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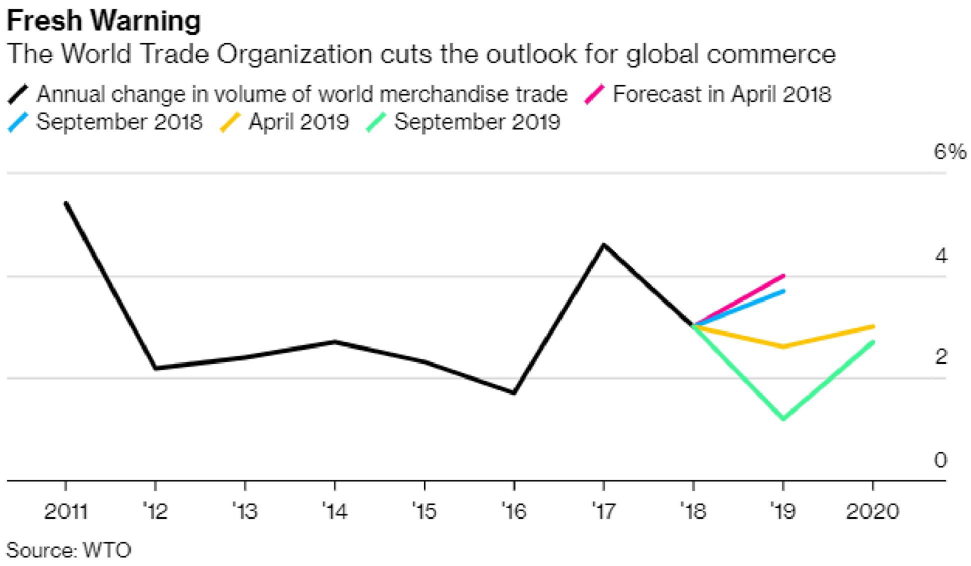
Market Update: 3rd October 2019

Recessionary concerns peak as the US Economy stumbles

The global economy flashed warning signs this week as a wave of economic data revealed a contracting manufacturing industry, falling exports and declining sentiment. With continued trade uncertainty weighing on the global economy, industry executives over the globe have complained of contracting activity, while the World Trade Organisation cut its global trade forecast to the lowest in a decade.



In the latest signal that the US economy is beginning to struggle as a result of slowing global growth, trade uncertainty and geopolitical issues, the US ISM manufacturing index posted the largest contraction in September since the end of the 2007-2009 recession, reflecting a slowdown in the US and global economies.

In Tuesday's data release, the Institute for Supply Management (ISM) said its Manufacturing index fell to 47.8 last month from 49.1 in August, marking the lowest level since June 2009 (when the recession came to an end), and taking the manufacturing sector further into contractionary territory. The number came in much lower than estimates which were expecting a rebound to 50.1. The sharp decline re-ignited recessionary concerns, resulting in stock market declines and falling treasury yields. President Trump reacted to the deteriorating data in his usual manner, blaming the central bank for keeping US interest rates too high, however it is evident that the ongoing trade war is starting to have a profound effect on US manufacturing.

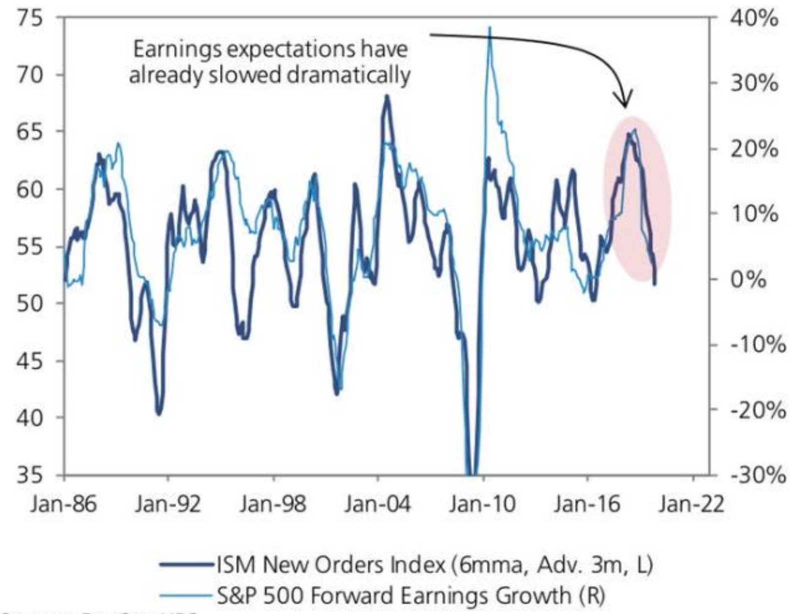
How Important is Manufacturing?

In contrast to the Eurozone, which faces more pronounced economic decline stemming from its reliance on manufacturing, industry makes up a much smaller part of the US economy, at around 11.6% of US economic output compared with 22.3% of Eurozone output (according to 2018 figures). Manufacturing may make up a small portion of the US economy, however it is a vitally important one, producing income and multiplier effects, particularly in the Midwest. There are signs that the industry's slump is beginning to spread to the larger service sector, therefore this will be a key area to watch going forward, with the ISM non-manufacturing data released today reporting a slump to 52.6 in September from 56.4 in the previous month. Alongside the services data, jobs data will be an important data point to watch tomorrow, giving an indication of the underlying health of consumer spending and domestic activity. Yesterday, US Private Sector employment data came in below expectations, adding 135,000 workers in September compared to August's downwardly revised 157,000. This paints a slightly bleaker picture ahead of Friday's jobs data.

Until now, weakness in the US economy appeared to be relatively contained, however as the data continues to deteriorate, there are growing concerns that the economic pressures will worsen unless a US-China deal is struck or tariffs are postponed further. In our view, visible damage has already been done to the US economy, therefore even if a deal was agreed, growth is likely to remain weak, with weakness feeding through into corporate earnings which cannot be ignored by markets for much longer.

Corporate Earnings Weakness

Considering that profit growth has been the main driver of the more than 10-year bull market, a contraction in earnings spells a challenging road ahead for equities. As lower growth and rising input costs feed into corporate earnings, earnings growth has been declining. According to Factset data, S&P 500 earnings declined by 0.4% in Q1 and Q2, however a larger contraction is now expected in Q3, with Factset estimating an aggregate earnings decline of 3.7% over the quarter for the index. The chart below shows the relationship between ISM New Orders and S&P 500 forward earnings growth. The correlation is undeniable, reinforcing our expectations for an equity market sell off driven by recessionary fears and declining corporate earnings.



Source: FactSet, UBS

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Increasing Uncertainty

Manufacturers have faced waning demand as they struggle to deal with a growth slowdown, exacerbated by the US-China trade war. Production, employment and inventories all declined in September, with only 3 of the 18 manufacturing industries tracked by the ISM reporting growth. Business investment has been declining as uncertainty remains over internal US politics, trade policy and issues such as Brexit, and the reality is that investing has ground to a halt as a result of all this uncertainty.

Away from the US, a measure of Chinese manufacturing improved on expectations, however the overall tone over the week was that the world economy is failing to rebound from the slowdown amid rising uncertainty. As leaders argue out their disputes, central bankers and governments are attempting to support demand and boost economic activity, however while trade disputes rage on, there are also industry-specific issues, such as autos in Germany and semiconductors in South Korea.

As it stands, parts of the global economy are showing resilience. Services are growing while falling unemployment is supporting consumer spending, however any weakness in services or jobs data would indicate further weakness in the US economy, such as indicated in this week's data. A resolution to the US-China trade conflict would provide some relief for central banks, however a deal still looks unlikely this year as the sides remain far apart, with economic weakness likely to become more pronounced in the meantime.

Positioning

Overall, the weakness seen in the leading economic indicators in recent months suggest that the deterioration in earnings will get worse from here. The US ISM data spells a bleak picture for equities over the coming months, with sentiment becoming increasingly risk averse as a result. Our portfolios are well positioned to benefit from further equity market weakness, and this week's developments are broadly in line with our expectations.