Stop What You're Doing

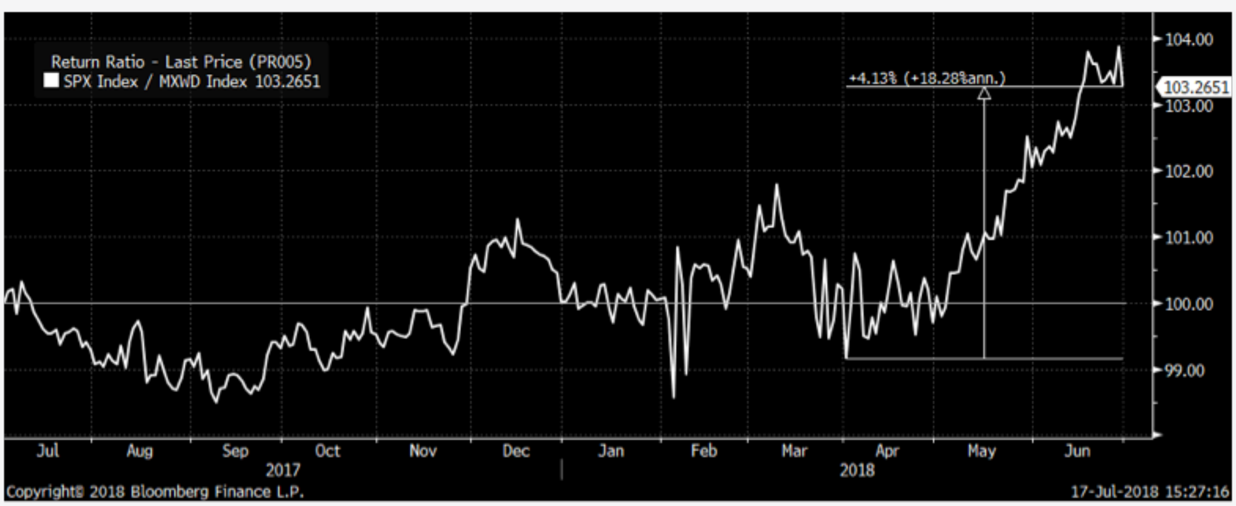
By Richard Thies

The primary subject of our last commentary was that the existing market narrative was at risk. We believed the consensus understanding of the global economy as being one undergoing synchronized growth was incorrect and was not priced for what the data were showing. We anticipated that this would result in volatility remaining elevated as the dollar appreciated broadly and slowing global growth began to be priced into equity markets. Our view was that it would be difficult for the market to transition from a narrative of coordinated growth, to one where the US economy was meaningfully diverging. The transition was challenging and the global economy did slow notably in the second quarter and that trend did spare the US. This was painful for global markets, but somewhat surprisingly to us, this malaise spared the US completely, with global equities lagging their American counterparts by a significant margin. (Exhibit 1) Looking ahead to the rest of the year and beyond, we see the major incremental driver of markets and relative performance across assets and geographies to be a potential second-derivative slowdown in US growth.

Second Derivative Test

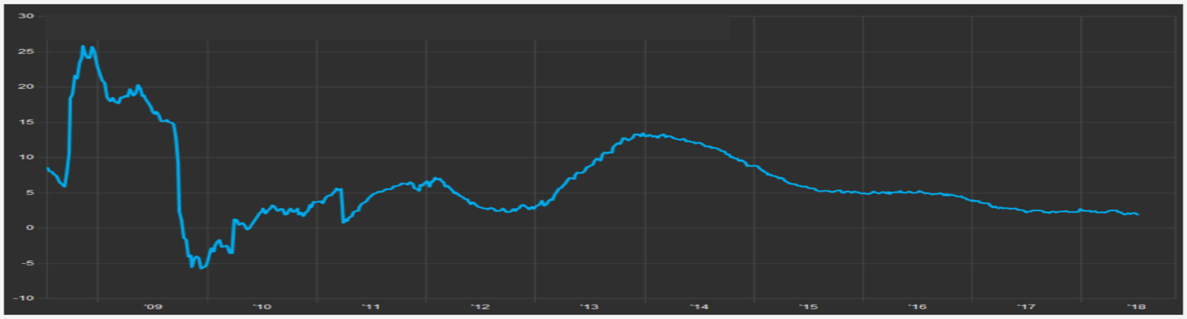
As a firm, we place heavy emphasis on the importance of second-derivative changes in earnings when analyzing companies. We think the same logic that makes this an effective tool for security analysis also works for major macro trends. With the US economy currently 10 months shy of its longest-ever upcycle (110 months, shy of the 120 month expansion that began in 1991), whether the American economy is approaching an incremental slowdown is a reasonable question to consider. When the US economy has just received a major fiscal shot in the arm, whose biggest growth impulse will be temporary, when the rest of the world is clearly slowing, and the US economic outperformance has been the primary driver of currency and equity returns, it's a question that must be asked. While knowing if the US is slowing is always material, given that the prevailing global market narrative has been one of US economic exceptionalism, we think addressing it carries particular merit today.

EXHIBIT 1:
The US significantly outperformed global markets in Q2 as economic trends diverged and the dollar strengthened



Source: Bloomberg

EXHIBIT 2:
Total credit injection to the US Economy



Source: Factset

Let's start by acknowledging that the US economy has seen a meaningful acceleration year-to-date and as such, you can easily paint a rosy picture of the economy. Our short summary is that the tax cuts have lifted final demand in the first half of 2018 and coming off an unexpectedly weak end to 2017, things have looked very strong. The question is whether some of the positives therein are sufficient to keep momentum going. Our philosophy is that growth that comes from stimulus, unless it improves productivity or investment, will ultimately revert. We do think there is an argument that the host of policies taken together encourage continued relative outperformance of business investment in the US relative to the world by essentially making it cheaper to invest in the US through lower taxes and more expensive to do so abroad with threats of tariffs and reprisals. The amount of the specific tariff is secondary to the persistent threat that trade regimes could change, which in itself greatly discourages investment abroad. All this to say, we agree those things are good and we also think there are other things that could matter more and that there are direct adverse side effects of those trade policies.

Credit Injection Deteriorates

First, as long-time readers of ours are aware, we place very heavy emphasis on the net credit injection into the US economy. The reason for this is that we still view the combination of the Fed and the commercial banking system to be the single largest creator of incremental spending power and their behavior together typically presages changes in US economic growth. On that, we think the data warrants some caution. There are two things of note occurring. First, the well-telegraphed contraction in the Fed's balance sheet is finally actually occurring, which figures to be a persistent headwind to total credit growth in the US for some time. Secondly, there was a pickup in bank lending since the second half of last year but that seems to running out of steam with loan officers broadly reporting weaker demand for loans which we think is a combination of many things, but specifically: 1) declining mortgage affordability, 2) already high leverage in private sector, 3) temporary weakness from tax cuts reducing need for short-term credit and 4) deteriorating credit quality in household space. Whichever is the primary driver is less important than the impact, which is a coming headwind to US growth. (Exhibit 2) The last time the total credit injection fell this low, the economy grew below 1% for three quarters.

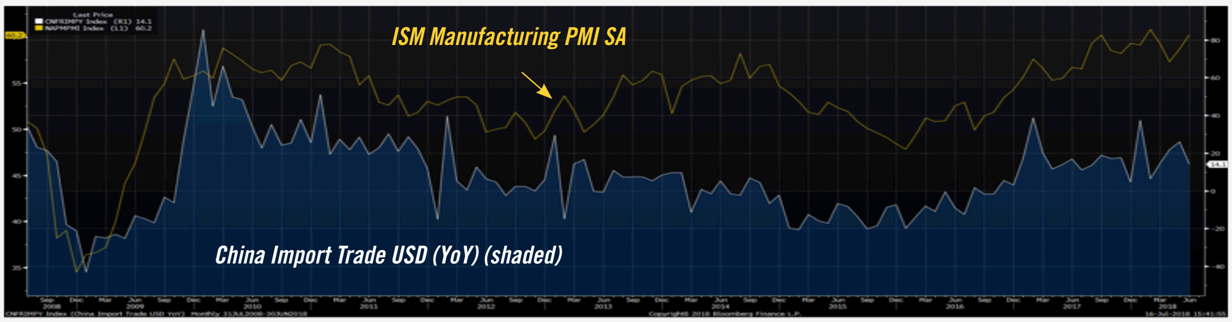
The Cost of Trade Heterodoxy

Second, we mentioned some of the positives of the tax and trade policies in the US above but some of the costs are also worth discussing. While we think the perpetual threats on trade can incentivize investment in the US over time, the near-term is rife with uncertainty which always has a chilling effect on private sector investment. We note that all of the US manufacturing surveys, the beige book, etc have included consistent mention about 'concerns' over changes to trade policy. You can also see this concern in the current data with inventories building and imports rising faster than production in anticipation of higher costs, which sets up for a deceleration in growth. There is great uncertainty on another impact as well, which is on price. There is no magic tradeoff available to the US economy, if prices are rising for goods, quantities of purchases will fall. Given the timing of tariff implementation, we would likely see the first drag from this in the fourth quarter. Again, supply chains and import relationships can change over time but that's not happening over time and with China having dominant market share in most consumer goods, purchasing power will fall and growth will very likely be worse in the fourth quarter than it is today.

The Manufacturing Renaissance Delayed

Thirdly, the problem with the overarching view of a US economic divergence is that it doesn't usually sustain. While the US has a relatively closed economy compared to other developed markets, it is not, in fact, an island and global pressures tend to be seen eventually. We see it as almost inevitable that the key indicator of US manufacturing growth, the Institute for Supply Management (ISM), will begin to fall soon. As we documented in our last quarterly, there have been many reasons to be cautious on ex-US growth, most of which came from the significant credit tightening in China, which impacts many more countries than China. While the US is low on the list of cyclically sensitive major economies to China, it is still on the list. (Exhibits 3 and 4) Aside from the behavior of past relationships, we see evidence in the data already that some corporate sentiment is already softening, namely with regard to capex intentions (Exhibit 5).

EXHIBIT 3:
China Imports tend to lead US cyclical data and have rolled over

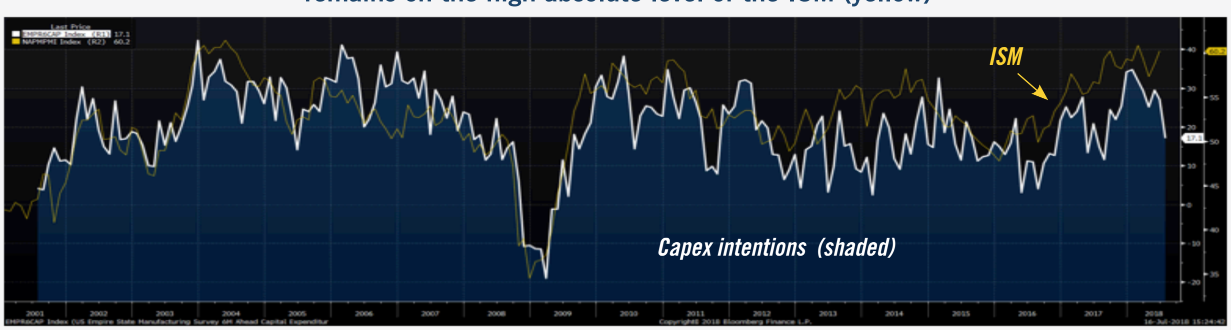


Source: Bloomberg

EXHIBIT 4:
Ongoing Chinese deleveraging will continue to weigh on Chinese demand, Chinese imports and ultimately global manufacturing including the US

Source: Bloomberg

EXHIBIT 5:
Capex intentions have already started to roll over (white), while the market's focus remains on the high absolute level of the ISM (yellow)



Source: Bloomberg

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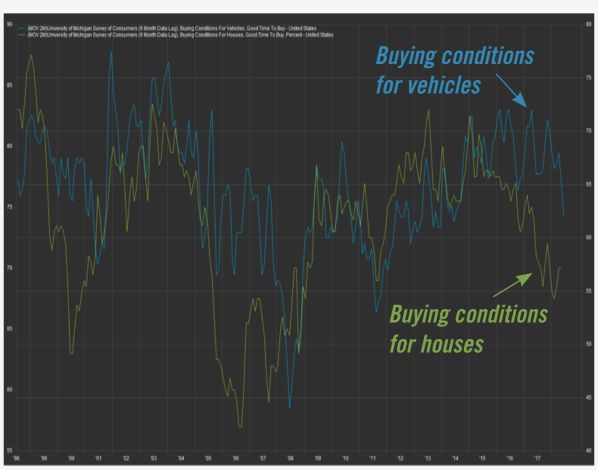
Consumer Health

A final point is on the state of the consumer. There is a prevailing narrative that rising wage growth will lift the next leg of the cycle. Thus far, wage growth has been disappointing but clearly labor markets are healthy and the growth should come. We have seen surprisingly little about the fact that real wage growth is actually seeing an incremental slowdown and even much of the tax cut windfall is being eaten up by higher gasoline prices. (Exhibit 6) Perhaps then, it is less surprising that we see some typically bearish data points on the broad consumer cycle from some things that have less quarter-to-quarter noise. We see purchasing intentions for high-value discretionary items and housing are falling notably (Exhibit 7). We will spare the reader 100 charts on housing and just say that you can very clearly see the impact of higher rates on housing data and leading indicators and it all looks quite poor incrementally. The affordability data is well-known at this point, but we suggest keeping an eye on inventories which for the first time in about five years have stopped declining and if recent trends continue, could end the year roughly flat or even in positive territory, which typically is not a great forward looking occurrence. (Exhibit 8). We are hard pressed to remember economic accelerations in the US which occurred amongst a declining housing market.

EXHIBIT 6:
Despite the prevailing narrative, real wage growth is hardly robust

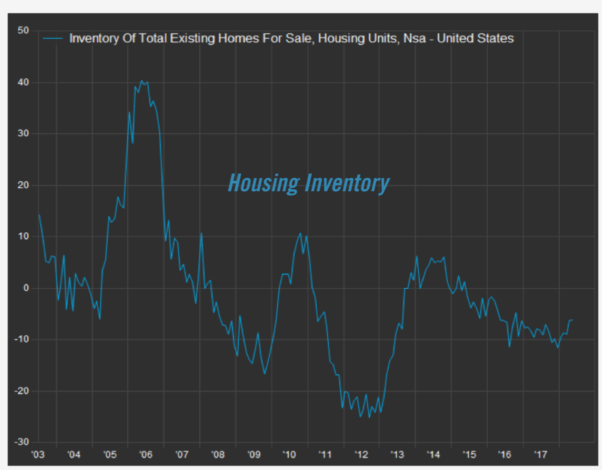
Source: Bloomberg

EXHIBIT 7:
Consumer surveys for purchasing intentions of autos, housing and other items are deteriorating quite notably



Source: Bloomberg

EXHIBIT 8:
Housing inventory has ceased its steady nearly five year decline amid falling affordability (y/y growth)



Source: Factset

Conclusion

To sum up, we think the incremental growth momentum in the US is of the utmost importance. We believe this not only for what it will likely mean to US equities and risk sentiment but also what it means for relative winners and losers around the world. Ultimately, we see building signs that the next second derivative change in US growth expectations is likely to be negative. If that is correct, then what has worked of late is not likely to continue working and you should stop what you're doing. Alternatively, the rest of the world could emerge from its doldrums to end the year largely driven from China easing policy, in which case investors should also stop what they're doing. We see the continuation of US growth continuing to surprise positively on its own while the rest of the world slows as very unlikely, and that is broadly how markets are priced.

About the Author

Richard Thies is a portfolio manager. In addition to his portfolio management responsibilities, he provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. He also conducts in-depth analyses of specific events and potential scenarios at the region, country and sector levels.

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