Recession, is it NOW?

By: Sandy McIntyre, Capital Markets Strategist
October 9, 2019

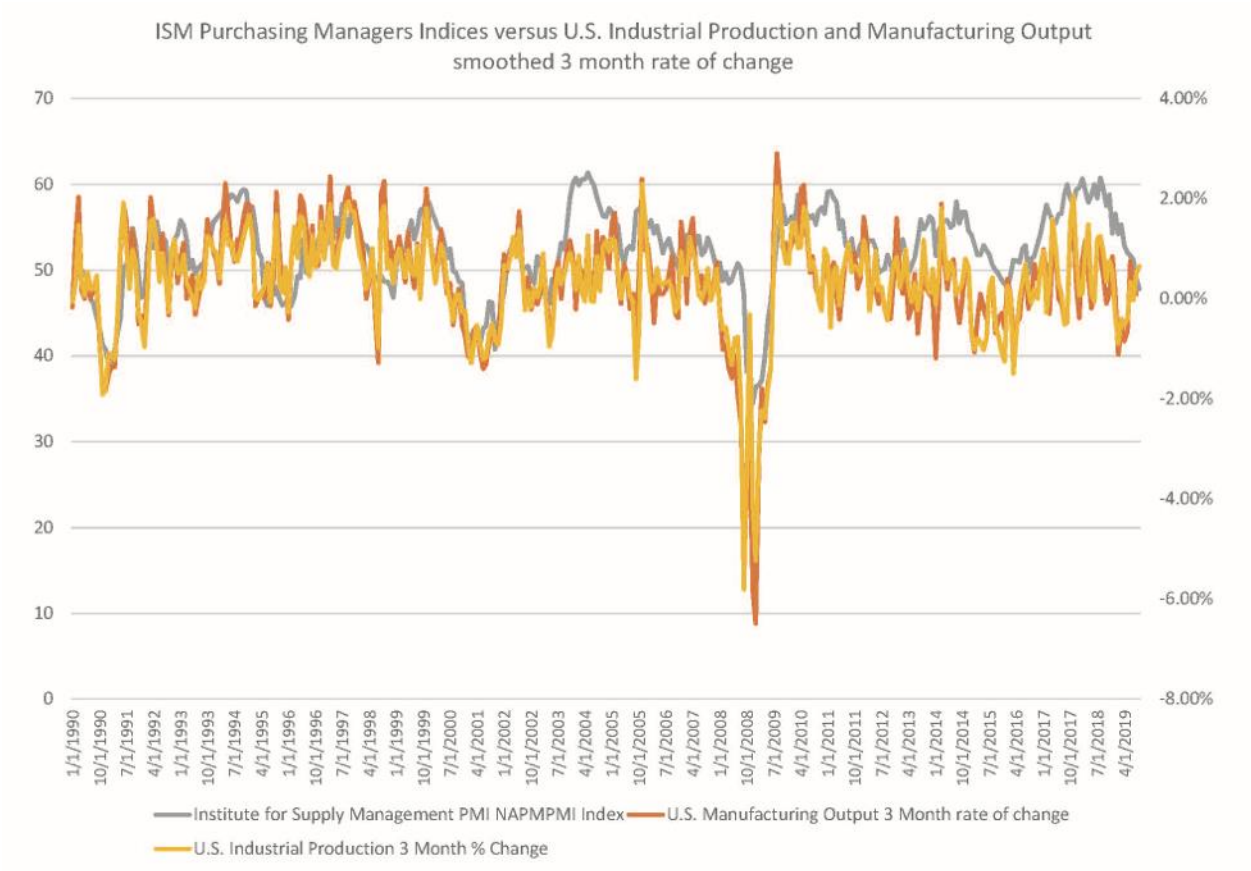
The first week of October was terribly confusing for investors. The first data point confusion was around manufacturing purchasing managers indexes (PMIs). The Markit version came out on September 30 at a level of 51.1, an improvement on the prior four months. Then, on October 1, the Institute for Supply Management PMI was announced, showing a further decline into contraction territory at 47.8. The divergence prompted Markit to come out with an analysis of the divergences on October 3. This is a link to the document:

https://ihsmarkit.com/research-analysis/explaining-us-manufacturing-pmi-survey-divergences-Oct19.html

Markit's conclusions are quite important. The report states that the Markit PMI is a much larger survey size and, according to Markit, gets around an 80% response rate. In their view this allows for more stable results. They also point out that the ISM survey tends to reflect business conditions in larger companies. Larger companies tend to have a more global footprint. The conclusion is important:

> "Pull all of the above factors together and it becomes clearer as to why the ISM data may have exaggerated U.S. manufacturing in 2017 and 2018, and why it is now possibly overstating the weakness. As chart 5 shows, global manufacturing growth outside of the U.S. (as tracked by IHS Markit's other PMI surveys) accelerated sharply in 2017, and has since matched the pattern of growth shown by the ISM. More recently, note that global-ex-U.S. growth has slowed sharply to some of the weakest rates seen over the past ten years (albeit not as steep as 2012).
>
> **Global vs U.S.**
>
> As the ISM data is seemingly more reflective of the performance of multinationals than the IHS Markit survey, we argue that it is sending misleading signals regarding the health of the U.S. economy. A more reliable picture of U.S. manufacturing trends is offered by the IHS Markit survey. Moreover, given the greater volatility of the ISM data relative to the IHS Markit and official data, it is possible that the current steep decline signalled by the ISM simply represents another case of the survey exaggerating the rate of change."

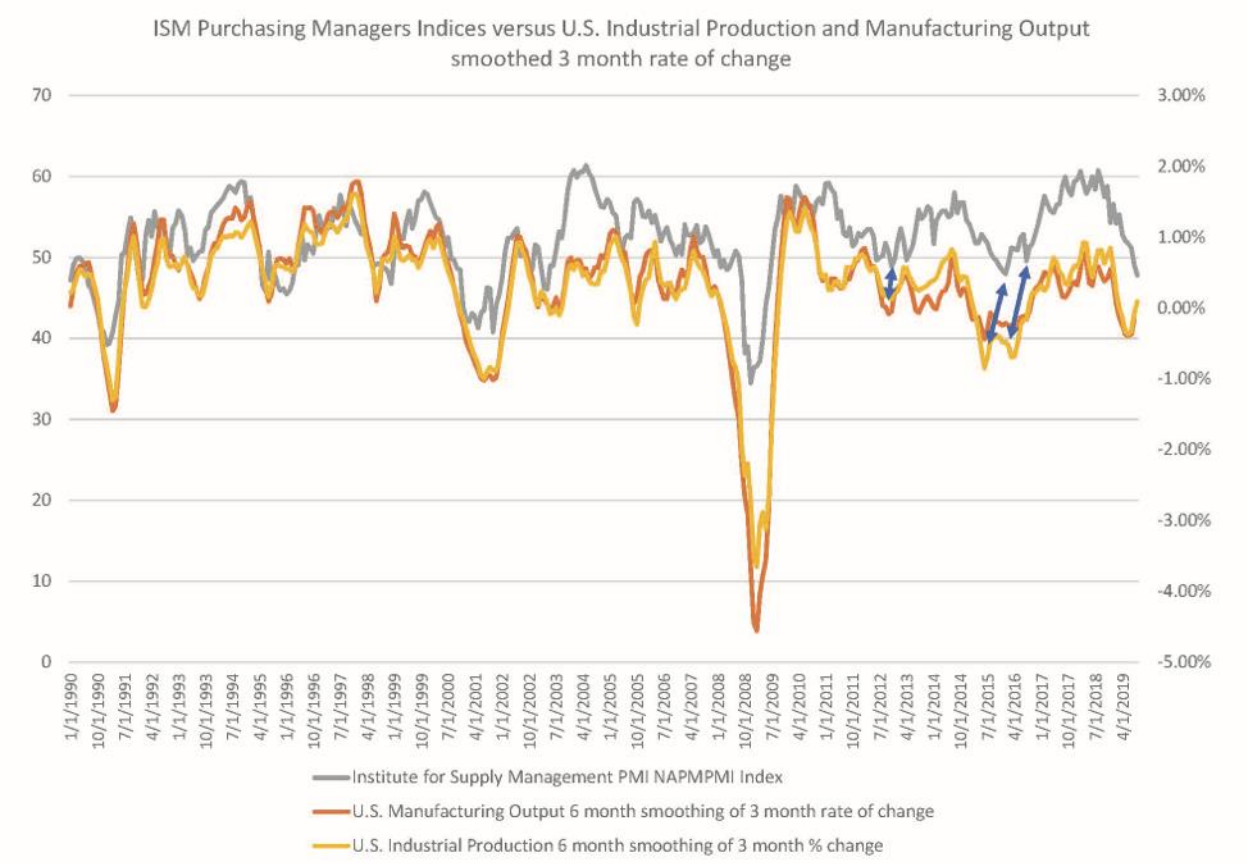
I have tried to replicate the charts in the Markit analysis but the available data for the Markit PMI on Bloomberg does not go back to 2007. One of the issues with these surveys is they are inherently subjective. Given Markit's criticisms of the ISM survey – that it is narrow, volatile and impacted by global conditions – I thought it would be worth comparing the survey to some hard data, namely U.S. industrial production and the manufacturing output sub index of that series. Unfortunately, the hard data is even more volatile. It would be very difficult to extract signal from noise in looking at the quarterly rate of change in manufacturing and industrial production.



Sources: Institute for Supply Management, Federal Reserve Bank of the United States, Bloomberg Finance L.P. and CI Investments Inc. As at October 1, 2019

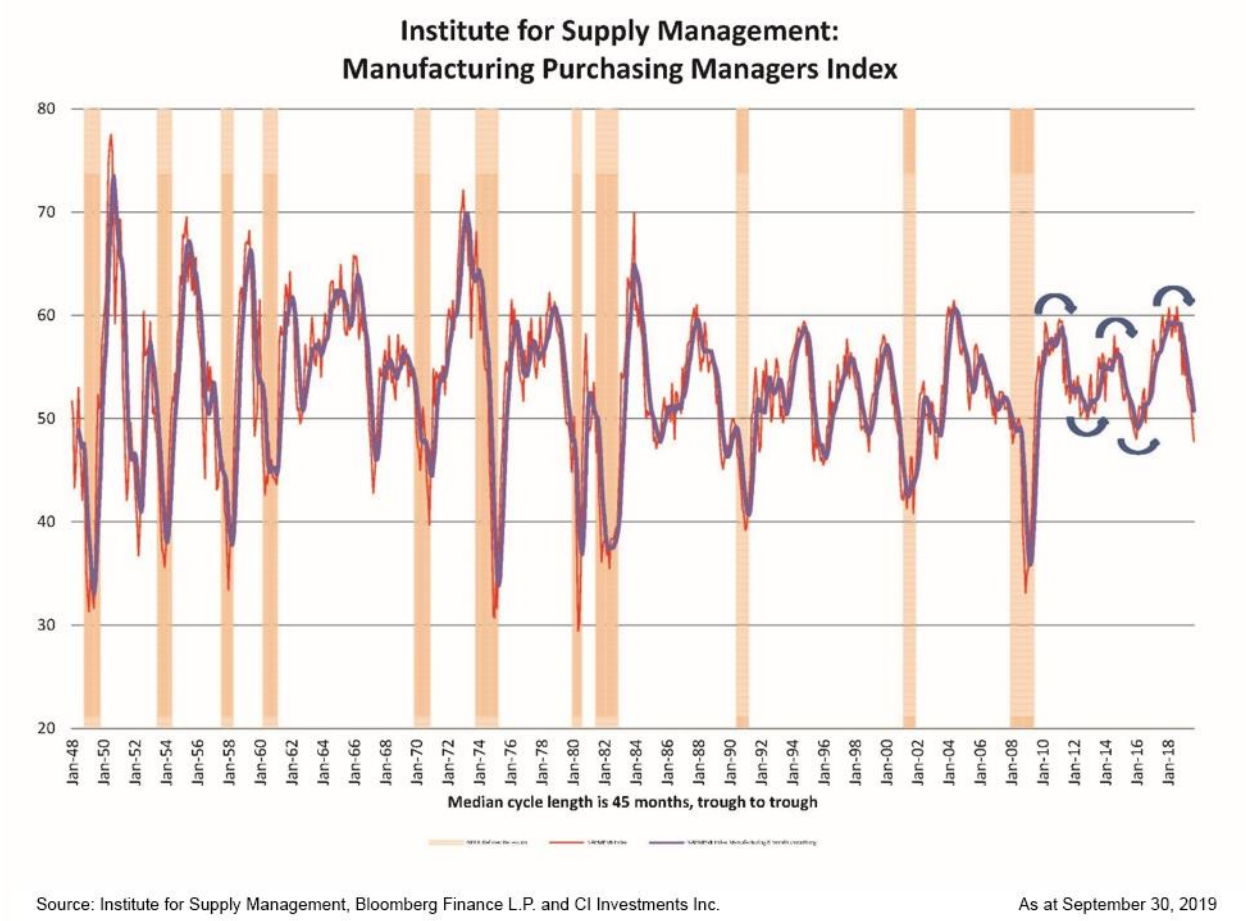
It can help to smooth noisy data series to see if you can establish trends. I used a six-month smoothing of the three-month rate of change for manufacturing and industrial production and I think there are signals. The industrial data series tend to lead the survey results. This makes

sense, as the surveys reflect an organization's response to recent activity. In the last manufacturing downturn, the hard data led the survey. It appears to be leading again. Industrial production turned upwards over the summer.



Sources: Institute for Supply Management, Federal Reserve Bank of the United States, Bloomberg Finance L.P. and CI Investments Inc. As at October 1, 2019

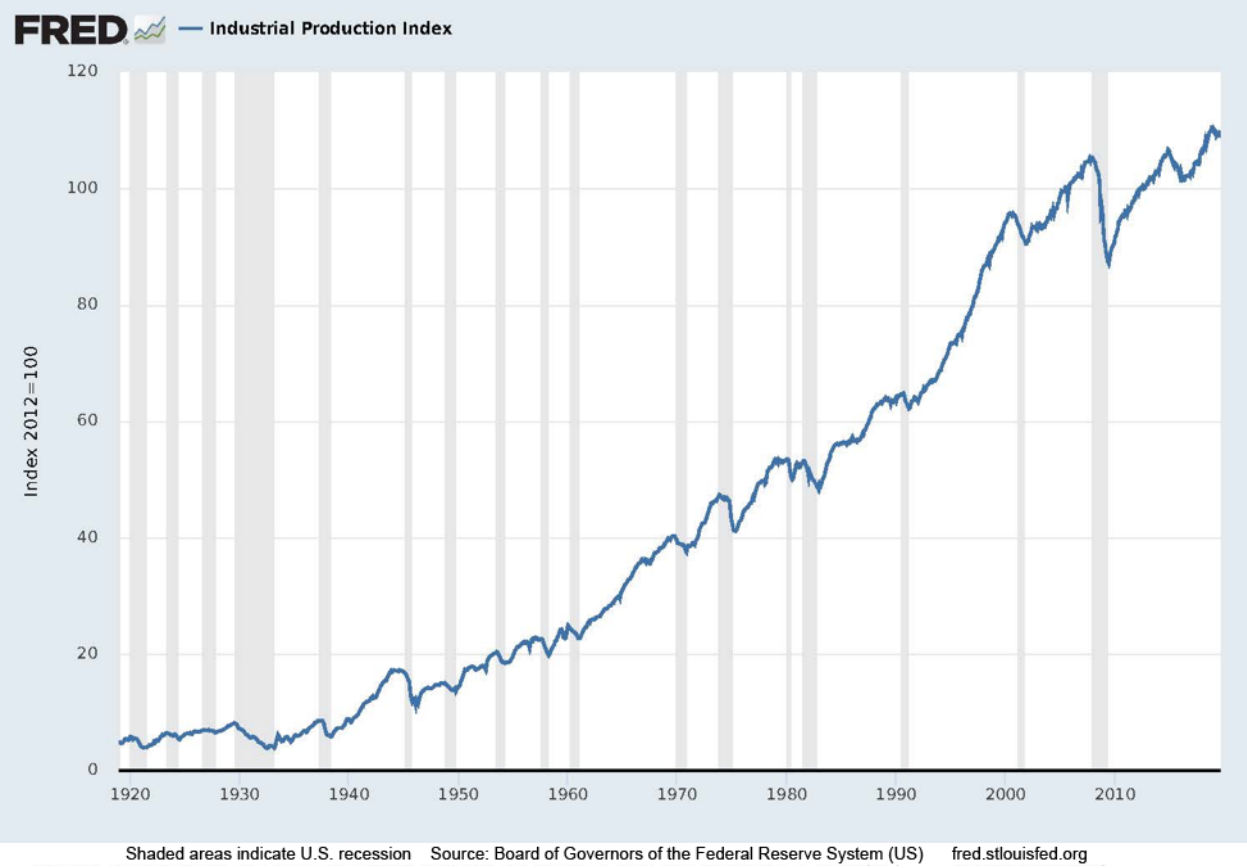
Does the ISM survey data provide accurate indication of impending recessions? I have updated my ISM chart below to include a six-month moving average (blue line). Note that it smooths peaks and troughs and has not yet broken the 50 level. Recessions are buff bands. In the 71 years of this data series there are no recessions with the ISM Manufacturing in the high 40s. Recessions occur with the ISM in the low 40s for an extended period. Prints around 42 are needed to confirm that the U.S. is in recession. While it is possible that the current uncertainty around trade policy will pull the ISM survey down, actual activity is going the other direction. I would look for the ISM surveys to stabilize rather than deteriorate further.



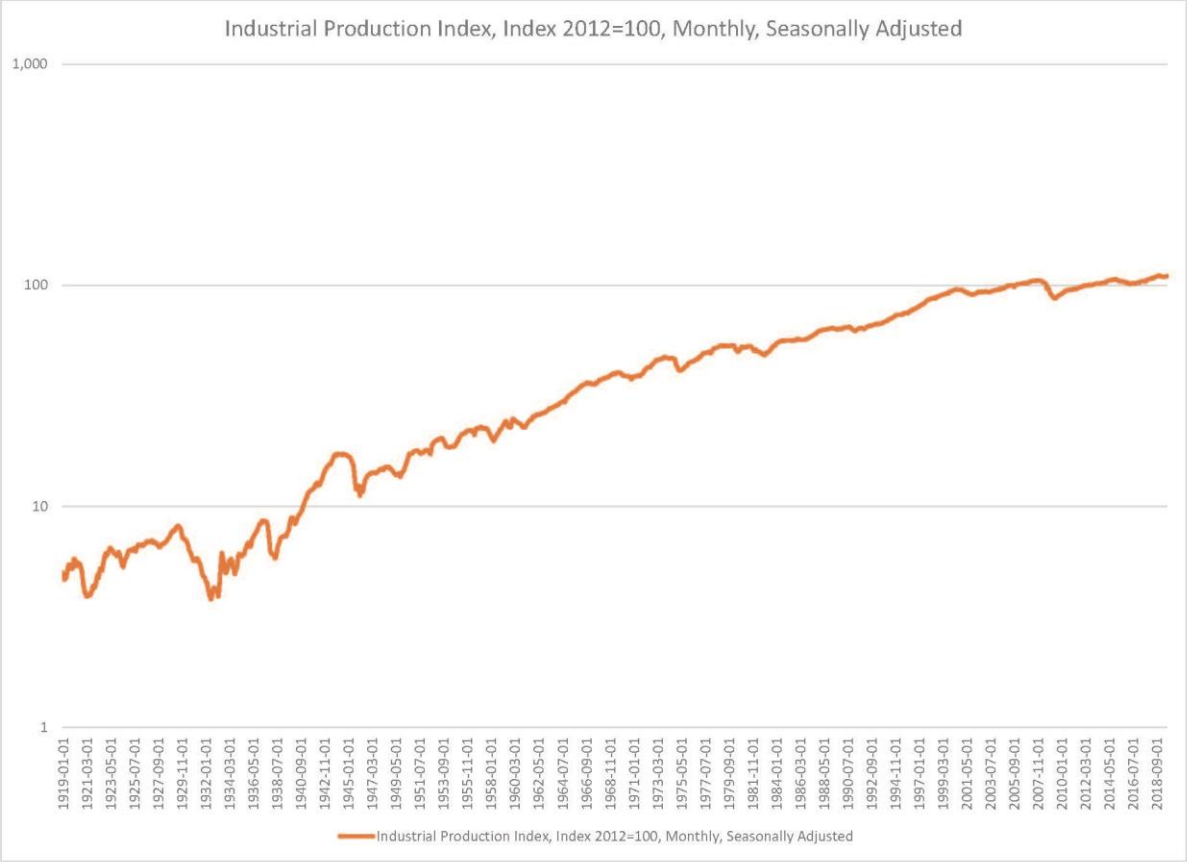
Source: Institute for Supply Management, Bloomberg Finance L.P. and CI Investments Inc.

As at September 30, 2019

Manufacturing's share of the total economy has been in structural decline for decades. Most recently it has been around 11%. Its influence is in structural decline. One chart that I did find shows total output. It is at very close to record levels despite having slowed during this ISM downturn. Note that the production decline is much less pronounced than in the 2015/16 downturn. That was a manufacturing recession that did not drag the total economy into recession.

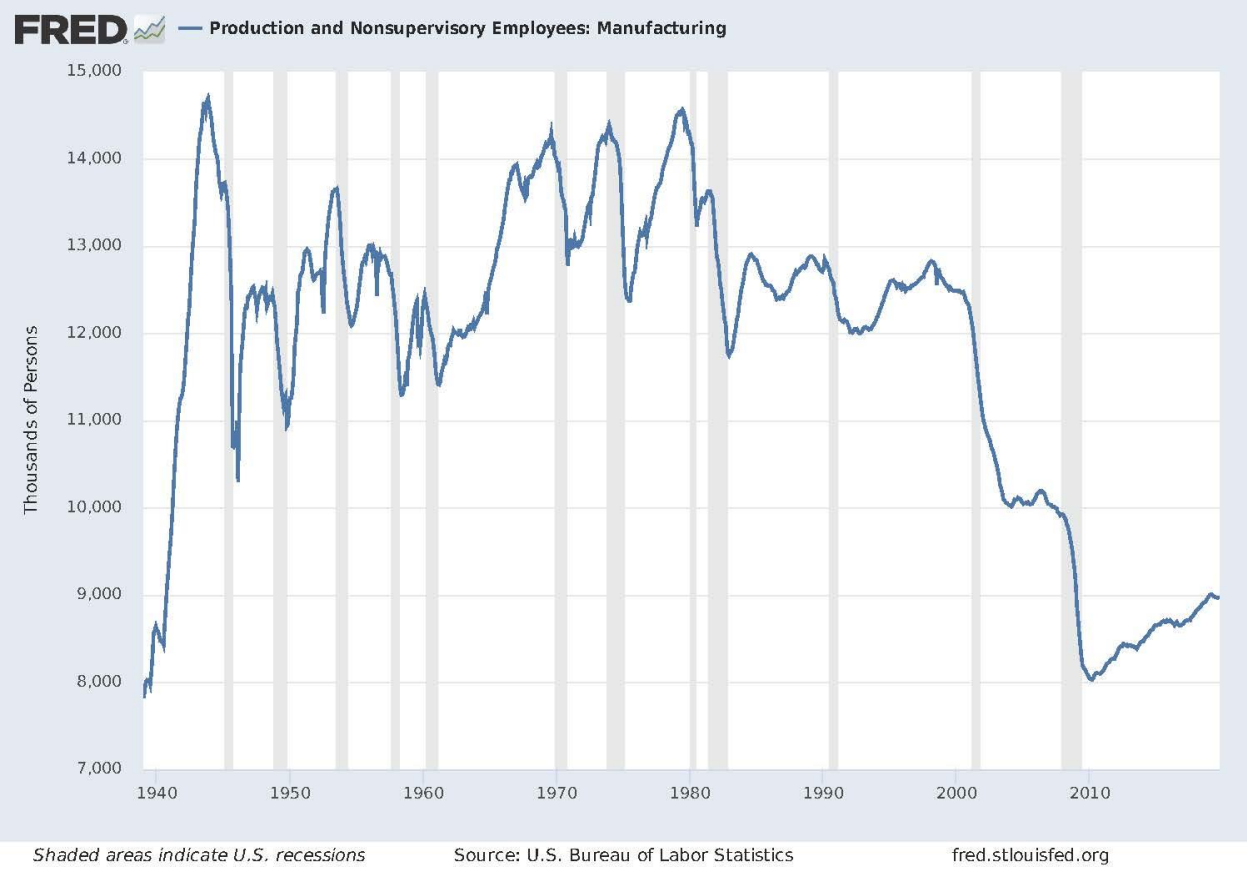


Note that this chart is not log scale, so it makes current-period activity look more severe than earlier periods. I downloaded the data and redid the chart in log scale. A very different chart! Industrial production is much smoother in the modern era. There is a lesson in this; for very long-data series you should always use log scale to retain proportions.

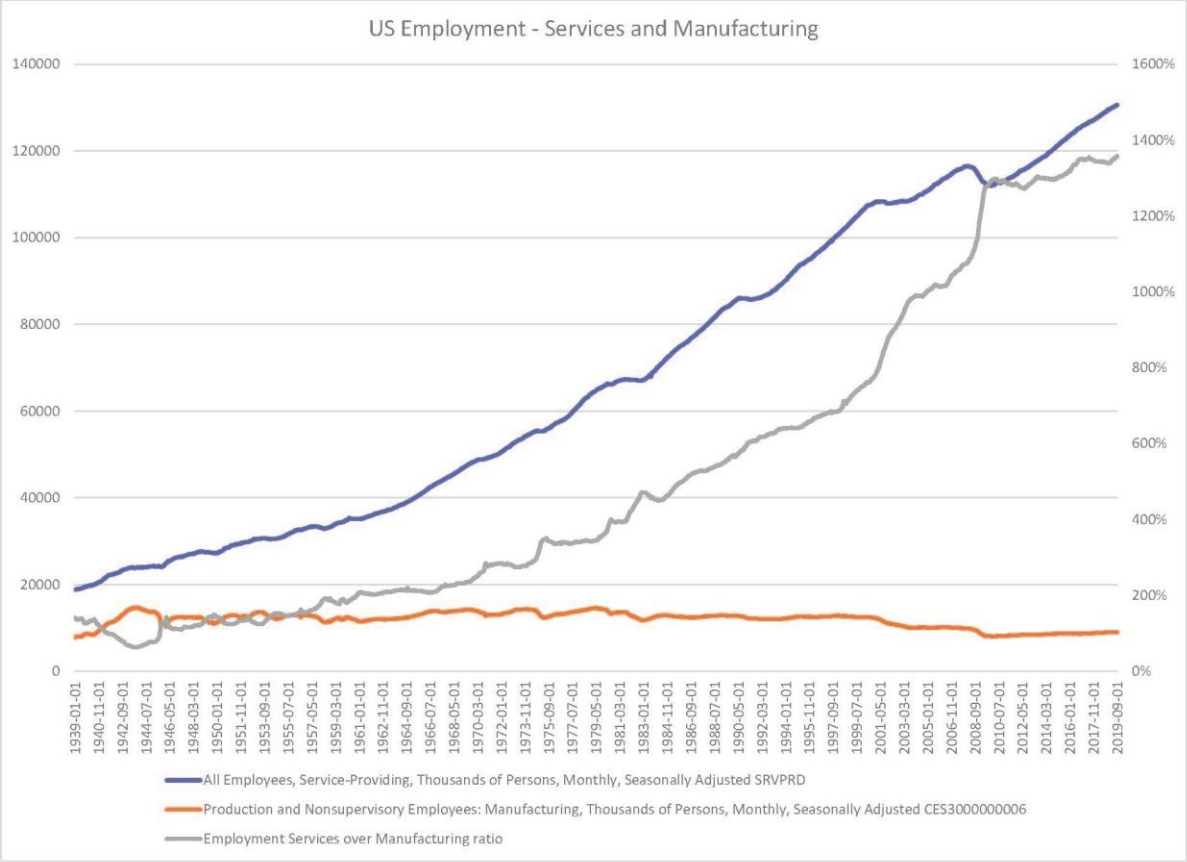


Sources: Bureau of Economic Analysis and CI Investments Inc. As at August, 2019

I also looked at employment. The number of production and non-supervisory employees in manufacturing peaked in November 1943. A peak that was again reached in 1969, 1973 and 1979. Since 1979 manufacturing employment has been in structural decline, with 14.5 million employees declining to 9 million, while output has more than doubled. There is nothing the politicians can do about this. The assembly line for manufactured goods has structurally changed.

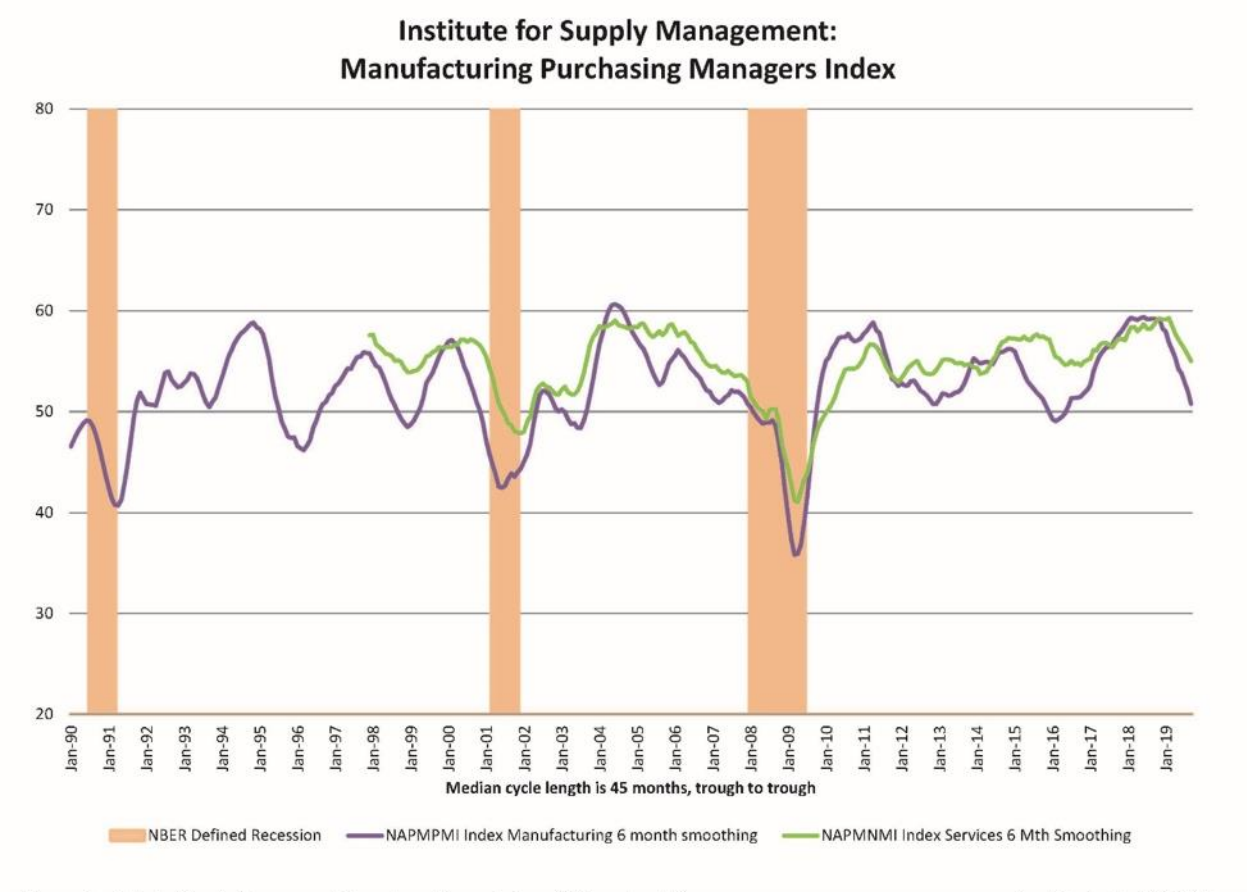


The next chart shows U.S. employment in services versus manufacturing. Both retained a similar share of the work force until the mid-1950s. Since then, employment in services has been in a secular uptrend. It has been affected by manufacturing downturns, but to a much lesser degree as time passed. The grey line on this chart is the ratio of services to manufacturing. Services employment was 140% of manufacturing in 1939 when the data starts. It is now pushing 1,400%. I think this is a trend.



Sources: Federal Reserve Bank of St. Louis and CI Investments Inc. As at September 2019

The economy is in structural change. Why do stock market investors anguish over the direction of Manufacturing PMIs? Services employment tends to be very widely distributed while manufacturing employment is more concentrated and cyclical. Ultimately, services PMIs will tend to follow manufacturing as there is a knock-on effect as manufacturing employment declines. The following chart looks at the manufacturing PMI since January 1990 with services starting in July 1997. In both cases I have used a six-month smoothing to block-out some of the noise.



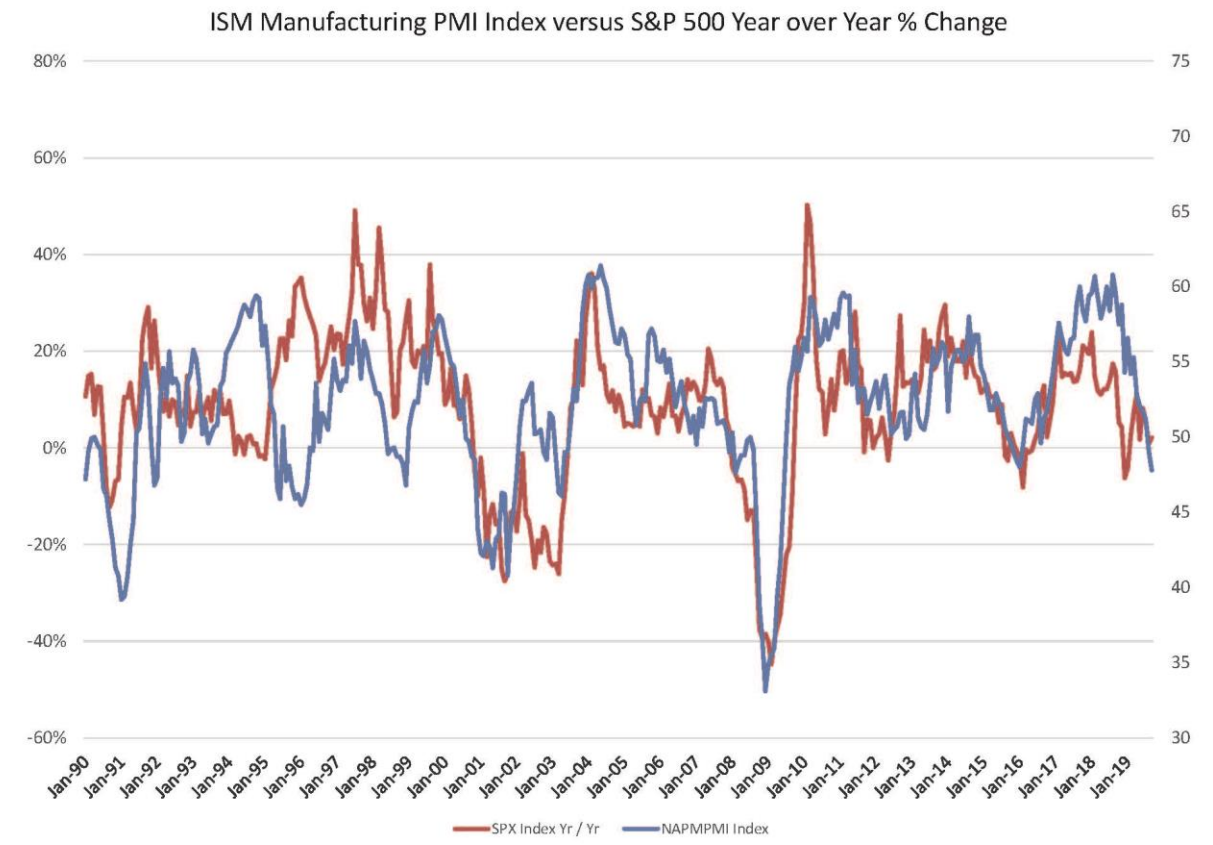
Source: Institute for Supply Management, Bloomberg Finance L.P. and CI Investments Inc. As at September 30, 2019

Both manufacturing and services PMIs are in a down trend, but neither is at a level that indicates material risk of recession. Regardless of whether there is risk of recession, the earnings of the companies that comprise the S&P 500 Index follow the ISM Manufacturing PMI directionally. Since earnings are reported on a quarterly basis I have used a three-month smoothing for the PMI.

Source: Bloomberg Finance L.P. and CI investments Inc.

As at September 30, 2019

It is premature to suggest that earnings are about to recover. Every turn in earnings takes time for a bottom or trough to form. Third quarter 2019 reporting season is just starting. Reported earnings for many index members will be affected by the economic uncertainty that comes with the deterioration in sentiment and is amplified by the constant barrage of news/noise concerning the U.S.-China trade dispute. Why is this important? Because the stock market ultimately follows earnings and earnings follow the PMIs.

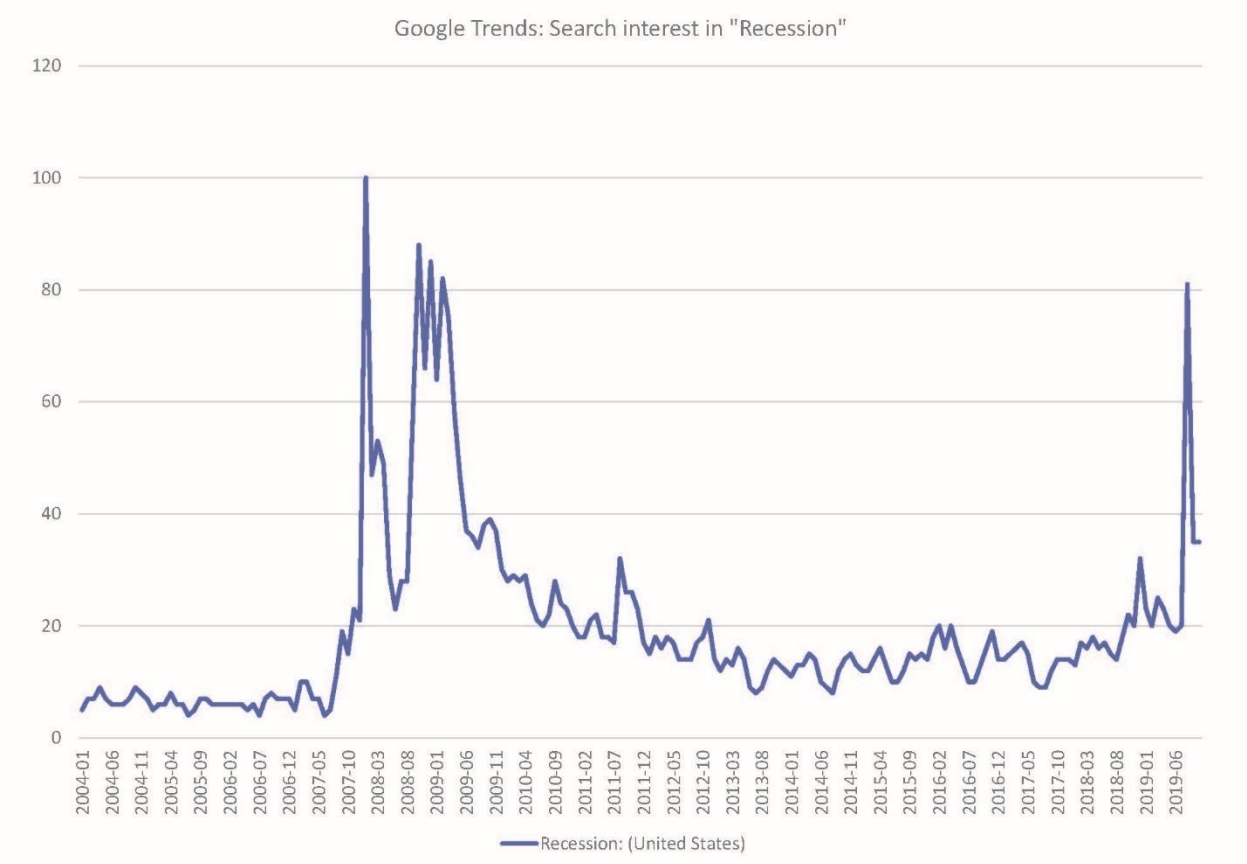


Sources: National Association of Purchasing Managers, Bloomberg Finance L.P. and CI Investments Inc. As of September 30, 2019

I wouldn't rush out today to spend my cash reserves. I'd give reporting season some time to see if there is any positive earnings momentum. But I'd also be prepared for one of Stocky's (my nickname for the economy's hyper-active pet, Stock Market) periodic panics and be ready to allocate capital for a turn in the cycle. My personal view is that this will be the third manufacturing cycle within a much longer economic cycle.

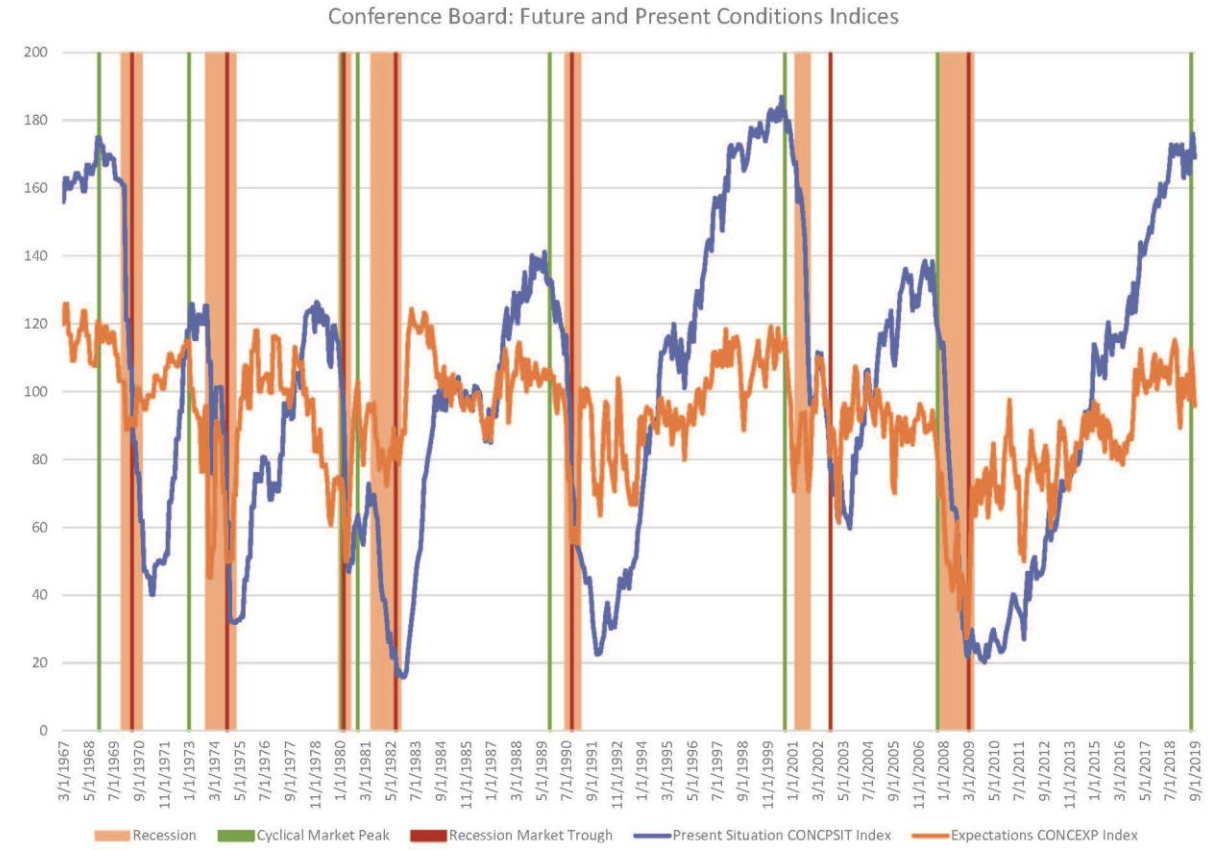
The key ISM internal data points to watch are inventory levels, which are still too high, and new orders. New orders and new export orders were very weak in September. These series will take time to turn. If you look at the chart above, you will see that at inflection points, the blue line, Manufacturing PMI, tends to lead the red line, the S&P 500 Index year-over-year change. Investors should have time to see this work out over the next few months. They should also be prepared to act if and when Stocky panics.

There are issues that worry me. A recent spike in recession searches shows up in Google Trends. They spiked in January 2008 as the U.S. entered recession and they have spiked again in August 2019.



Sources: Google Trends and CI Investments Inc. As at October 2019

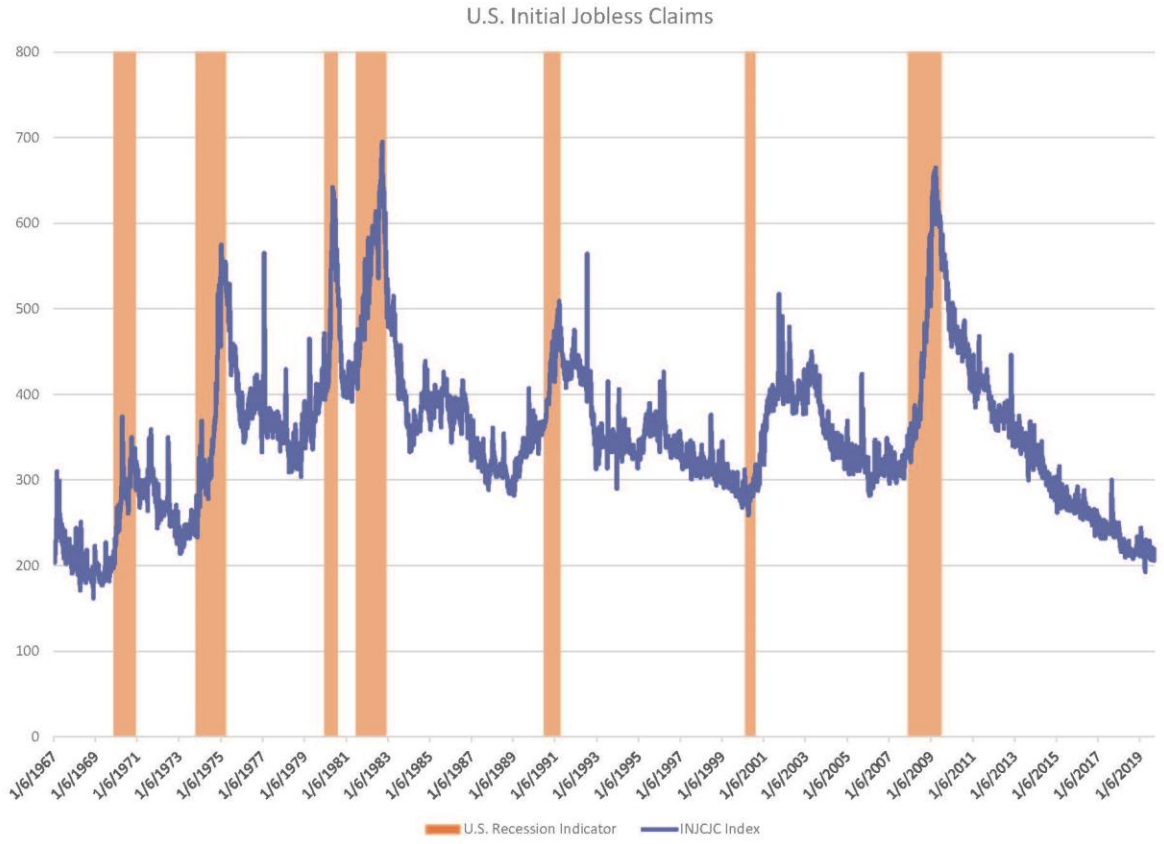
A consumer worried about recession is very likely a consumer who is losing confidence in their future conditions. The Conference Board's Present Situation and Expectations Indices are at elevated levels. The green bars on this chart indicate cyclical market peaks. They invariably occur at inflection points where the consumer is losing confidence. Watch the expectations index closely.



Sources: Conference Board, Bloomberg Finance L.P. and CI Investments Inc.

As at September, 2019

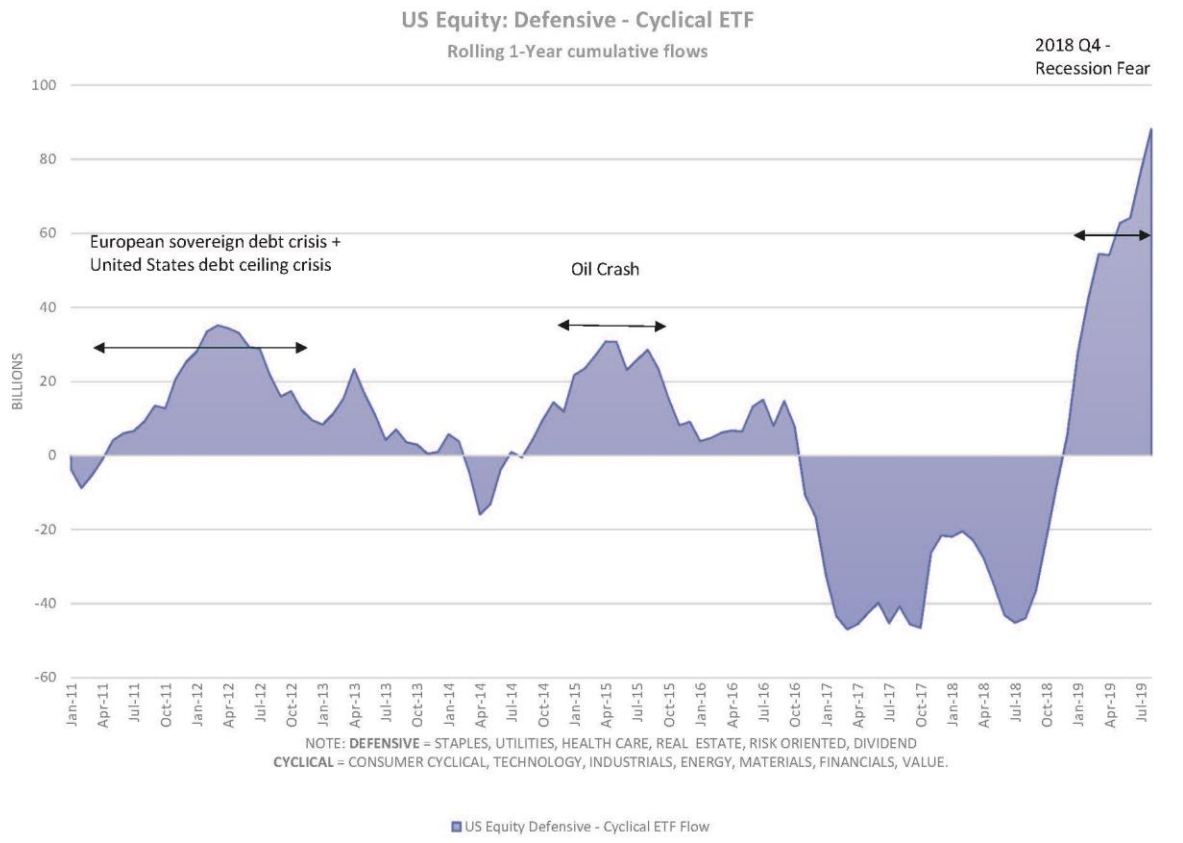
Consumer confidence is also very closely tied to initial jobless claims. They are at levels last seen in the late 1960s, levels last seen in a population a third smaller than today.



Sources: National Bureau of Economic Research, U.S. Department of Labour, Bloomberg Finance L.P. and CI Investments Inc. As at October 4, 2019

Unfortunately, confidence falls rapidly, and jobless claims rise rapidly as the country enters an economic downturn. I am not by nature a pessimist, but I worry that it will be hard to sustain current levels of confidence.

A year ago, my advice was to prepare for an inverted yield curve by improving the quality of your portfolios. In the equity portfolio, I recommended skewing your holdings to quality and defensive sectors. This advice worked. If you look at fund flows, over $80 billion more has flowed into ETFs of defensive sectors and strategies versus cyclical and growth sectors and strategies. Prepare for this trade to reverse.

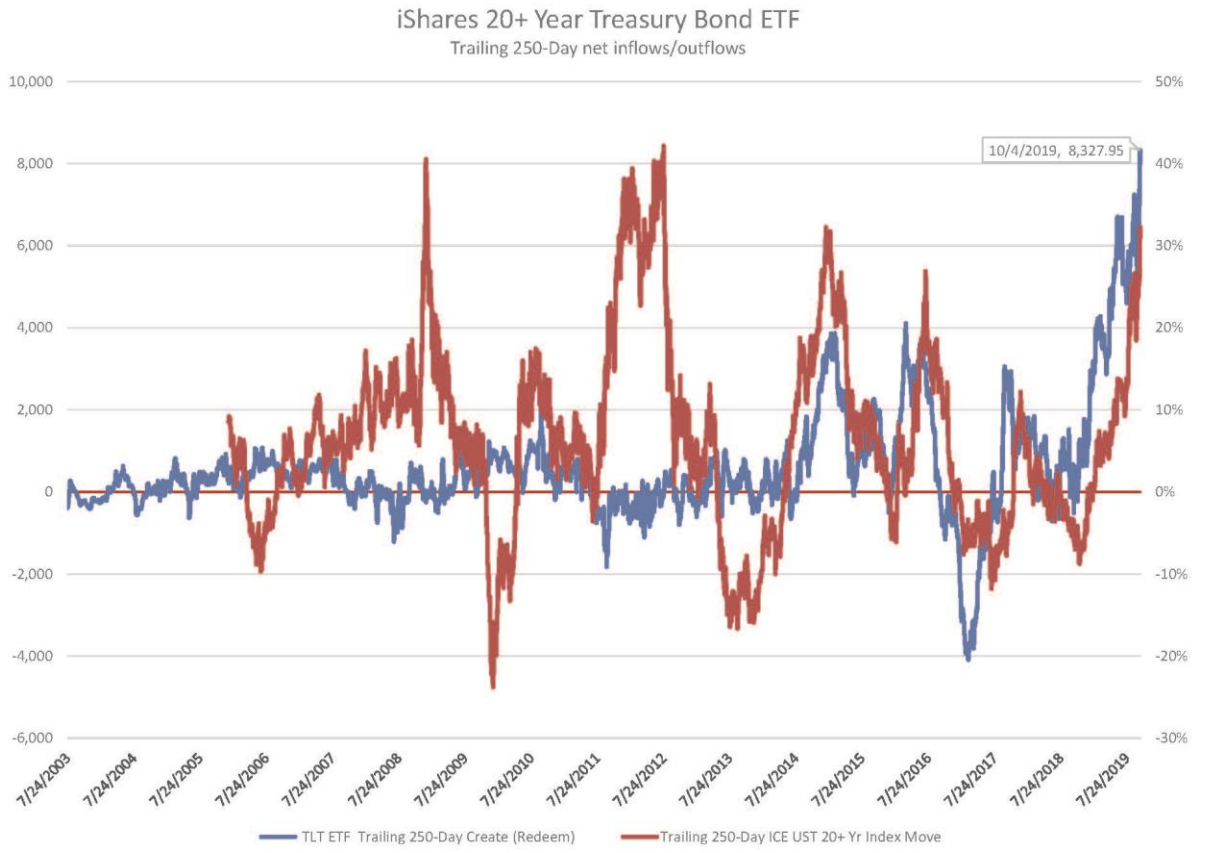


Source: Morningstar Research Inc., CI Investments Inc. As at August 31, 2019

I also pointed out that inversions of the yield curve invariably happen when long-term interest rates fall, and recommended adding duration to your portfolios to help mitigate equity risk and profit from falling long-term interest rates. This advice worked.

If you added duration you are part of a very popular trade. Over the past year the iShares 20+ Year Bond ETF has vacuumed up over $8 billion, $1 billion in the last 20 trading days alone (to October 8, 2019)! As the ETF has become a preferred (liquid) vehicle for adding and subtracting duration, the performance of long-duration bonds (the red line in the chart below) has become directly correlated to fund flows (blue line in the chart below) into and out of the ETF, which was up over 30% over the past 250 trading days. Fade the move, shorten duration. Your risk-reward is now asymmetrical. A 50-basis point move up in yields for the 30-year Treasury bond would generate a capital loss of 9.7% from the current yield of 2.08% (this bond yielded over

3% in March). This loss would be equivalent to over four years of income. If we are not going into recession, consider going back into short duration high yield and better-quality BBB-rated bonds.

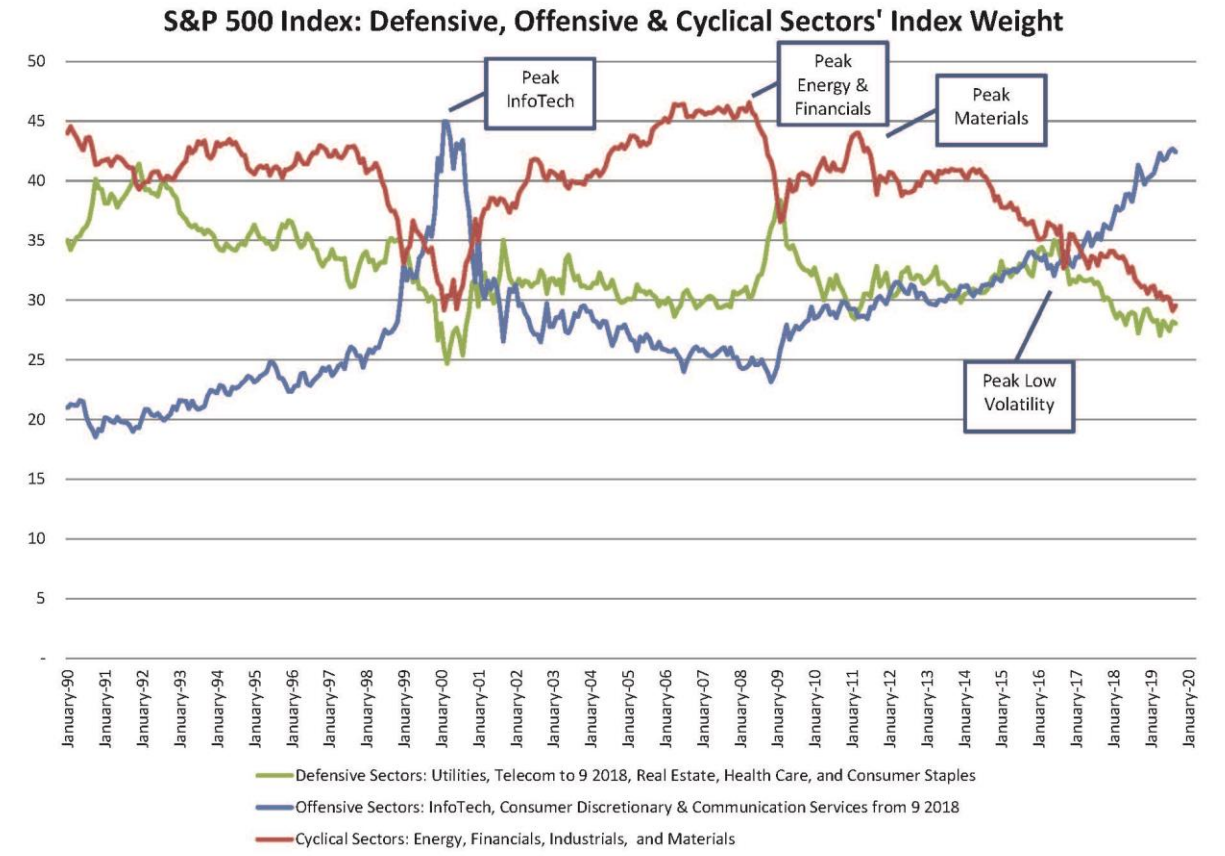


Sources: Bloomberg Finance L.P. and CI Investments Inc. As at October 8, 2019

I pointed out last year that floating-rate debt makes no sense when short rates stop rising and credit quality for these loans can be weak. You don't want to hold that asset class through an easing cycle. This advice worked. Holders of floating-rate debt have been treading water over the last year. The large Invesco Senior Loan ETF (ticker BKLN) returned around 2% while shedding a third of its capitalization (-$2.7 billion). If they had been forced to sell into a severely weakening credit environment the returns could have been much worse. I'd continue to be a seller of this asset class. We still do not know the outcome for this easing cycle: soft landing or recession.

I also pointed out that interest rate spreads typically begin to widen on weaker quality bonds as the economy slows. So far spreads have been quite orderly. Credit markets seem to be worried about company-specific default risk rather than cyclical default risk.

I have less conviction today. The reasons for becoming cautious in 2018 have not gone away. If you added defensive sectors to your portfolio a year ago you have been well rewarded. I would be taking profits on consumer staples, utilities, REITs and volatility targeting portfolios (low volatility). The money flow into the defensive sectors has been extreme. These are not cheap sectors with a strong growth profile. They are slow growth and expensive. I'd look to redeploy that capital into sectors that will benefit as the cycle turns positive. At this point, I suggest looking for companies with strong balance sheets and well-covered dividends in the traditional cyclical sectors. I'd continue with appropriately valued new economy companies, but would steer clear of the high valuation concept stocks. This involves selling what has been hot and buying "under-performing" companies.



Sources: Bloomberg Finance L.P. and CI Investments Inc. As at September 30, 2019

The cyclical sectors have as low a weight in the S&P 500 Index as they had at the peak of the Tech Bubble. They are under-owned. I am not a fan of energy and materials but feel the revulsion for industrials – and especially financials – is overdone.

My tactical cash is typically 5-10% of portfolio. It is currently at the high end of the range. I bought the December sell-off and took some profits in early May. I did not buy the August sell-off. The ISM deterioration needed more time to play out. I am of the view that the outcome for this soft patch will be a soft landing and re-acceleration.

I've noted above where I'd be looking: quality companies in little loved areas of the market. I made my reputation doing exactly that the last time the market sector weights were as aggressively skewed as they are today, 19 years ago as the tech bubble was peaking. After years

of passively chasing the winning companies and sectors, the market has become lopsided. It always normalizes when new sectors and companies start performing. The money flow should move to the new leaders. The new leaders will have a materially lower index weight than the old leaders. I have yet to find a cycle where the old leadership leads yet again. Active management wins when markets are in transition. Indexing was a world of pain for years after the market was this lopsided 20 years ago. Have your shopping list ready for when Stocky next panics. He will.

Sources: Bloomberg Finance L.P., Morningstar Research Inc. and CI Investments Inc., as at October 9, 2019.

IMPORTANT DISCLAIMERS

applicable law, it is not undertaken, and specifically disclaimed that there is any intention or obligation to update or revise FLS, whether as a result of new information, future events or otherwise.

Published October 18, 2019.