Five Slides Investors Should be Watching

Joe Lavorgna
Chief US Economist
SMBC Nikko

(212) 610-1741
joseph.lavorgna@smbcnikko-si.com
February 17, 2023
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
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
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
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
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
Disclaimer

This presentation is for discussion purposes only and is not intended to be an offer to sell or the solicitation of an offer to buy any securities, or any commitment to underwrite, subscribe for or place any securities, is not an offer or commitment to provide any financing or extension of credit or service, and does not contain any tax or legal advice. This presentation has been prepared by SMBC Group (which may include, collectively or individually, any of the following entities in the Americas Division: Sumitomo Mitsui Banking Corporation ("SMBC"), SMBC Nikko Securities America, Inc. ("SMBC Nikko"), SMBC Nikko Securities Canada, Ltd. ("Nikko Canada"), SMBC Capital Markets, Inc. ("SMBC-CM"), SMBC Leasing and Finance, Inc., JRI America, Inc., and SMBC Rail Services LLC) and is being furnished by SMBC Group solely for use by the client or potential client to whom such materials are directly addressed and delivered. This presentation is confidential, and is the property of SMBC Group subject to copyright. Any reproduction of this presentation, in whole or in part, is prohibited, and you may not release these materials to any person, except to your advisors and professionals to assist you in evaluating these materials, provided that they are obligated, by law or agreement, to keep the presentation confidential. These materials do not constitute research, a recommendation or an offer or solicitation to any person to enter into any transaction or adopt any hedging, trading or investment strategy. Prior to participating in any such transaction, you should consult your own independent, competent, legal, tax, accounting and other professional advisors.

In preparing this presentation, SMBC Group has relied upon information available from third parties, including public sources, and we have assumed, without independent verification, the accuracy and completeness of such information. Specific prices, indices or measures, including ranges, listed in this document were prepared at the time the document was prepared, and are subject to change without notice. SMBC Group makes no representations to and does not warrant this presentation's accuracy or completeness. SMBC Group expressly disclaims any liability for any use of the information set forth herein, including, without limitation, any use of the information set forth herein in the preparation of financial statements or accounting material.

These materials may contain forward looking statements, which may include projections, forecasts, income estimates, yield or return, future performance targets or similar analysis. These forward looking statements are based upon certain assumptions. All forward looking statements are based upon currently available information and SMBC Group is not obligated to provide an update. Actual events may differ from those assumptions. Opinions, projections, price/yield information and estimates are subject to change without notice. There can be no assurance that estimated returns or projections will be realized, that forward looking statements will materialize or that actual results will not be materially lower than those presented. Past performance is not necessarily indicative of future results. Any transactions or strategies addressed may not be suitable for all parties. The value, price or income from transactions or strategies may fall as well as rise. SMBC Group or an affiliate may have a position in any of the underlying instruments, assets, indices or rates mentioned in this document. You should make your own independent judgment or seek independent financial and tax advice with respect to any matter contained herein.

SMBC is subject to Japanese firewall regulations and therefore absent client consent, non-public client information may not be shared with SMBC Nikko Securities Inc.

SMBC Nikko is a US registered broker-dealer of SMBC Group. Nikko Canada is a US and Canadian registered broker-dealer of SMBC Group. SMBC-CM is provisionally registered as a US swap dealer with the CFTC. Capital markets and other investment banking activities for SMBC Group are performed by a combination of SMBC Nikko, Nikko Canada, SMBC Nikko Securities Inc. and SMBC-CM. Lending and other commercial banking activities are performed by SMBC and its banking affiliates. Derivative activities may be performed by SMBC-CM or SMBC. SMBC Group deal team members may also be employees of any of the foregoing entities. SMBC Group does not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with SMBC Group or for the purpose of avoiding U.S. tax-related penalties. © 2020 SMBC Group. All rights reserved.