-rejects-draft-11571294766?mod=hp_lead_pos1

[5] The Wall Street Journal, October 16, 2019. https://www.wsj.com/articles/u-s-retail-sales-fell-in-september-11571229234?mod=djem10point

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