3 Economic Indicators to Watch in the Second Half of 2022

The Federal Reserve is actively trying to curb demand in the economy by raising rates, and all the talk is about whether they can usher a 'soft-landing' without triggering a deep recession. So, the Fed will be a key factor to watch in the second half of the year. But I also have three other economic fundamentals investors should put on their watchlists, as they could be key in determining the path of the economy and markets over the next year.

Economic Fundamental #1: The Yield Curve

As a quick refresher, the yield curve represents the difference between long-term and short-term interest rates, which also serves as a proxy for loan profitability for banks. Since banks borrow at short-duration rates and lend at long-term rates (generally speaking), a steep yield curve creates higher net interest margins, which usually results in more credit, loans, and economic activity. On the flip side, an inverted yield curve signals it is more expensive to borrow money short-term than long-term, which means something is likely awry in the credit markets.

Historically, the yield curve has been a good forward-looking indicator for the economy, which is why rapidly rising short-duration U.S. Treasury bond yields are worth watching closely. In the chart below, the yield curve is presented as the 10-year U.S. Treasury bond yield minus the 3-month U.S. Treasury bond yield – the preferred measure. A declining line means the yield curve is flattening, and if the line falls below 0%, it means the yield curve is inverted. As seen below, the yield curve is clearly in a flattening pattern and close to inverting, making it a key indicator to watch in 2022.

Source: Federal Reserve Bank of St. Louis[1]

An inverted yield curve signals credit markets could come under strain, but it is not an immediate indicator of recession and/or bear market. There is usually time for investors to act.

Economic Fundamental #2: Leading Economic Indicators

The Conference Board Leading Economic Index is a pretty solid indicator for future economic activity. Because the index measures leading indicators like New Orders, Building Permits, Jobless Claims, Credit Spreads, and the stock market, it offers a comprehensive picture of expectations for future economic activity. A high and rising LEI almost always signals economic expansion ahead.[2]

In June, however, the LEI fell by 0.8% to an index reading of 117.1, which is still quite high relative to the years leading up to the pandemic but also marks four months of consecutive decline. In the first half of the year, the LEI fell 1.8%, which was a reversal from the 3.3% growth posted in the second half of 2021. Whether or not the LEI recovers or continues to decline in the second half will be a key indicator to watch in the second half, and could offer the clearest clue of a possible recession later in 2022 or early 2023.

Economic Fundamental #3: Earnings

Finally, there is the ever-important economic fundamental of corporate earnings, which are the single biggest driver of stock market returns, in my view. With roughly half of S&P 500 companies reporting, total earnings are up +1.4% from the same period last year on +11% higher revenues, with 75.5% beating EPS estimates and 65.7% beating revenue estimates. This is a slightly lower beats percentage than we typically see from this group, but the silver lining is that some of the key results were not as bad as many feared – driving stocks to rally.[3]

Looking ahead, inflationary pressures and supply-chain challenges will continue to factor for companies, but we are also hearing a lot more about the negative impact of the strong US dollar (which I will write about next week) and signs of weakness among lower-income consumers. How these issues continue to impact shifting earnings estimates will be crucial for investors to track.

Bottom Line for Investors

It is important to remember that the stock market is a discounter of future economic conditions – not economic conditions today. That's why the three economic fundamentals I think investors should keep an eye on in the second half of 2022 are all leading indicators, not lagging or coincident indicators. Looking ahead, I do not see severe warning signs appearing just yet, but the environment is becoming more challenging.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Fred Economic Data. July 29, 2022. https://fred.stlouisfed.org/series/T10Y3M#

[2] Conference Board. July 21, 2022. https://www.conference-board.org/topics/us-leading-indicators

[3] Zacks.com. July 28, 2022. https://www.zacks.com/commentary/1960253/taking-stock-of-the-earnings-picture

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

We take a look at three investment categories that investors might consider in a world of high inflation and rising interest rates.

Category 1: Value and Dividend-Paying Stocks

In the previous decade's era of low inflation and a dovish Fed, dividend stocks and value stocks were largely seen as second fiddle to high-flying growth stocks. The bond market was also locked in a secular bull market until early 2020, which gave fixed-income investors good reasons to hang tight in bond portfolios.[1]

The tides have now turned. The Federal Reserve has decisively shifted into hawkish mode in light of soaring inflation, and the bond market has been suffering losses in lockstep with stocks as yields rise. That has made dividend stocks look like attractive options for yield-seeking investors who are interested in long-term growth with steady and elevated cash flows.

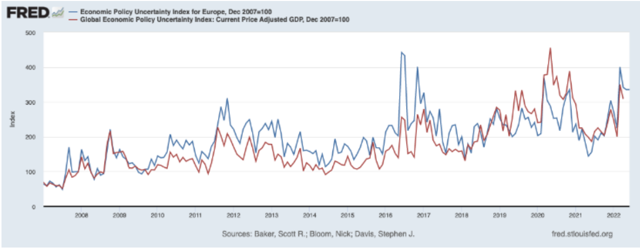
On the value stock side, value has a history of outperforming growth during periods of rising inflation and interest rates. Since value stocks are generally known for strong current cash flows, investors know what they're paying for in a rising rate environment. With growth stocks, higher cash flows are expected in the future, which gets discounted by higher rates and makes investors rethink the premiums they want to pay. The proof is in the pudding: from 1978 to 2020, value stocks delivered an annualized return of 10.9% in rising rate environments, versus 3.4% in falling rate environments.[2]

Category 2: A Focus on "Quality"

A historically tight labor market may offer some respite to higher electricity bills and higher prices at the pump and the grocery store. Just about any American who wants a job can find This category is related to the first one, in that investors may increasingly favor companies with strong balance sheets, free cash flows, and sizable gross profit margins. If rising rates and a hawkish Fed will arguably lead to slowing economic growth in the months and quarters ahead, these are the types of companies that are likely best suited to weather any economic challenges and market volatility.[3]

Category 3: International Stocks

Looking ahead, an unfortunate reality is that the war in Ukraine is showing few signs of ending anytime soon. Russia has also been applying leverage over Europe in the gas markets, by cutting the flow of natural gas down to 20% of normal capacity. Taken together, these factors have driven European economic uncertainty (blue line) and global economic policy uncertainty (red line) to levels not seen since June 2016 – when the United Kingdom voted to leave the European Union (Brexit).



Source: Federal Reserve Bank of St. Louis[4]

But that does not mean Europe's economy is doomed, and there is a distinct possibility that Europe may not fare as poorly as many expect. Stocks appear to be discounting very challenging conditions: the current P/E ratio for the MSCI EAFE index is at long-term lows not seen since the recessions of the past few decades, which again we think opens up the possibility for earnings resilience leading to a positive upside surprise.

In the Emerging Markets space, it is worth noting that China's central bank, the People's Bank of China, confirmed its commitment to provide accommodative fiscal and monetary policies as the country continues to push ahead with its zero-Covid strategy. If the Chinese government also reduces ambiguity around its regulations on technology companies, which appears possible, investors could regain the confidence to invest in the region. In our view, the potential upside in the Chinese economy is unique within a global economy otherwise struggling to generate growth.

One final upshot: historically, high and rising inflation expectations have led foreign stocks to outperform domestic US stocks. With foreign stocks having lagged US stocks for some time now, some mean reversion feels likely sometime in the not-too-distant future.

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[1] Reuters. July 12, 2022. https://www.reuters.com/markets/europe/volatile-us-markets-boost-appeal-dividend-stocks-2022-07-12/

[2] Black Rock. July 21, 2022. https://www.blackrock.com/us/individual/insights/equity-investing-ideas-amid-higher-rates-inflation

[3] Black Rock. July 21, 2022. https://www.blackrock.com/us/individual/insights/equity-investing-ideas-amid-higher-rates-inflation

[4] Fred Economic Data. July 31, 2022. https://fred.stlouisfed.org/series/EUEPUINDXM#

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The MSCI ACWI captures large and mid-cap representation across 23 Developed Markets (DM) and 27 Emerging Markets (EM) countries. With 2,986 constituents, the index covers approximately 85% of the global investable equity opportunity set. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

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