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MACROCOSM

Recession Risk at Last?

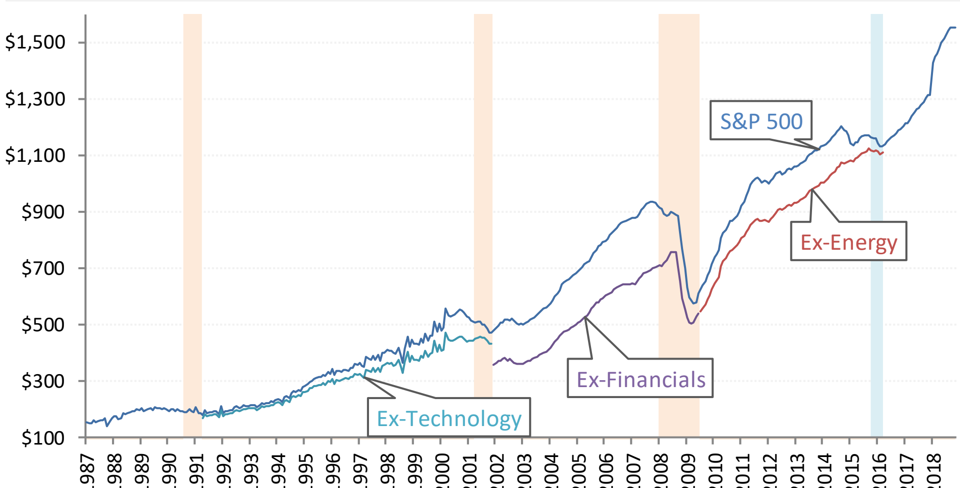
Tuesday, November 20, 2018
Donald Luskin

Here we go again. China and oil trigger an earnings decline and credit-spread breakout.

For the last two years we've fought against recession calls from our competitors and recession fears from our clients, and pushed back at all the usual recession narratives – "quantitative tightening," "excesses," "strong dollar," "sugar high," "cycle long in the tooth" and so on. We've been very right. *Now we have our own reasons and indicators that worry us. We see a situation a lot like early-2015 to early-2016, with the very same factors in play.* We went on recession-watch then (see "Houston, You're the Problem" March 9, 2015), and ultimately we were wrong in the sense that an official recession never occurred. But it was a near-miss, and stock markets and credit markets had long and deep corrections then. Indeed, we think of the period from Q4-2015 through Q1-2016 as an "undocumented" recession, which ultimately served as a "mid-cycle refresh" for the growth surge from mid-2016.

The key indicator that most gets our attention now is the decline in S&P 500 forward earnings (please see the chart below). Declines were excellent leading indicators of the official recessions of 1990-91, 2001 and 2008-09, and the "undocumented" recession of 2015-16. The present decline is brand new – the top was October 25, and we anticipated it a couple weeks before (see "One Sell-Off, So Many Causes" October 15,

S&P 500 consensus forward earnings 365-days forward
Recessions: Official Undocumented



Source: Various, TrendMacro calculations

Update to strategic view

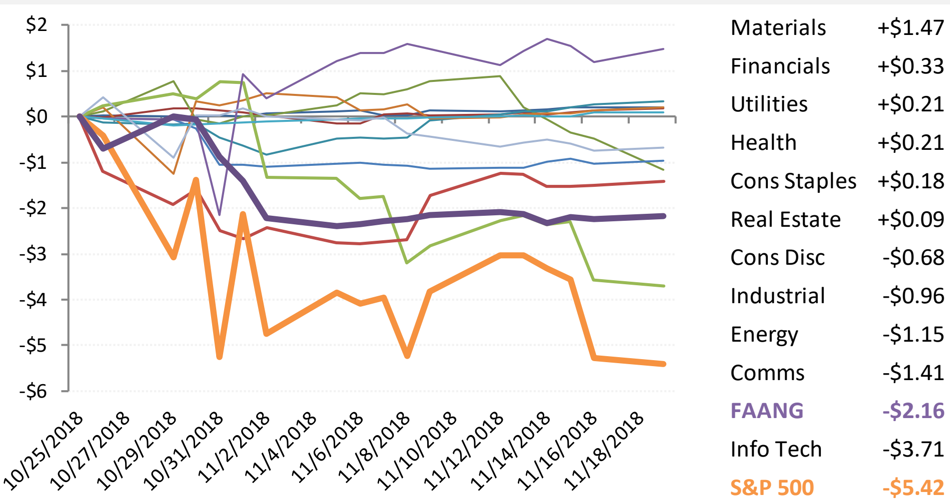
US MACRO, US STOCKS, US BONDS, ASIA MACRO, OIL: We are going on recession-watch, because of incipient weakness in our two most important leading indicators – declining S&P 500 forward earnings, and widening high-yield credit spreads. Like the last time in 2015-16, prime causes are China and oil prices. Unlike past pre-recession periods, this time there is no single sector responsible for the forward earnings decline. The China-facing Info Tech sector has been the hardest hit. High-yield spreads are dominated by the Energy sector, hit by the sharp decline since Khashoggi's death. This is not a full recession call yet, but we are at Condition Red. We hope to avoid recession, and continue to think the present equity correction is only that. Our hopes are contingent on our expectations for a "framework" for resolution to the China trade war from the Trump-Xi summit at month-end, and production cuts from OPEC.

[Strategy dashboard]

2018). So far it is barely detectable, only $5.42 billion, or 35 bp of total earnings. *<u>But it is an alarming hard-stop versus the furious pace of upgrades we've seen over the past two years, even discounting the one-time surge this January due to the effects of the corporate tax cuts enacted last December.</u>*

- This does not mean the consensus is predicting that today's earnings are "peak earnings." Indeed, the forward consensus is still almost 20% above today's trailing earnings, according to Bloomberg. So earnings are expected to grow.
- *<u>But what this does mean is that expectations for earnings 365-days forward from today are lower than expectations for earnings 365-days forward were on October 25. We believe recessions are caused by falling intermediate-term growth expectations – and confidence. Changes in forward earnings capture that, which is why they are such a good leading indicator.</u>*
- Each prior S&P 500 forward earnings decline began with sharp declines in a single sector that more than explained the overall decline. It was easy to be lulled into complacency by ignoring that sector and removing it from the calculation (again, please see the chart on the previous page). *<u>This time around, there is no single sector to blame. Forward earnings in six sectors out of eleven have continued to rise, and they've declined in five</u>* (please see that chart below).

Change in S&P 500 forward earnings from October 25 USD billions



Source: Bloomberg, TrendMacro calculations

- Information Technology is the largest contributor, and Communications Services the second-largest. But even combined the two do not fully explain the overall decline.
- While the "FAANG" stocks have corrected, as a portfolio, more than three times more than the S&P 500 overall – and, we think, the loss of the mystical faith investors had placed in them explains a lot of the present sentiment environment (again, see "One Sell-Off, So Many Causes") – their earnings decline explains less than half that

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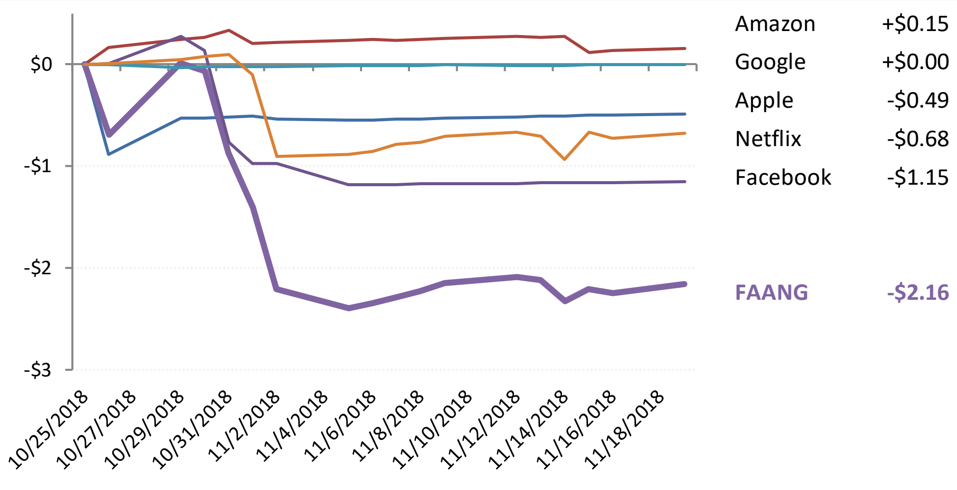
Change in S&P 500 forward earnings from October 25 USD billions



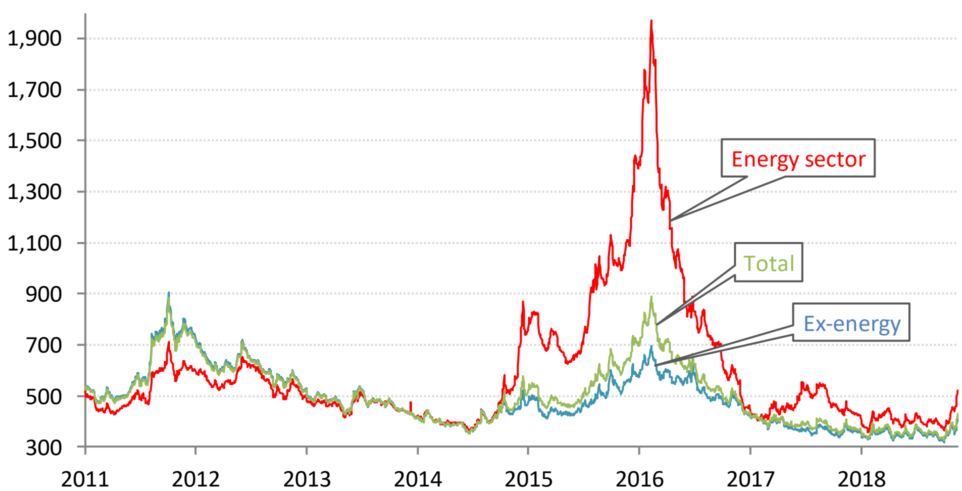
Source: Bloomberg, TrendMacro calculations

of the S&P 500. Indeed, forward earnings have declined in only three of the five FAANG stocks (please see the chart above).

- Apple, the only FAANG stock in the Info Tech sector – the largest contributor to the S&P 500's overall earnings decline – explains less than a fifth of that sector's decline.
- The earnings decline in the Info Tech sector has some very specific stories within it – such as the strange nexus between Nvidia and the suddenly no longer profitable Bitcoin mining industry. But at risk of confirmation bias, we are inclined to think that the major threat to the sector is the complex of risks arising from China – risks that won't abate until there is a resolution to the US/China trade war (see, among many, "Chinese Tariff Torture" October 29, 2018).
- Tech companies' earnings are the most vulnerable to the costs of either paying tariffs on goods from China or re-engineering their supply-chains to avoid those tariffs. They are the most vulnerable to costs of harassment by Chinese regulators.
- But they are not uniquely vulnerable to the biggest risk of the trade war: that it pushes China off a systemic cliff that destabilizes all the emerging economies, and indeed potentially throws the whole global economy into recession (see "Our Knife at China's Throat" October 8, 2018). *A systemic threat from China is one of the risks today that was also present in the forward earnings decline that preceded the deep and long-lasting global market correction and "undocumented" recession of 2015-2016.*
- *China today looks very much like it did then – only worse.*
- Then there was a stock market crash (see "China: Toil and Trouble, but No Bubble" July 10, 2015) – *equity prices are lower today*. Then the yuan was in long, gentle controlled depreciation (see "On the RMB Devaluation" August 11, 2015) – *today is in a sharp weakening*. Then GDP growth was slowing – *today it is at the second-slowest pace in the history of the data* (see "On the Margin: China Sees the Cliff" October 19, 2018).

- *<u>The other similarity, then and now, is the sharp decline in crude oil prices from the peak in early October. That peak coincided, to the day, with the first news reports of the death of "journalist" Jamal Khashoggi, which we believe led to a chain of events resulting in substantive supply-relief to global crude markets through the waiver of US secondary sanctions on Iran</u>* (see "OPEC's Gifts to Trump" November 14, 2018).
- To be sure, falling oil prices are good for consumers – and they lower both reported inflation and inflation expectations, which will likely send signals to the Fed that serve to reduce the risk of a hawkish policy error. *<u>But falling oil prices are also a shock to global liquidity and US credit markets – which, in our view, were major contributors to recession-risk in early 2016 when the global crude price traded in the mid-20's</u>* (see "The Recession Caused by Low Oil Prices" January 8, 2016).
- Even though US crude production is now at all-time highs, the Energy sector's contribution to S&P 500 forward earnings is only about half what it was in 2014, when the crude price was above $100. Nevertheless, the crude price drop of the last seven weeks has made the Energy sector the third largest contributor to the present decline in S&P 500 earnings overall (again, please see the chart on page 2).
- *<u>We've seen a sharp widening of high-yield credit spreads, led by the Energy sector</u>* (please see the chart below). They were at cycle tights on October 3, the very day of the peak in the crude price.

ICE BofAML High Yield Bond Index Spread to Treasuries, basis points



Source: Bloomberg, TrendMacro calculations

- At the moment, so far, the widening is merely a faint reminder of the catastrophe of early 2016 that effectively shut down the high-yield market for a while – but it's worth noting that today the Energy sector is 16.5% of the face value of that market, somewhat higher than it was going into 2016.
- Along with S&P 500 forward earnings, high-yield spreads are our most closely-watched indicator of growth-potential and risk-

preference. *As with earnings, the indications here are so far quite small in the grand scheme of things, and still preliminary. But it very much gets our attention when our two favorite indicators suddenly point in the wrong direction – we take it seriously.*

- It's worth noting that our other favorite indicators are not especially worrisome. Bank lending growth is fine. Consumer debt service burdens are quite low. Inventory/sales ratios are in good shape.
- And we are encouraged by the strong shift in market expectations for Fed rate hikes. December is no longer a sure thing, and after that, the curve is projecting just one more hike over three years! In one sense that's bearish because it reflects the fear in the air, but more deeply it means the market believes the Fed can smell it too and will act appropriately cautious about it.
- We're not making an official recession call yet. But we're bumping everything up to Condition Red and standing by the blower.
- *The main contingency here, obviously, is China.*
- We continue to think that all the diplomatic emanations are just what you'd expect prior to the announcement of a "framework" for trade to be announced by presidents Trump and Xi in Buenos Aires at month-end (see "On the Margin: In the Beginning was the Word 'Framework'" November 16, 2018).
- Our views are not changed by the widely reported dramatics of Xi and US vice president Pence over the weekend at the Asia-Pacific Economic Cooperation conference.
- *But make no mistake about it – if the US and China can't settle this soon, then the cost and frictions of either paying or avoiding the US tariffs will be a very real drag both on earnings growth, managerial attention, and confidence. And worse, the continuing corrosive effects on systemic stability in China accrue risks that, if eventuated, would have significant global reverberations.*
- *We expect OPEC to announce official or unofficial production targets at their upcoming Vienna meeting, which should stabilize oil prices – but here there is a risk of self-reinforcing decline, again emanating from China, if consumption-demand growth deteriorates.*
- *For now we're going to stay with our call that the present equity market correction is just that – a correction. In 2015-2016 that's all it was, though it was a long one, and somewhat deeper than we have experienced so far.*

Bottom line

We are going on recession-watch, because of incipient weakness in our two most important leading indicators – declining S&P 500 forward earnings, and widening high-yield credit spreads. Like the last time in 2015-16, prime causes are China and oil prices. Unlike past pre-recession periods, this time there is no single sector responsible for the forward earnings decline. The China-facing Info Tech sector has been the hardest hit. High-yield spreads are dominated by the Energy sector, hit by the sharp decline since Khashoggi's death. This is not a full recession call yet, but we are at Condition Red. We hope to avoid recession, and continue to think the present equity correction is only that. Our hopes are contingent on our expectations for a “framework” for resolution to the China trade war from the Trump-Xi summit at month-end, and production cuts from OPEC.