Federated

′Step away from the television′

Brainwashed investors think things are really bad. That may be good for stocks.

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That's what an advisor I met this week during my travels in the Seattle area tells his clients. "They're scared because they have a TV." Another shared that his clients are "always nervous." And another, "A lot of my clients are selling real estate this week," for fear of the markets. And yet another, "Where should we put all our cash (that worried clients have insisted on holding, anticipating trouble)?" Anxiety over the R word (or "banana" as the Carter administration called it, refusing to say "recession") has increased sharply the last four months for almost everyone who remembers the 2007–2009 Great Recession. Though data is sparse on weak economic conditions, investors are being bombarded with news suggesting such an event is imminent. The number of stories referring to a recession soared in August, with related Google searches running at 3.5 times June's pace. R-word worries were discussed everywhere I went this week. "I've never heard so much talk of a recession in my life! ... and yet there was no talk of recession in 2007!"

"Can we really worry ourselves into recession?" an incredulous advisor asked me. Not according to Evercore ISI, which in reviewing the last 100 years, finds no instance in which the U.S. was "talked" into a recession. The indicators it's watching as a sign of a downturn are unemployment claims (near a 5-decade low), layoffs (August was a bad month, *more below*) consumer confidence (just off a 20-year high) and the S&P 500 (at the moment, within a good day or two off its all-time high). Which is to say, not a lot is flashing red. Discussing the knee-jerk tendency to attribute every market gyration to the trade war, a frustrated advisor remarked, "I don't care if I ever hear the word tariff again." I don't think most consumers are discussing the trade war so much as gasoline prices are trending down and by early October could reach $2.40 a gallon, an 18% year-over-year (y/y) decline; jobs keep growing (August nonfarm jobs disappointed but were still solid, while ADP private payrolls jumped, *more below*); pay is rising (U.S. hourly compensation accelerated 4.4% y/y in the second quarter, and August hourly earnings rose 3.2%, *more below*); and mortgage rates are falling (they hit a 3-year low this week and are just off their lowest levels since at least 1971). Bank loans alone were up $17 billion last week and 5.1% y/y. All of this supports consumer spending, which accounts for about 70% of the economy and is going strong.

The turmoil of macro data and sentiment over the summer led to a *record reallocation of assets out of equities* by investors. They have sold $200 billion of equities so far this year and bought $700 billion of bond and money market funds. August alone saw one of the biggest outflows from equity exchange-traded funds in years, and the American Association of Individual Investors (AAII) survey shows expectations for the next six months continuing to trend bearish. These trends may be setting the market up for a run, with the spread between the AAII investor sentiment and ISI's proprietary global strength indicator at levels that that historically have indicated positive forward market returns on a 1-, 3- and 6-month basis. Meanwhile, the last time the bond market was this oversold in yield (and overbought in price), the S&P rallied 62% in 18 months and the 10-year yield climbed 262 basis points! As to the trade war, if investors assume Trump is not interested in scuttling the early October talks before they happen, risk assets could rally sharply into the meeting. A Fed rate cut at its Sept. 17-18 gathering could add more fuel, particularly if it surprises with a half-point, which currently isn't priced into the markets. My last Seattle meeting was a too-much-fun luncheon with a group of advisors who, for the first time during this week's travels, wanted to discuss politics. Who will be the Democratic nominee? I suggested it will be the one who can persuade his/her demographic target to get out the vote. Who can beat Trump? "How can he be our president?? .... His ties go down to here!!" Too much fun. And an advisor chuckling on his way out the door, "Vote early and vote often!"

POSITIVES

- **Services flash green** The Institute for Supply Management (ISM) said monthly non-manufacturing activity rebounded in August by the most in six months, led by a surge in new business—the third biggest gain on record—and the biggest increase in new orders in six months. As long as services, which account for over 85% of economic activity, are holding up, the near-term odds of recession remain low.
- **The labor market is tight** Led by small businesses, which rebounded after three months of weak performance, ADP private payrolls shot up 195,000 in August, the most in four months. Initial jobless claims also remained near five-decade lows. And while the nonfarm jobs report at 130,000 came in below consensus, the jobless rate held at 3.7%, employment relative to the overall population hit a decade high, the number working part-time for economic reasons fell to its lowest since 2001, average weekly hours worked rebounded and hourly wages continued to climb higher.
- **The equity market likes stimulus** And it's getting it as central banks around the world continue to ease (the People's Bank of China made a move today); the fiscal deficit to nominal GDP ratio in the U.S. has climbed to 4.5%, one of the largest non-recessionary fiscal accommodations in the postwar era; and annual growth in the real U.S. money supply has jumped threefold since late last year.

NEGATIVES

- **Manufacturing's rut deepens** August ISM activity fell much more than expected to a contractionary 49.1, its lowest since early 2016. New and export orders led the broad-based weakness. On a more positive note, July factory orders rose the most in nearly year. On a y/y trend basis, however, orders declined the most since October 2016.

- **Construction sends worrisome capex signal** July construction spending disappointed, led by a y/y drop-off in private and commercial activity. Notably, nonresidential spending, which accounts for about a fifth of capex, fell a broad-based 0.8% during the month.
- **Where the trade war is hurting** The sharp slowdown in global and domestic manufacturing is centered on trade, as evident in Challenger's monthly count of layoffs. August layoffs spiked nearly 38% to their highest total for the month since 2009, with the biggest y/y increases coming in manufacturing and transportation. Trade was cited as the reason for almost a fifth of announced job cuts.

WHAT ELSE

Inflation might be much lower and growth much stronger than the Fed thinks The systematic replacement of inferior products and services through innovation leads official statistics to overstate true inflation by 0.5% per year, according to a paper in the latest American Economic Review. This suggests core PCE is closer to 1% y/y than 1.5%, real GDP growth and productivity are both understated by 0.5% per year, and consumer incomes are stronger by 0.5%.

Hmm Although consumer confidence is just shy of its peak and consumer views about their present situation are the strongest since 2000, the spread between the two headline Conference Board and University of Michigan gauges is near the widest on record. Deutsche Bank says this gap historically has proven to be a reliable recession signal.

Soaring pork prices in the Year of the Pig? That's not good In addition to a slowing economy, the trade war and Hong Kong protests, President Xi has to worry about surging pork prices. The Financial Times reports that pork prices threaten to spoil celebrations on Oct. 1 of the 70th anniversary of the formation of the People's Republic of China.

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Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

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