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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index (SPX) generated a lot of noise this week as it jumped upward on news that the additional tariffs on just about everything from China were going to be only on about half of those imports. Then, after after the major media outlets ran headlines recognizing the significance of degree the yield curve had inverted, plunged about 3% on Wednesday. Friday, as Walmart came through with increased sales, the Index climbed part way out of the hole to close out the week at 2888.68, down just over 1% for the week. Over the last two weeks, despite all the headlines, the SPX has only lost about 1.5% and is down about 4.6% from its all-time high. Very notably though, at its current level, the stock market is a bit lower than it was last September and about where it was in January of 2018.

The U.S. Treasury 10-year note closed out the week yielding 1.557%, having lost almost a third of a point in a week. With the 90-day T-bill yielding 1.89%, the Treasury yield curve has gone from slightly inverted to very substantially so. Of more concern to economists and investors, the 30-year Treasury bond yield declined below 2% for the first time in its history to close the week at 1.97%, yielding about the same rate as the 1-month T-bill. West Texas Intermediate Crude Oil (WTI) largely followed the stock market for the week but had a better recovery at the end and was up 1.18% at $54.91. It remains down nearly 17% from a year ago on forecasts of weaker global demand.

The Economy

There were three stories in the U.S. economy this week and together they provide a prime example of classic cyclical macroeconomics. The first is the rather dramatic increase in the Treasury yield curve inversion. The bond market is to the economy and stock market as a barometer is to hurricanes. Inversions are a reliable forecast of future economic slowdowns, but those slowdowns may or may not be severe and they, like hurricanes may mostly hit somewhere else. On the other hand, a severe and prolonged inversion strongly suggests that the probabilities are high that one is about to experience some very unpleasant and potentially damaging economic weather. Different forecasting models are putting the chances of a recession at varying levels, but all agree the risk is very real.

The second story is to be found in manufacturing. Most goods sold in the U.S. are still made here and U.S. manufacturing output is reported to have fallen 0.4% in July. Manufacturing output is a leading indicator and the persistent fall in that metric this year is another indicator that the upstream end of the supply chain is slowing down. That slowdown may not show in end-user purchases for several months, but manufacturers are very responsive to orders from the companies that ultimately sell to the public. Still, the ISM factory activity index only fell to 51.2 in July, indicating some growth is still happening.

The third story is consumer activity, and that is a lagging number as consumers tend to keep spending for several months after the rest of the economy peaks. Retail sales jumped upward by 0.7% in July. The contrast between consumer purchases and all the other data was initially confusing, then the University of Michigan Index of Consumer Sentiment for August dropped from last month's 98.4 to 92.1. Respondents to the survey indicated they were on a spending spree to purchase consumer goods before the tariffs hit and raised prices. They also were more concerned about the future than they have been previously. The index measuring consumer's future expectations dropped to 82.3.

Stock analysts are collectively forecasting a significant slowing in corporate earnings. At the beginning of 2019, the consensus was for a 10% earnings growth, but that consensus has now downshifted to 1.5% for the calendar year. Meanwhile, Germany appears to be on the verge of entering a recession as its export-driven economy is impacted by U.S. tariffs and Great Britain appears to be on course for a "no-deal" Brexit that has the potential to have a negative impact on everyone concerned.

Taken together, the available data suggest that the trade-war the U.S. is waging with much of the rest of the world has a high potential to create both a domestic and global recession sometime in the next 12-18 months that could be exacerbated by parallel developments globally. Recessions are normally preceded by bear markets, so be prepared for a bumpy ride. The good news is that this is looking very much like a classic lead up to a normal cyclical recession and such events are normally followed by healthy rebounds.

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