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US Market Outlook

A deeper look into its economic data

MACRO | ECONOMY | EQUITY MARKET

24 February 2016

Executive Summary

- Equity markets have crashed since the start of the year, and this might just be the tip of an iceberg.
- Credit spreads have widen and the yield curve seems to be flattening. Investors are becoming wary, as we enter a risk-off environment.
- Economic data is not as good as it seems. Employment, profitability and manufacturing are at a turning point.

US market down since start of 2016

The US financial markets have tanked since the start of this year, making it the worst even start to the US equity market in history. This seems to be largely driven by the deflationary pressure of oil prices and the crash China's equity market. These two external factors seems to have an unusually huge impact in the US equity market. Questions have to be raised on why the US equity market has reacted so badly to a lower oil prices and the crash of emerging markets.

Lower oil price are hurting the smaller producers

Historically, lower oil price is seen as a positive sign as this implied lower energy cost for most businesses. However with lower oil price, profitability from the energy sector will be affected as revenue decline in tandem with oil price. As profit get squeezed, the ability for energy companies to repay their debt came under severe stress when smaller companies started to default on their debt obligation. This might be a catalyst for the domino-effect of defaults that is yet to coming. The unknown ripple effects of defaults may have adversely affected the equity market.

China leading a global rout

The China equity market plunged at the start of the year and triggered the limit for trading halt twice in just the first week of trading for 2016. In additional, the indecisiveness of the China government on their circuit-breaker policy and their continuous ban on stock sales by large shareholders didn't instill much confidence in the market. Even after numerous warnings and statements release by top officers from PBOC, market have continued to head southwards. The correlation of the global equity markets was at an all-time high in January, underlying the movement in the US equity market as it reacted negatively to the news of economy slow-down in China.

This has created panic for most investors thus warrant a look into the fundamental of the US economy and investigate if the recent market movement is a canary in the coal mine for what is to be expected for the rest of 2016.

Taking a cue from leading market indicators

Looking at the 3 major US equity indices, it is clear that the **S&P 500** together with **Nasdaq composites** Index and **Dow Jones Industrial Average** are all ominously returning negative since start of the year. However to understand the real significant of this current market down swing, we need to take a deeper look at other more telling indices.

Based on our technical analysis, The **Dow Transport**, **Russell 2000** & **MidCap 400** are leading indicators of the markets, and it is not hard to see why. The Dow Transports is often a leading indicator because people and businesses ship and freight more stuff when the economy is doing well, and they pull back when it isn't. The Russell 2000 and MidCap 400 consist of the smaller and medium size companies listed in US and are generally more susceptible to a market down.

Tradable instrument:

ETF:

DBXT S&PShort US$X@ - SGX:HD6

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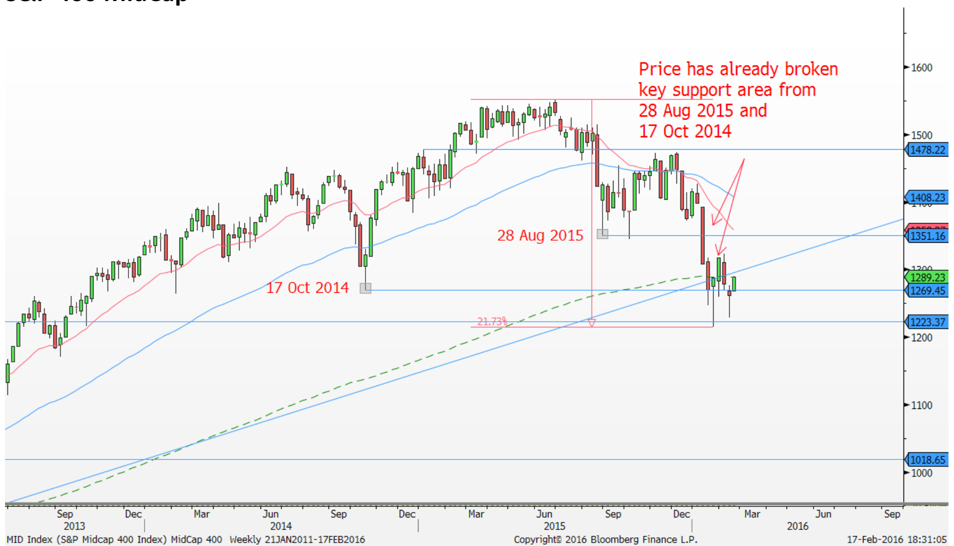
Dow Jones Transportation

Dow Transport Weekly chart *red line = 20 exponential moving average*, *blue line = 60 EMA*, *Green line = 200 EMA*

Russell 2000

Russell 2000 Weekly chart, red line = 20 exponential moving average, blue line = 60 EMA, Green line = 200 EMA

S&P 400 MidCap



S&P400 Midcap Weekly chart, red line = 20 exponential moving average, blue line = 60 EMA, Green line = 200 EMA

Source: Bloomberg

The above 3 charts have all experienced a technical recession (20% from its previous high). If this is an indication of what is to come, we should be expecting the worst for the US equity markets.

Besides looking at the asset price of the equity markets, we should also pay attention to other financial markets. An analysis can only be holistic when we study both the equity and the debt market in cohesion. Credit play an important role in economy as it enhance economic growth. Furthermore any default in the High Yield bond can be a potential catalyst which could trigger a market crash and put the economy back into recession.

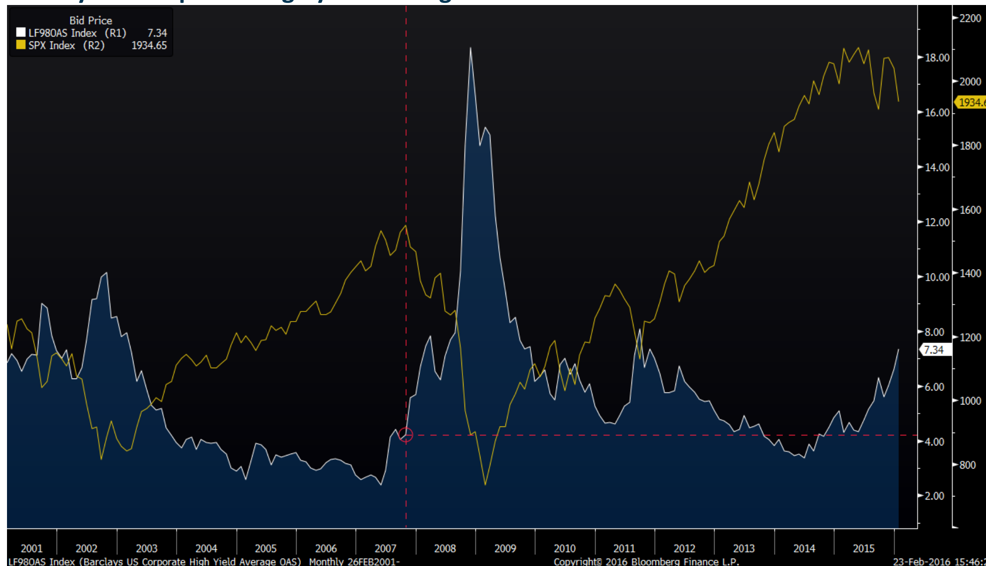
Cheap money may have fueled an Credit bubble which is waiting to burst Again

It should come as no surprise that the largest financial market in the world is the US bond market with a size of US$39 trillion as compared to the total US equity market capitalization of US$26 trillion. The US bond market is definitely a space that we need to watch closely so as to get a better understanding of the overall health of the economy.

Credit spread widening

The credit spread of the bond is an indication of the risk premium that an investor would pay to own a corporate bond over a risk-free asset (e.g 10-year US Treasury note). Therefore a study of the credit spread can shed some light on the level of risk appetite in the market, with higher spread reflecting a more risk-adverse environment.

Barclays US Corporate High yield Average OAS



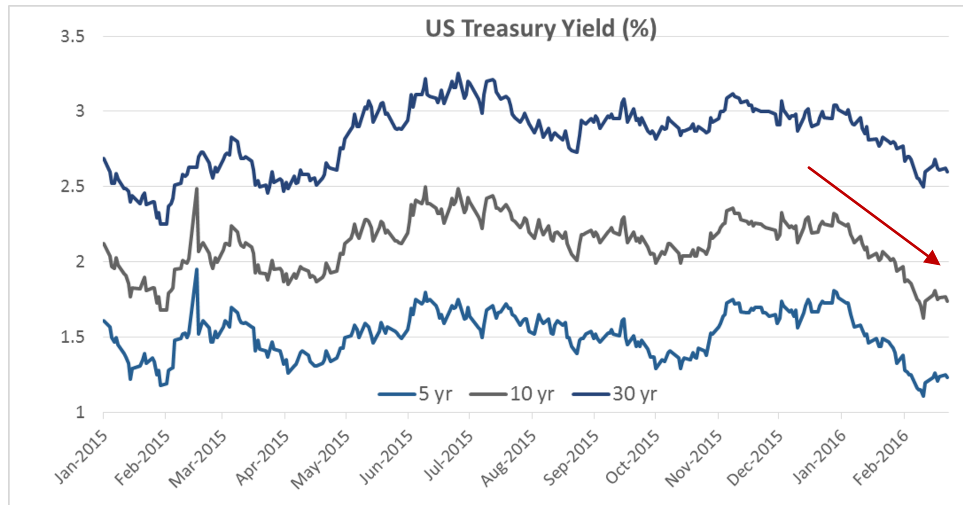
Source: Bloomberg

Looking at the **High-Yield (HY)** market, current level spread is already at a much higher level than the credit spread during the market peak of 2007 as identified by the red circle. Credit spread is reaching the pre-crisis high sending another warning sign for investors to be wary.

The phenomenon in the increasing spread is not only isolated to the **HY** markets, credit spread for **Investment-Grade (IG)** bonds have also reached the pre-crisis high of 2007. With credit spread widening and default risk going up, sovereign debt is also reflecting the flight-to-safety mentality.

Yield Curve flattening

In such a risk-adverse market with a less than healthy appetite for risky assets, we see huge inflow into treasury. The US Treasury yields have drop significantly, signally a tremendous increase in demand for the sovereign debt (safe haven asset.)



Source: US Treasury, PSR

Yield is inversely related to price, as price increases, yields fall. Price of treasury increases due to the demand outstripping supply. With treasury yield at different tenor periods reaching new low, the hunger for safe assets have never been stronger in recently years.

Not only did the yield curve shift lower, the yield curve is flattening as the demand for the longer end of the curve (30yr treasury) increase due to the uncertain in the market. If the yield curve continues to flatten and ultimately invert, it will send a very strong negative signal on the U.S. economy.

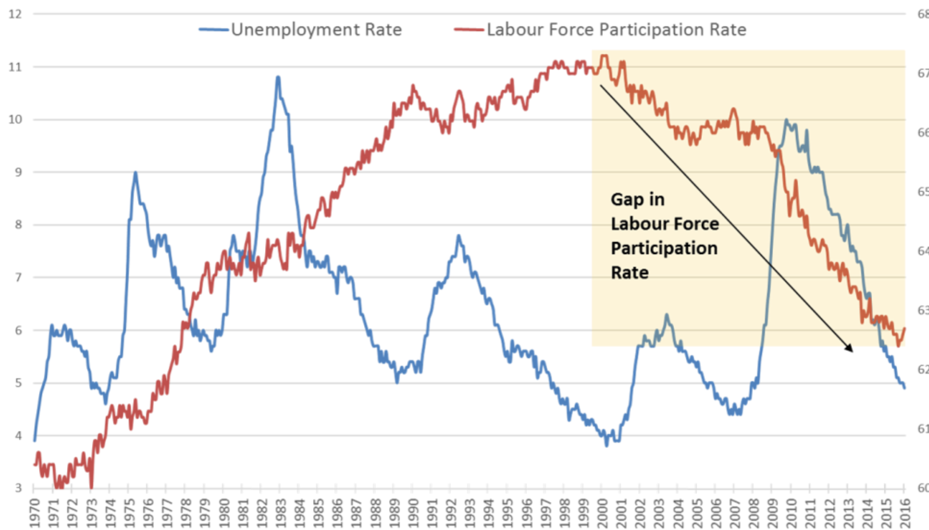
To conclude, the financial markets have already shown signs of weakness. The equity market have peaked since August 2015 and credit spread are at its most recent high. The million dollar question now, is whether the underlying economic of the United States concur with the current state of the financial markets. Given a great deal have been said about the recovery of the economy and the raising of interest rates by the Federal Reserve as a sign of confidence in the economy, let us take a further look at the health of the economy.

Is the financial market reflecting the true state of the US economy

Both the equity and bond markets have shown early warning signs of an economic slowdown as observed by the action of wary investors in a risk-off environment. Having financial markets as a leading indicator, we dived into the fundamental of the US economy to see how the economy has recovered since the Great Recession of 2008.

Employment data is not as rosy as it seems

Employment is an important data for and is pivotal in the decision making process for the Federal Bank.

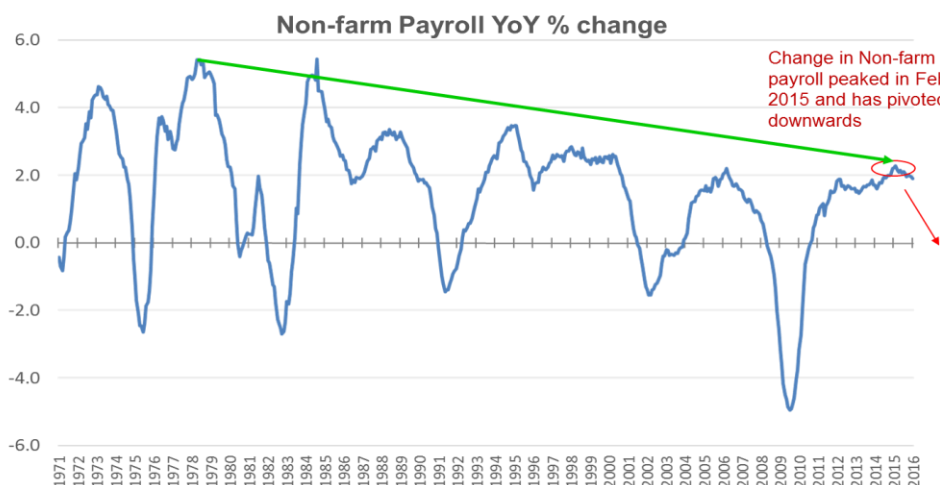


Source: CEIC,PSR

With the most recently unemployment data, the Obama administration proudly took credit for turning around the economy and lower the unemployment rate from the high of 10% to 4.9%. In additional, they mention an uptick in the labour force participation but failed to mention that the labour force participation rate was still far below the pre-crisis level as seen from the chart above. Mathematically, this simply implies that the number of people employed has not increase with a decrease in unemployment rate.

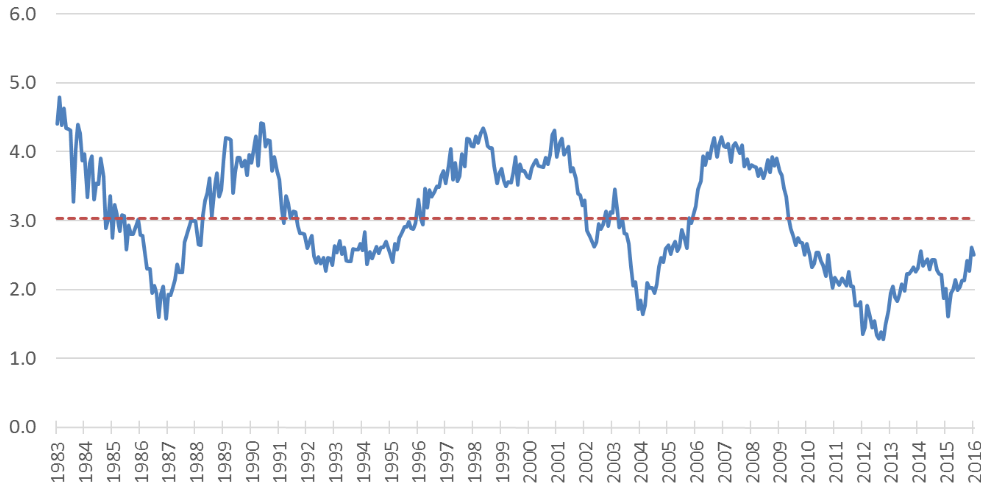
An unemployment rate below 5% is considered full employment by the Fed, however the full employment they are experiencing today, is not the same full employment as they had experienced during 2005 to 2007 as labour force participation have not recovered. The prolonged cyclical unemployment caused by the Great Recession have turned into structural unemployment and ultimately leading to discouraged workers leaving the work force (lowing labour force participation).

Furthermore, Increment in Non-Farm payroll (an important economic data which account for private employment excluding farming employment) has peaked in Feb 2015 and trended downward.



Source: CEIC,PSR

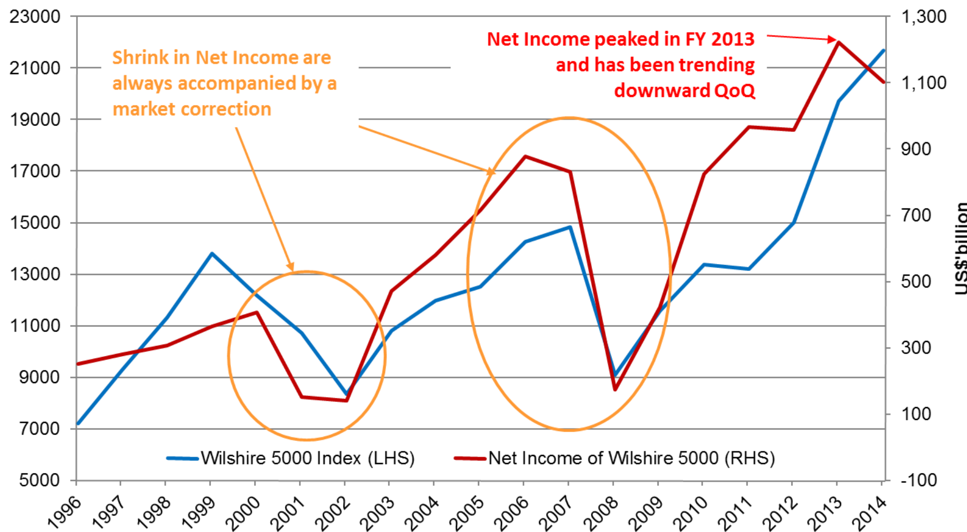
Finally, to cap-off the poor employment data, real average hourly earnings growth rate have not been back at its pre-crisis high and still below the long term average growth rate of 3%. If employment data have not really improved, could businesses be generating higher profits with lower employment cost?



Source: CEIC, PSR

A stock market crash always follows when business profit dipped

Taking a look at the net income reported by the companies in the **Wilshire 5000** (the biggest 5000 companies in US), we observed that Net Income has peaked in FY2013. Looking back at history, a peak in Net Income is usually followed by a stock market crash.

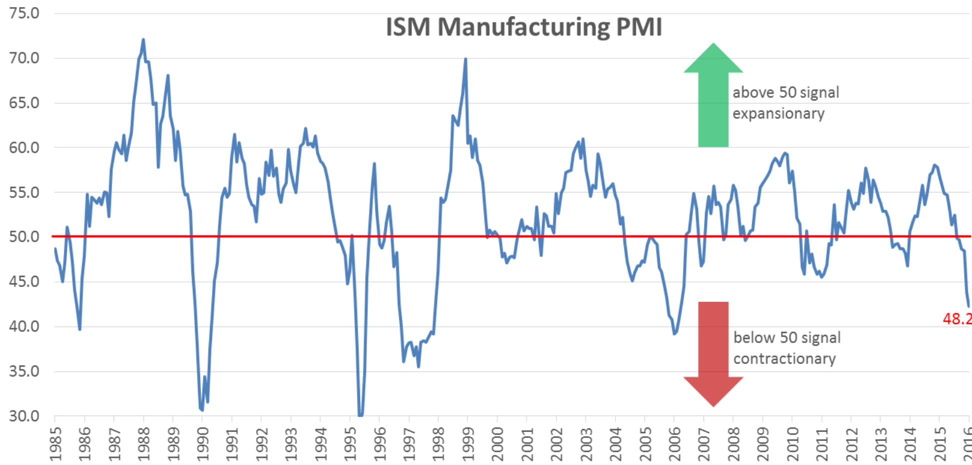


Source: CEIC,PSR

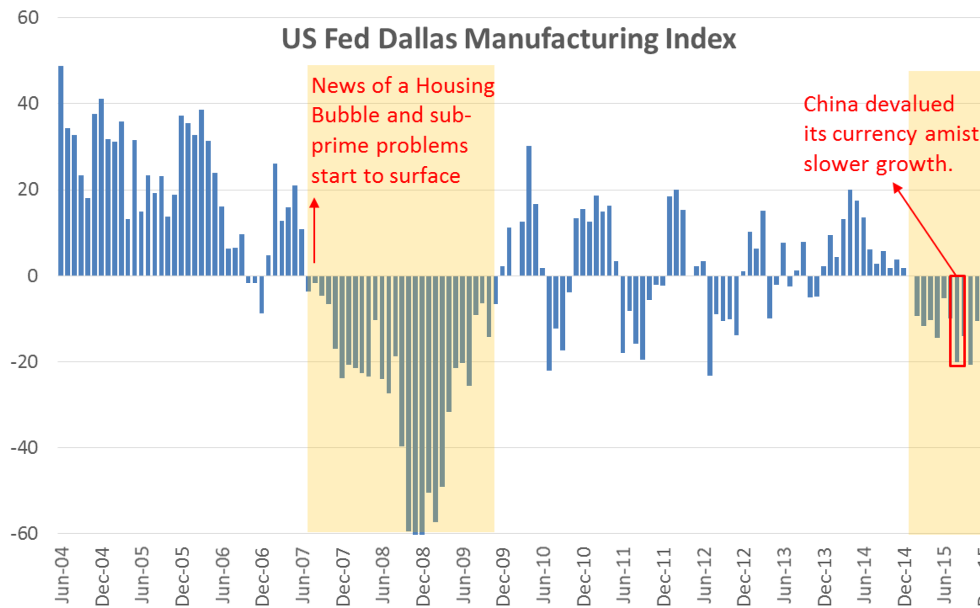
If we believe in this correlation, the stock market should be heading downwards. The only question is the magnitude of the fall.

Manufacturing is in recession, the numbers don't lie

As much as the US politicians wants us to believe the economy is no longer depend on manufacturing, we cannot deny the fact that manufacturing still plays an important part in the economy and more often than not, manufacturing has provided an early warning signal of recession. Manufacturing is already in recession.



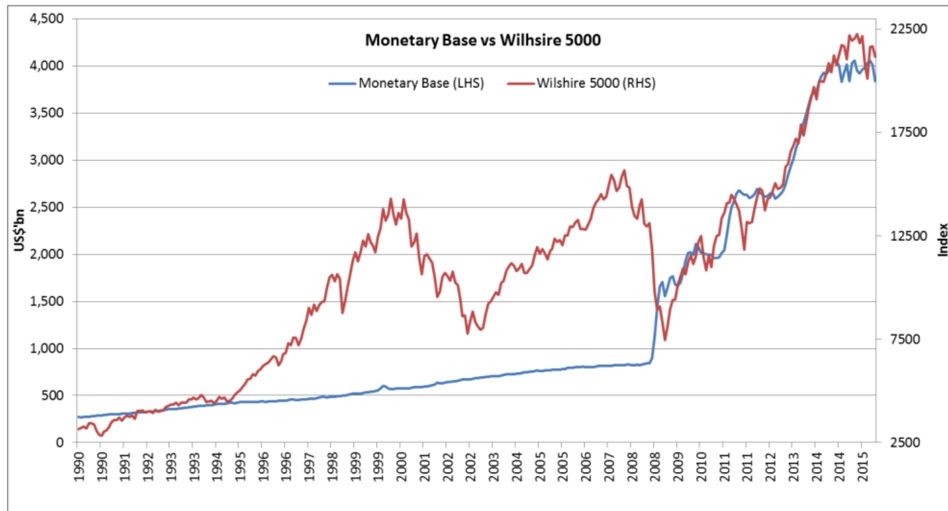
Source: CEIC,PSR



Source: CEIC,PSR

Final food for though

Loosen monetary policy has been the only driven for the past 7 years. It is not a coincidence that the US stock market rally in the past 7 years was accompanied by an unprecedented monetary easing policy. The low interest rate environment coupled with the Quantitative Easing (QE) have extended a typical 7 years boom-bust cycle. With the end of QE the equity has also seeming peaked back in May 2015.



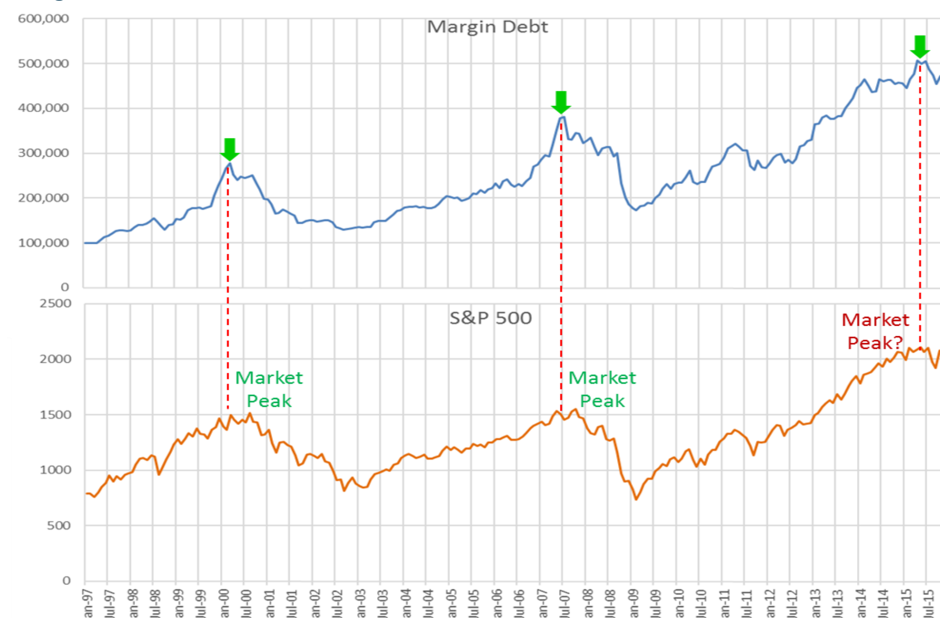
Source: CEIC, PSR

Conclusion

From the data, we can see that the U.S. economy is on the brink of another recession. As always, market participants have already began pricing in these information and we can see it being reflected in the financial markets with the risk-off mentality. Besides the weakening fundamental of the economy, we believe that the effectiveness of monetary policies have also reached its limit. As Central banks around the world looks to continue the party with NIRP (Negative interest rate policy), it will be hard for the Fed to reverse their rate hike decision and execute a NIRP effectively without losing their credential. The end of an era for the Central Bankers might be just around the corner.

Lastly, we included a bonus chart on the relationship between Margin Debt and S&P 500. The chart is quite fool-proof and reinforce our notion that the market might have peaked in the middle of 2015.

Margin Debt to S&P 500



Source: CEIC, PSR

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