Five Slides Investors Should be Watching

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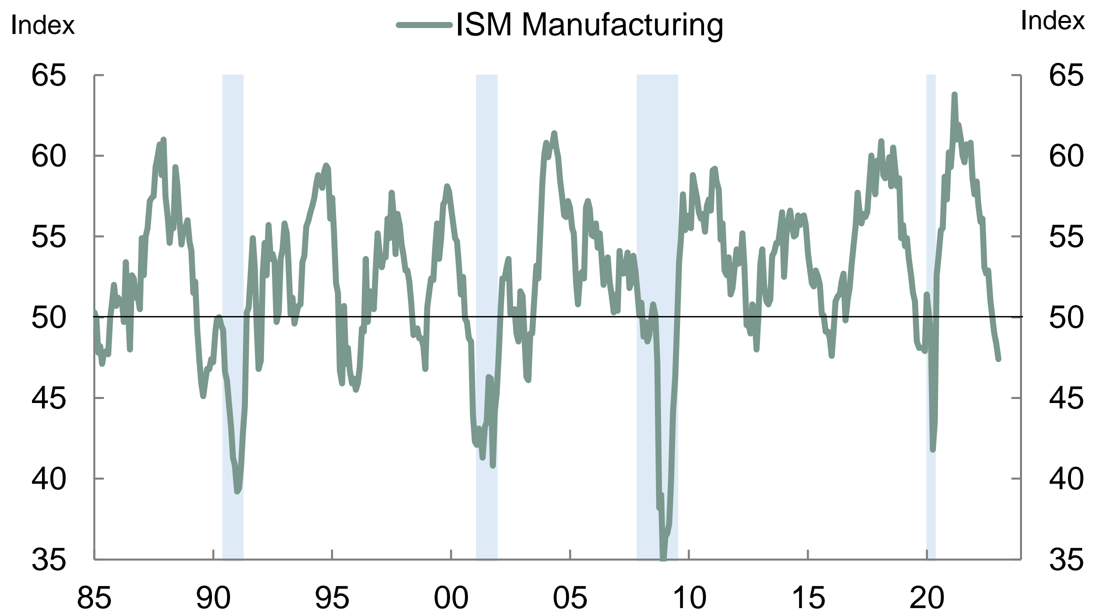
Three Months of Contraction With Possibly More in Store

The factory sector is highly cyclical which means that it leads the underlying trend in real GDP growth. Troublingly, the ISM manufacturing survey has contracted for three months in a row, which is never a good sign. Furthermore, the latest Philadelphia Fed Survey suggests that a fourth consecutive sub-50 reading is possible. As long as ISM manufacturing remains below 50, the broader economy is at risk for recession especially with the Fed still raising interest rates. Normally, when the ISM contracts, the Fed cuts rates!



Source: Institute for Supply Management, Haver, SMBC Nikko

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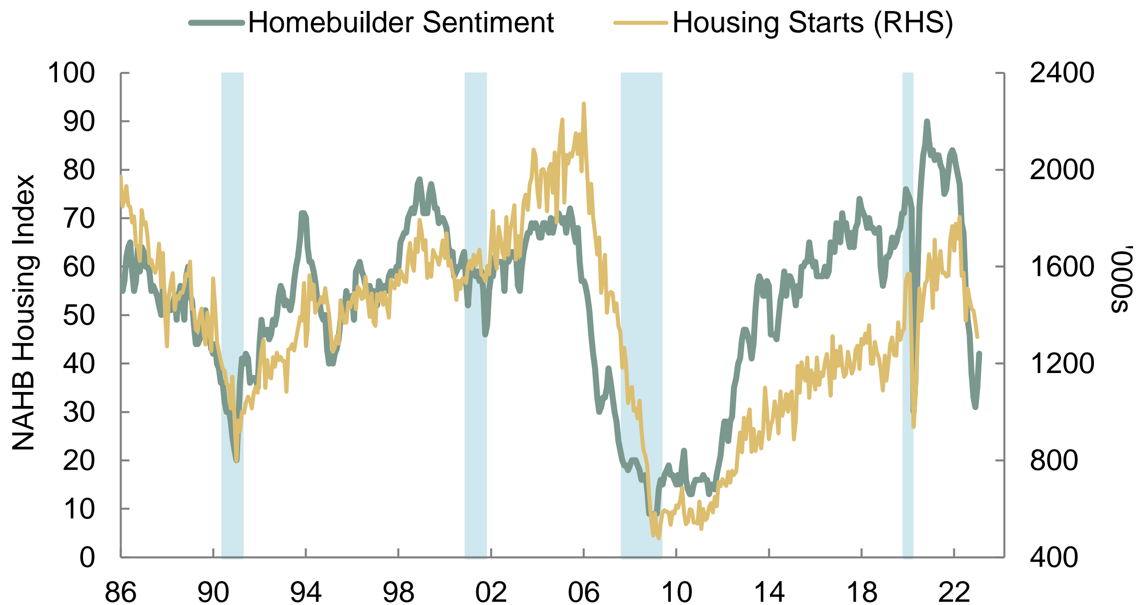
A Bounce That May Not Last

Homebuilders' sentiment rose in February for the second month in a row, but this was after a record large drop over the previous 12 months. Meanwhile, housing starts remain in freefall, down 21% from January 2022. Since nearly every past recession was preceded by a collapse in housing, the sector needs to quickly rebound to avoid a hard landing. But with mortgage rates still well above last year's low, a sustained improvement in residential real estate remains doubtful. This weakness could eventually spill over into the labor market.



Source: NAHB, Census, Haver, SMBC Nikko

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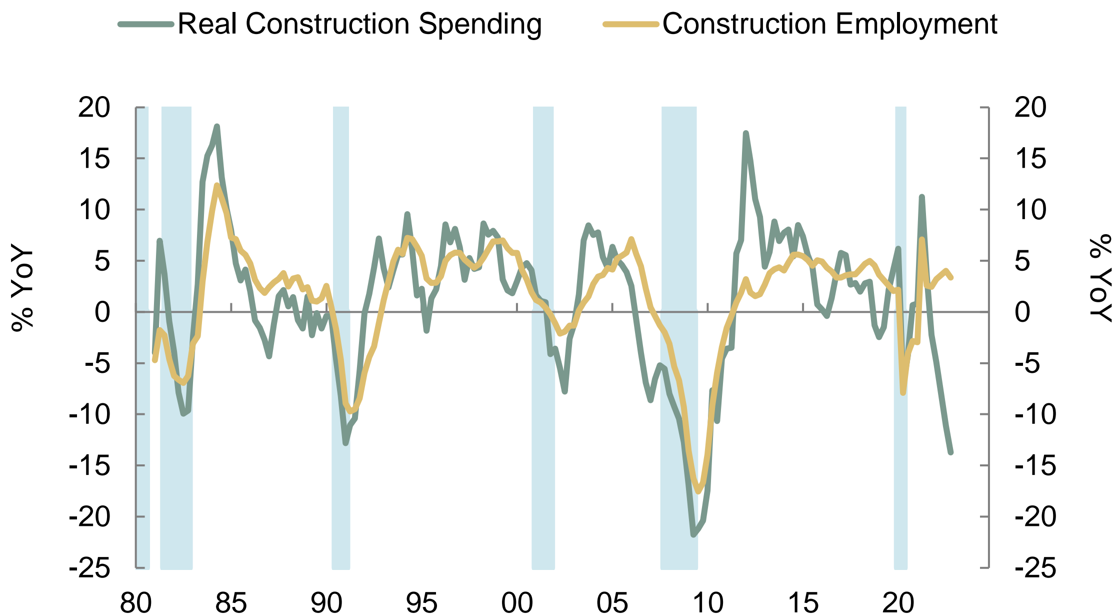
Tight Now But For How Long?

Despite the ongoing weakness in housing activity, overall construction employment continues to expand as the sector made a new high last month. This is highly unusual because there is now a record large gap between inflation-adjusted construction spending and total construction employment. Past disparity was always resolved with employment declining to meet demand. If this happens again, the labor market will lose over 700k construction jobs, enough to push the unemployment rate up nearly half a percent. But given construction's large multiplier, the ultimate negative impact on the labor market could be much bigger. The performance of overall construction sector is central to the economic outlook.



Source: BEA, BLS, Haver, SMBC Nikko

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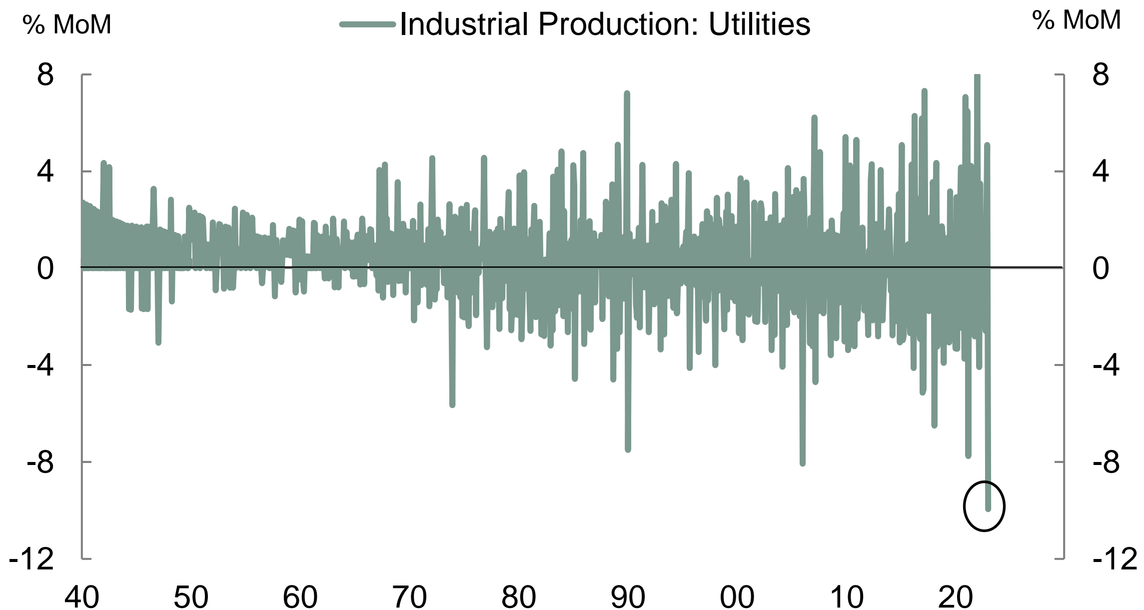
Biggest Drop Ever!

Economic activity always slows in January, the result of inclement weather and payback from the December holiday shopping season. However, many parts of the country experienced unseasonably warm weather which could have temporarily lifted the "seasonally adjusted" data. Not only may this have boosted January payrolls, but it also could have accounted for the 7% jump in January restaurant sales. More evidence of a potential positive weather-effect can be seen in the production of utilities where output of electric and gas usage fell 10%.

This was the largest monthly decline ever recorded going all the way back to 1939! If weather was the primary culprit boosting the economy, then a big payback in activity is in store.



Source: Federal Reserve, Haver, SMBC Nikko

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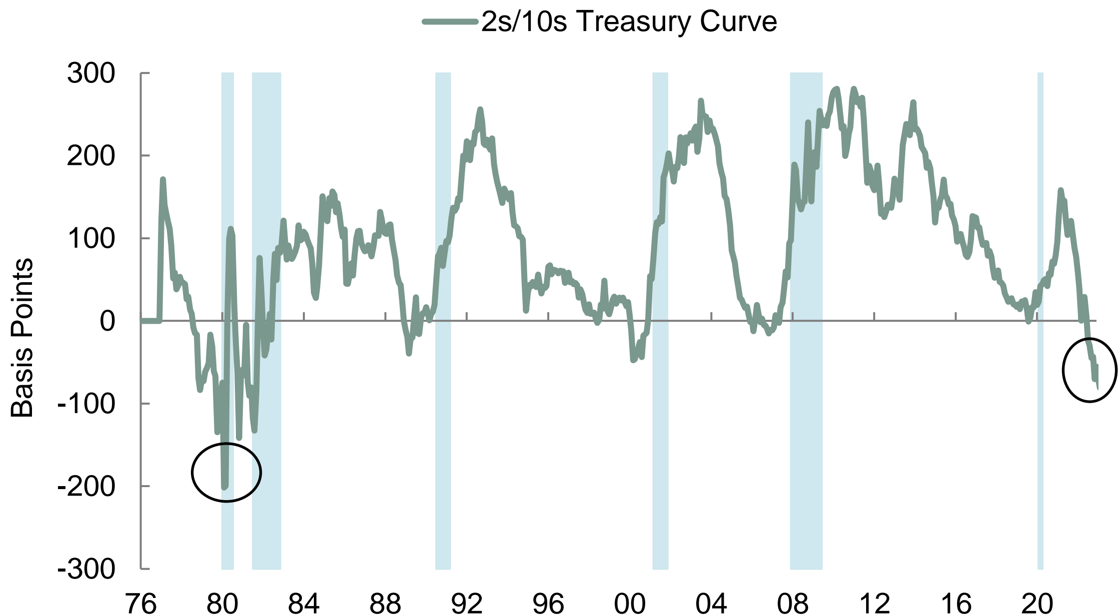
A Perfect Track Record

The yield curve has an unblemished track record predicting recessions. The spread between short- and long-term rates went negative last July and recently hit a record low. But when the level of interest rates is considered, today's inversion is even larger than the early 1980s. This is worrisome because an inverted curve dampens credit creation, the result of banks borrowing short to lend long. Last quarter, the Fed's Senior Loan Officer Survey showed recession-like readings in bank lending standards for consumer, commercial real estate and commercia/industrial loans, never a good sign. The inverted yield curve is troubling so the sooner the curve normalizes the better. Stay tuned because the economy is not out of the wood yet.



Source: Federal Reserve, Haver, SMBC Nikko

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