Economic Commentary

QNB Economics
economics@qnb.com
08 September 2019

US leading indicators are flashing warning signs

US economic growth has been robust in recent quarters, supporting global demand through a period of weakness associated with a manufacturing slump and increased uncertainty. Indeed, it is not a daunting task to find macroeconomic and financial indicators supporting a US bullish story. Equity prices are close to all time highs, GDP is still growing above potential and different measures of unemployment are hovering around multi-decade lows. However, one should take a more nuanced approach when looking into the data, as certain indicators lag or coincide with the economic cycle while some others lead the cycle.

In the case of the US, positive macroeconomic data is mostly coming from lagging or coincident indicators, presenting a picture of the recent past or immediate present rather than telling us about the future. Leading indicators are presenting a much less rosy picture and to some extent are even flashing warning signs about the US economy moving forward. Our analysis delves into a selection of leading indicators and what they are telling us about the US economy.

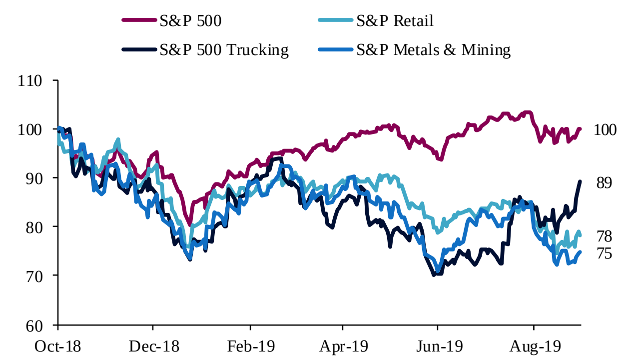
Chart 1: Yield Curve Inversion
(Spread between 10-year and 3-month US Treasuries)

Sources: Haver, QNB analysis

First, on the fixed income space, different metrics from the US government yield curve, which is the yield differential between similar instruments with different maturities, have inverted. For example, the benchmark spread between 10-year and 3-month Treasuries. This is a leading indicator of recessions as lower long-term yields imply lower growth expectations and higher short-term yields imply monetary tightening. This sign has been triggered in advance of the last seven US recessions since the early 1960s, usually giving a year or two of warning.

Second, on the equity space, despite the S&P 500 and other equity benchmarks hovering around all time highs, a deeper look inside the indexes suggest a very different picture. While the general market has been propped up by defensive stocks (pharma, utilities and staples) and a handful of outstanding performers, front-end cyclicals are pointing to a rather tough environment. Front-end cyclicals include trucking, retail and the S&P metals and mining, and are usually more sensitive to cyclical economic changes. As such, front-end cyclicals often act as bellwethers of turning points, especially when they diverge from the broader indexes. While the S&P 500 is still slightly up from the October 2018 highs, front-end cyclicals are down by roughly 25-10% during the same period. In addition to that, US corporate earnings have peaked in Q3 2018, which strengthens the argument, as such peaks commonly precede a cyclical shift towards a downswing in demand.

Chart 2: US equity price divergence
(10 October 2018 = 100)



Sources: Bloomberg, QNB analysis

Third, weakness is also appearing in real activity. The ISM Manufacturing Purchasing Managers' Index (PMI) peaked in August 2018 at 60.8 before collapsing to 51.2 in July 2019. Forward looking ISM PMI new orders are worse, just one inch above the contractionary threshold of 50. US private capex has slowed precipitously and high frequency indicators such as durable goods orders and capital goods imports also point to further weakness. Even the strong labour market is starting to deteriorate. While the unemployment rate is still close to multi-decade lows, hiring activity (payroll addition) is worsening and aggregate hours worked for the private sector is diminishing. This normally anticipates a new cycle of layoffs.

The warning signs from leading indicators are aligned with our view that the US economy is bound to slow by more than consensus anticipates. This is due to the waning effects of the "sugar rush" provided by the fiscal stimulus, the lagging effects of previous monetary tightening, the spillovers from global sluggishness and trade war uncertainties.

For these reasons, we believe that the US Federal Reserve (Fed) will have to respond accordingly by easing monetary policy further. In our view, the Fed will cut rates by 25 basis points (bps) in September, when the Federal Open Market Committee meets. We then expect a further 50bps of interest rate cuts before the end of the year. In fact, we believe this is the beginning of a substantial easing rather than just a "mid-cycle adjustment," and expect further cuts going into 2020.

QNB Economics Team:

James Mason
Senior Economist
+974-4453-4643

Luiz Pinto*
Economist
+974-4453-4642

Abdulrahman Al-Jehani
Research Analyst
+974-4453-4436

* Corresponding author