BearBull
Global Investments Group

Economic Research

WEEKLY ANALYSIS

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Robust job market and economic cycle in the US

Fed stays the course. Record job creation and wage increases. Long-term interest rates no longer contracting. Equity markets on the upswing. Caution on earnings expectations.

Key points

- Federal Reserve stays the course in spite of market jitters
- 0.25% rate hike to 2.5%
- Fed marginally reduces its growth outlook for 2019 to +2.5%
- Job market will vindicate the Fed
- Strongest job creation and wage increases since 2008
- Leading indicators are now pointing to increasing concerns
- GDP will benefit from a favourable consumption climate in Q1
- Donald Trump's strategy is far from beneficial for the US
- Inflation and long-term rates stabilise
- Limited prospects for the dollar
- As only 20% of investors are optimistic, it is time to be contrarian on equities

Federal Reserve stays the course in spite of market jitters

The FOMC's last meeting of the year took place in a particularly challenging political and economic context, amidst threats of a government shutdown, the Sino-American crisis, the stock market plunge, and the bursting of the speculative bubble on a number of tech stocks, to name but a few. Just weeks away from the end of the year, the Fed's options were limited, as it had to endeavour not to further distress investors who were already jittery and liable to scare themselves further and depress the price of almost all financial assets even more upon the slightest increase in uncertainty or signs confirming their fear of an impending recession.

FOMC members had to carefully assess the economic situation as well as the risks of a collapse in investor confidence to avoid another market panic. Indeed, the investment climate had already sharply deteriorated after the 0.25% rate hike implemented in September, obliterating all stock market gains for the past year. The stabilisation of share prices in November remained fragile and was likely to be upset in the event of disappointing news.

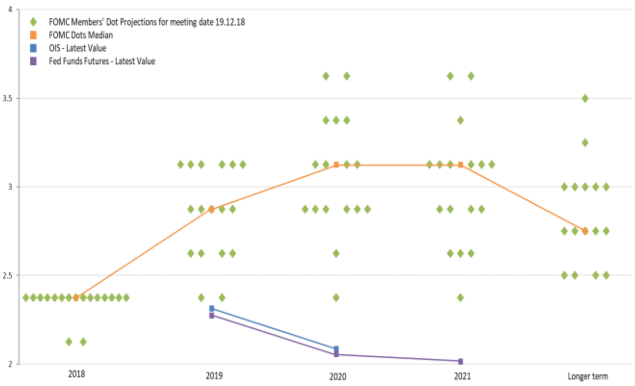
Indeed, as surprising as it may seem, barely a few days after the release (28 Nov.) of Q3 growth data (+3.5%), the fear of a recession spread like wildfire. A number of less reliable statistics and excessive fear of a yield curve inversion supposedly signalling an impending recession were enough to stir up further panic and trigger a sell-off that slashed another -10% off the main equity indices over the first two weeks of the month.

The Fed's commentary (19 Dec.) in connection with the widely anticipated 0.25% rate hike to 2.5% seemed particularly measured, however, and apt to calm investor jitters. Indeed, there was essentially no change in the evaluation of economic conditions that could have led to fears of a sharp slowdown in 2019. Thus, the economic outlook was still considered robust, in spite of a very slight decrease (0.1%) in GDP growth expectations for 2019 to +2.5%.

FOMC members seem aware of market fears but remain convinced that the US economy is growing at a sustained pace. We believe the Fed will exhibit a large degree of flexibility in conducting monetary policy. The drop in the dot plots indicates that risks tied to international political factors have been taken into account, suggesting heightened caution with regard to raising rates in 2019.

According to the Fed, the Fed funds rate should thus be 2.4% by the end of 2018, 3.1% by the end of 2019, and 3.4% in 2020.

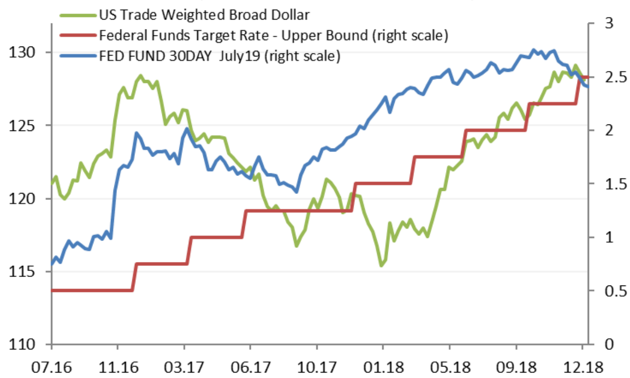
FOMC Fed funds projections



Sources: Bloomberg, BBGI Group SA

We believe that for now the FOMC is going down the path of implementing two rate hikes in 2019, the first of which is unlikely to occur in H1.

Fed funds, target rate and trade-weighted dollar



Sources: Bloomberg, BBGI Group SA

The Fed will stay mindful of not stoking further fears of excessive action that could trigger a growth shock.

In our view, current economic conditions continue to benefit from a combination of positive factors that will bolster GDP growth.

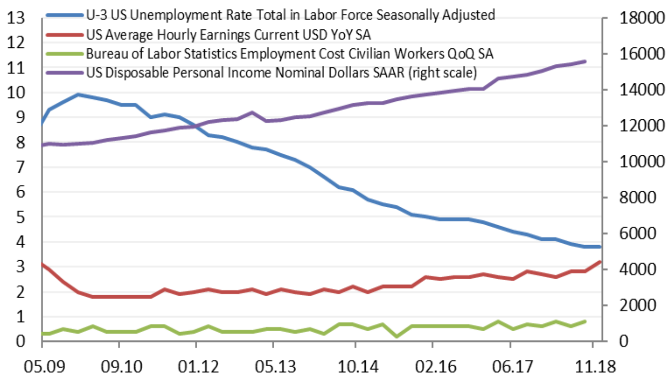
Consumption in particular will likely be boosted by increasingly significant developments in the job market and by the very sharp decline in energy prices in the last quarter.

Job market will vindicate the Fed

The drop in the dot plots in a robust economic context gives the Fed substantially more wiggle room. In 2019, inflation is likely to guide its actions. For now, there is no significant change in the outlook on inflation. The decrease in energy and fuel prices should reduce the risk that price indices will rise above the Fed's target.

However, the job market continues to strengthen and could be a key factor with regard to both consumption and inflation. While the latter is considered to be close to the Fed's target rate, we think it may rise above 2% once energy prices react to the change in perception regarding the global economy. The risks of recession were overblown over the past few weeks and temporarily had a very negative effect on fuel prices, which will likely benefit very quickly from a normalisation of growth forecasts, driving an increase of the CPI.

Unemployment, earnings, employment cost, income



Sources: Bloomberg, BBGI Group SA

With regard to the job market, the latest statistics published showed very strong momentum. In December, job creation was the strongest since the beginning of the current economic cycle. With the creation of 312,000 new jobs, the US economy was displaying its vigour at the very same time as the stock market panic was spreading based on fears of a possible recession in 2019. The number of people employed in the US thus grew to 150,263,000, exceeding for the first time ever the 150 million mark. At the same time, October and November data were revised upward, showing solid employment growth in excess of 250,000 new jobs per month over the last quarter – a paradoxical situation given the investment climate of the past few weeks.

The Fed will also be keen to note the positive trend in hourly wages, whose growth rate of 3.2% in December was the fastest since April 2009. The slight increase in the unemployment rate from 3.7% to 3.9% is not a negative factor in light of the increase in the labour force participation rate of the US population seen in December. Indeed, the participation rate (63.1%) passed the 63% mark, showing that the strength of the economy is attracting new participants who had not been in the market until now.

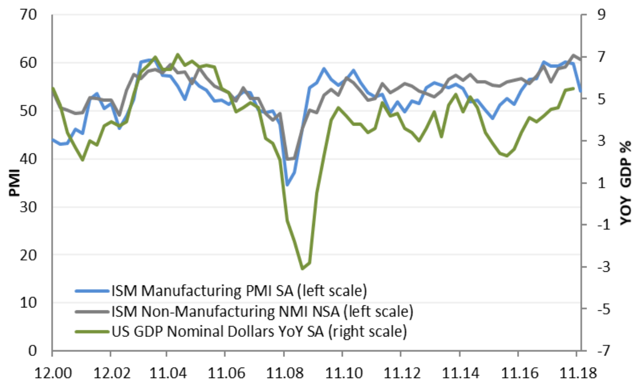
In 2018, the US economy created 2.6 million new jobs, that is, 400,000 more than in 2017.

The Fed was certainly correct in anticipating robust economic growth and not giving in to pressure from those who wanted a rate cut claiming a yield curve inversion that potentially signalled an impending economic recession.

Leading indicators are now pointing to increasing concerns

Leading indicators remained positive for the manufacturing sector until November, before dropping sharply from 59.3 to 54.1 in December. Indeed, the ISM manufacturing index currently seems to be indicating persisting uncertainty tied to the absence of resolution of trade tensions between Washington and Beijing. The chain of production of manufactured goods now seems to be increasingly impacted by the risks involved in current policy.

GDP and PMI



Sources: Bloomberg, BBGI Group SA

The December dip is the largest decrease since October 2008. The new orders segment tumbled from 62.1 to 51.1, but the employment indices continue to be solid, suggesting that, in spite of a likely slowdown in production, businesses remain confident and ready to expand their teams. The services indicator has stabilised since September, closing the year at 54.4. Most indicators continue to point to further economic expansion though likely at a slower pace.

GDP will benefit from a favourable consumption climate in Q1

In a relatively fraught environment, consumer confidence nevertheless continues to grow, further improving in December. Neither the stock market fall, nor the government shut-down, nor the Sino-American crisis seem to have impacted household confidence. US households are no doubt focusing on the concrete factors currently attesting to the strength of the economy, and indeed they are buoyed by the excellent job market situation, rising wages, lower energy prices, falling inflation, as well as the tax cuts. All these factors contribute to increased purchasing power.

Thus, even if the market sell-off was widely covered by the media, consumers are influenced more by positive trends in their income. Private consumption will very likely be a key factor in GDP growth in Q1 2019.

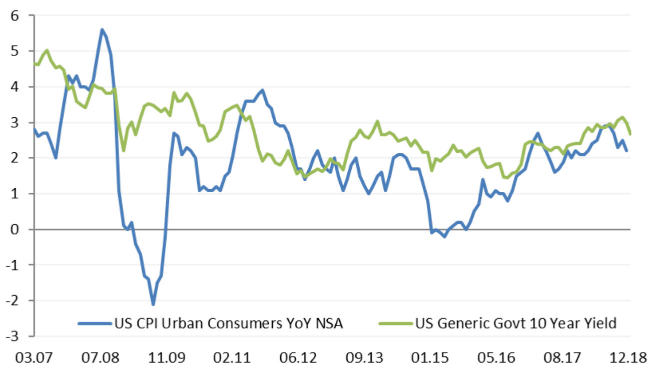
Donald Trump's strategy is far from beneficial for the US

As we have mentioned numerous times, the main risk factor for the US economy is more than ever generated by the US president himself. The truce has not yet produced tangible results likely to dispel the uncertainty still casting a shadow on the markets. An increasing number of US multinationals, moreover, are concerned regarding the potential effects of this conflict on their results. The earnings outlook for 2019 is starting to be more severely impacted in certain sectors, while the US trade deficit is sinking further into the red. **An agreement between the two superpowers will logically be reached before the loss of momentum threatening both economies actually materialises.**

Inflation and long-term rates stabilise

Falling energy prices are currently acting as a brake on inflation. However, we anticipate that a positive economic outlook should quickly reverse the downward trend in fuel prices. First, inflationary risks appear moderate, but expected inflation will likely increase gradually, driven in particular – as long anticipated – by wage increases (+3.2% in December), which should intensify in 2019.

Inflation and 10-yr US Treasury bonds



Sources: Bloomberg, BBGI Group SA

With regard to long-term rates, the correction from 3.2% to 2.6% seen in November and December appears to be petering out. It is unlikely that it will further benefit from the reinvestment of liquidity generated by the sell-off and from the fears of recession. Long-term rates will likely gradually increase back to 3%.

Limited prospects for the dollar

The dollar is still benefitting from attractive yield spreads against most currencies. In 2019, these spreads will likely be hit by rising interest rates in the Eurozone and other developed and emerging countries. We continue to expect the dollar/Swiss franc exchange rate to trend upward, potentially reaching 1 to 1.05 francs. The US currency will likely once again lose its attractiveness, very gradually, against the euro and emerging currencies assuming the stock market climate improves.

As only 20% of investors are optimistic, it is time to be contrarian

Several months ago, we noted that, in spite of Trump's personal beliefs, US businesses were clearly not immune to the risks resulting from the trade war with China. The past several weeks have shown to what extent taking into account the risks of a global economic slowdown could also impact US equities. Even one of the most iconic stocks on the US market, Apple, was not able to avoid mentioning the risks related to this wrestling match weighing on its performance, which caused a downward revision of its outlook for 2019. In a letter to investors, Tim Cook noted that the economic environment in China had already impacted sales in Q4 2018, which could fall from the initially expected 91 billion to 'only' 84 billion.

S&P 500, Nasdaq and GAFA

Sources: Bloomberg, BBGI Group SA

In this context, the fall in US share prices unsurprisingly and significantly reduced the valuation levels of S&P500 stocks. At around 14x 2019 expected earnings and -13% lower than the high reached on 20 September, valuation levels are attractive. However, keep in mind that analysts have not yet significantly reduced their earnings expectations for 2019. Careful attention should thus be paid to the real valuation of the market over the next several months, in particular if it starts trending upward and once again approaches the 2,900 mark.

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