PhillipCapital

US Market Outlook

Market is long overdue for a correction

MACRO | ECONOMY | EQUITY MARKET

8 June 2016

Executive Summary

- US Equity market has recovered but economy data still signal a weakening US economy.
- Credit market remains non-definitive while spread between yield of longer-dated US treasuries and short-dated treasuries narrowed.
- Unemployment, manufacturing and non-manufacturing data indicate a looming recession.
- Margin debt and monetary base suggest limited upside in equity market.

US Market rebound strongly

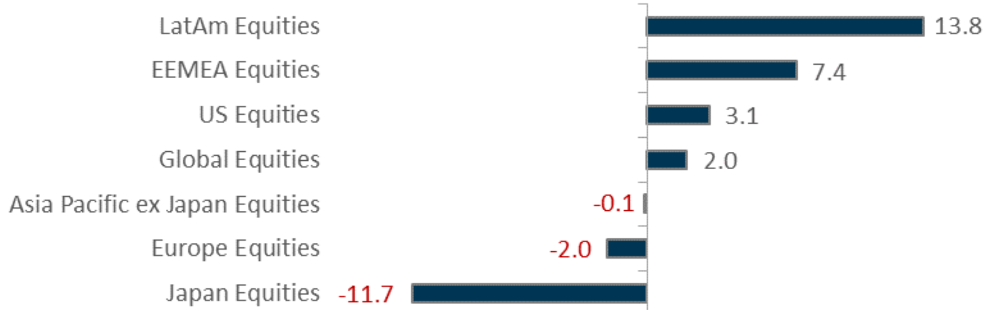
The US equity markets have rebounded strongly with S&P500 up by c.16% from the bottom seen in February 2016. Dow Jones Industrial Average has also recovered to a positive YTD performance of 2.6% as at end of May. Only the Nasdaq Composite Index is still below last year's closing. Nonetheless all the three US major Indices are signaling a strong bull market with no sign of slowing down, much less reversing.

Besides looking at the three major indices, we have previously mention that ***Dow Jones Transportation Index**, **the Russell 2000** and **MidCap 400 Index*** were key indices that we follow as they are good leading indicators when markets are falling. However, in a market recovery, they tend to lag and this is currently being reflected by how far-off these indices are from their most recent peak.

Global equity markets are decoupling

When the crash happened in January this year, equity markets around the world saw their correlation reaching a high of 0.9 (average 20 year correlation is 0.52). However, as the year progress, correlation has normalised and the equity markets decouple themselves from the tandem movement in prices. As at end of May 2016, return on equity markets represented by the MSCI Total Return are as follows.

Figure 1: Year-to-date global equity markets performance



Source: Bloomberg L.P, Phillip Securities Research

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Japan & Europe are still printing money

Surprising to note, countries which are still on expansionary monetary policies have taken a backseat in the recovery. Europe and Japan, the two largest economies after US and China, are still addicted to 'money printing' and have implemented Negative Interest Rate Policy (NIRP) to spur their economies. However, all these efforts seem to be in vain as their respective equity markets failed to recover to previous high.

In the initial years of the Quantitative Easing (QE), market participants cheered on as the additional liquidity help to artificially prop the market to new high, creating one of the longest bull market in history. However as the bull market runs its course, market realised that the additions liquidity have inflated an equity asset bubble with no significant improvement in the underlying economy. This might be the reason why the additional monetary stimulus have seems to loss its effectiveness, and thus explaining the staleness of the Europe and the Japan equity markets.

US rate hike inevitable

After the tapering of the QE program and the much anticipated first rate hike in December 2015, US equity market seems to be the only stronghold among the developed markets. The data dependent Federal Reserves (Fed) is ready to further reinforce the notion that US economy is growing on solid ground by looking to raise the interest rate for the second time within a year. As at 6 June 2016, the probability of a rate hike in June and July are 2% and 21.6% respectively, based on Bloomberg consensus.

Yield curve is flattening

Historically, US Treasuries curve has given a good forward guide to an economic recession. Preceding a crash, the yield curve will always flatten and invert. This happened in both periods before the 2000 dot-com crash and the 2007 global financial crisis. Currently, the spread between the 10yr/2yr US Treasuries has reached inflection point but looks set to fall even further. The yield curve is flattening as the spread goes to zero. This signals increased uncertainties in the market as it is difficult for the market to determine interest rates movements.

Figure 2: US Treasury 10-year over 2-year spread

Red Line: 10 years US Treasuries Yield, Blue Line: 2 years US Treasuries Yield, Green Line: 10 years – 2 years Spread

Source: Bloomberg

Financial markets vs Economic data

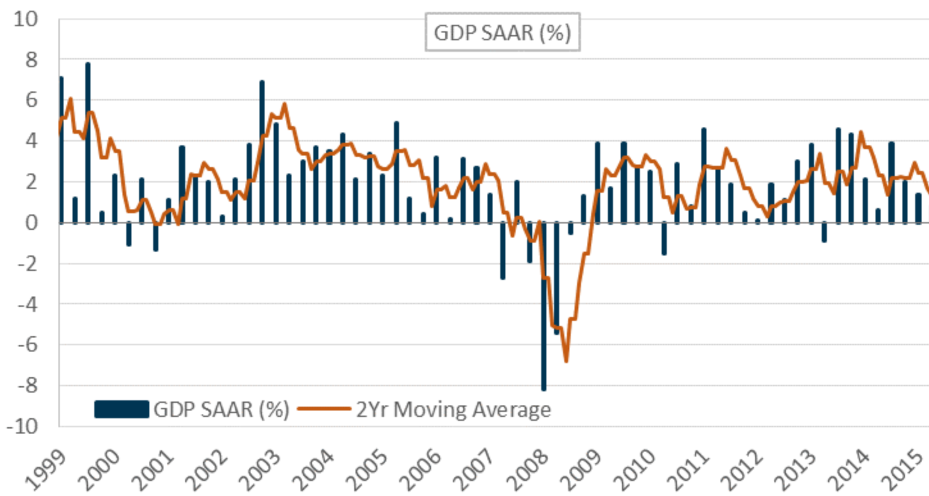
The US equity markets seem poised for the next upward run and the credit spread is yet to show any definitive sign of panic in the markets. It seems certain that Fed chairwoman Janet Yellen will raise the rates for the second time in less than a year. However, the Fed has consistently emphasised their approach of being data dependent. Therefore, we need to analyse the economic data to see what these data are signaling.

GDP growth rate & Inflation rate shows structural stagnation

We are about half way through 2016 and GDP data released for the first quarter of 2016 has been muted and disappointing. Seasonally-adjusted annualised rate of growth for the economy for 1Q 2016 was 0.8%. This has reinforced our notion that the economy is now beyond a prolonged stage of cyclical stagnation (low growth and high unemployment rate) and has evolved into a secular stagnation. Monetary policy is no longer sufficient to kick start the economy and only a structural change can have any form of impact.

Structural change needs to be stemmed from fiscal policy and the current candidates for the presidential primary has shown, yet again, that politicians are unwillingly to tackle the hard questions as they seek popularity vote in their campaign.

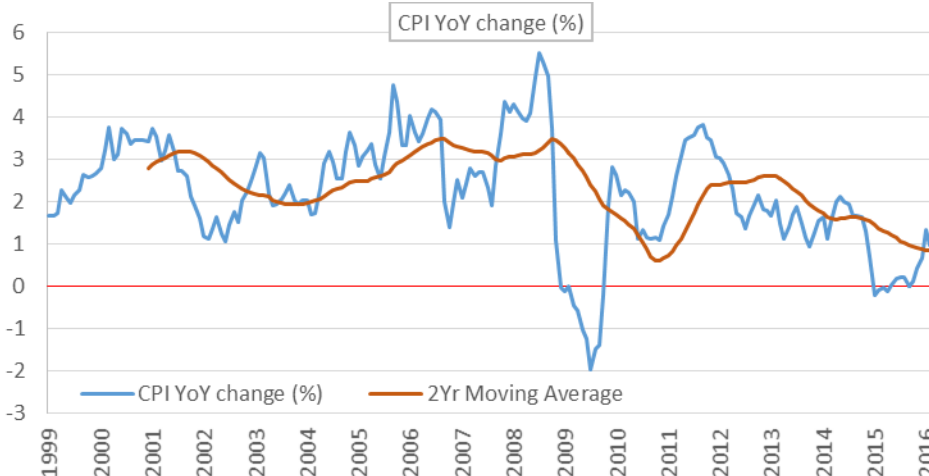
Figure 3: US GDP Seasonally-Adjusted Annualised Rate



Source: CEIC, PSR

Inflation rate based on the Consumer Price Index (CPI) have also failed to reach the 2% target that was deemed healthy by the Fed. A deflationary scare in the early months of 2015 has prevented the Fed from hiking rates earlier than planned. Even with a much welcomed year-on-year inflation rate of 1.1% reported in May, the overall trend of the inflation rate is still downward as clearly depicted in the 2year moving average.

Figure 4: Year-on-Year change in US Consumer Price Index (CPI)

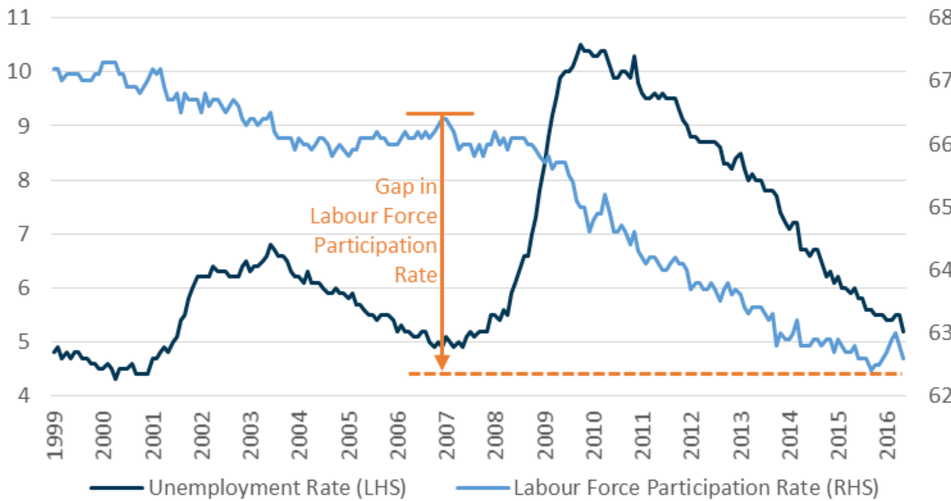


Source: CEIC, PSR

Employment data are not as rosy as they suggest

Employment data has always been pivotal in the decision making process for the Federal Bank. The most recent unemployment rate (for the month of May) was 4.7%. This was the lowest unemployment rate ever since the financial crisis in 2008. However, there was little call for celebration as it was matched with a decrease in labour force participation, which is near its recent historical low. There is a gap in the labour force participation since the 2008 crash as Americans give up on job search and fell out of the labour force altogether.

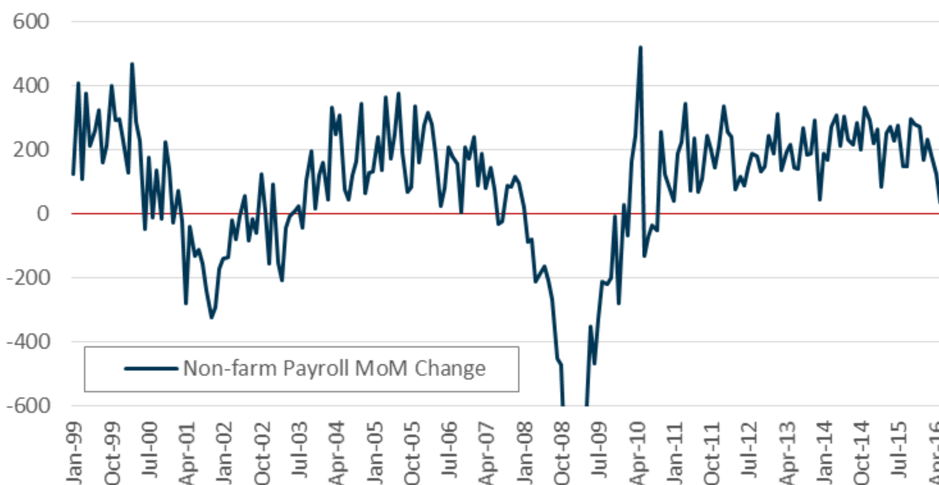
Figure 5: Unemployment rate vs Labour force participation rate



Source: CEIC, PSR

Besides the unemployment rate, the highly watched non-farm payroll data has also shown sign of weakness. The huge negative surprise of only 38k of jobs created in May, the lowest in 6 years, added confusion in an already erratic labour market. In addition, there was also a huge negative revision in the April data from 200k to just 160k.

Figure 6: Non-Farm Payroll year-on-year growth

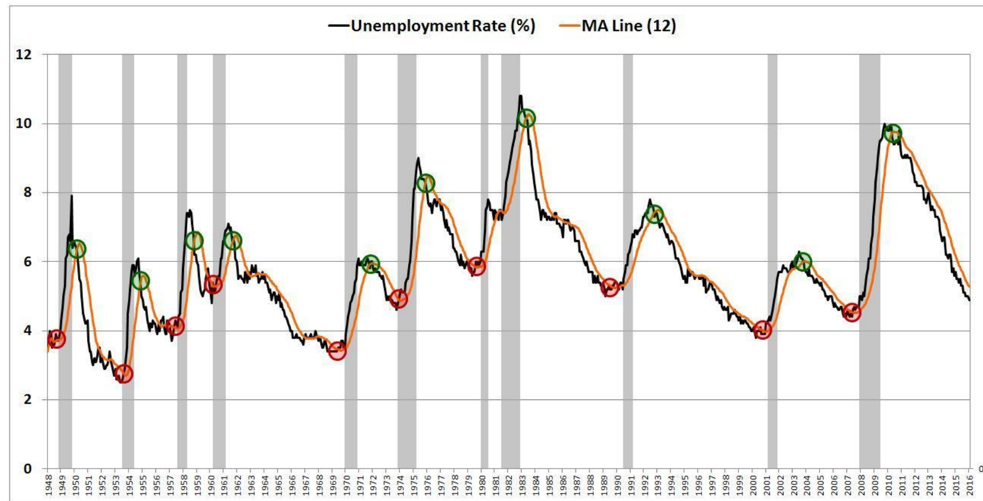


Source: CEIC, PSR

Unemployment as a leading indicator for recession

Since 1948, unemployment has always been a good indicator of a US economy recession. Whenever unemployment is at its pivotal low and start to trend upwards, it is usually a good sign that the US economy is heading for a recession. A good way to view a change in trend is when the unemployment rate ticked up above its 12-month moving average as shown in the chart below. The red circle denote a change in trend and the gray shaded area denote a period of a US economic recession. We can observe that a red circle always preceded a recession.

Figure 7: Change in trend of unemployment rate precede a recession



Source: www.philosophicaleconomics.com

The table below shows, in each of the eleven recessions that occurred since 1948, the trend in the unemployment rate turned higher months before the recession began. The average lead for the period was 3.45 months.

Figure 8: Average lead time of Unemployment in month

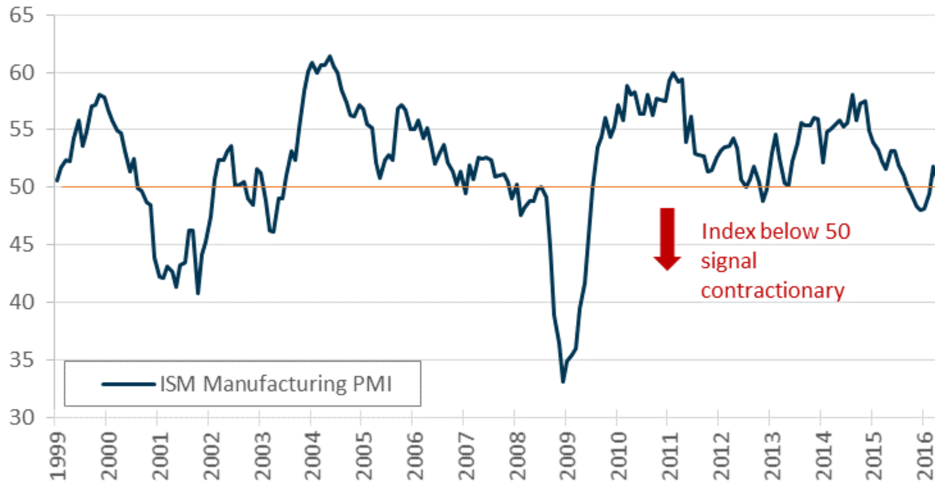
RECESSION START	UE TURNED HIGHER	LEAD
1948.11	1948.06	5
1953.07	1953.07	0
1957.08	1957.04	4
1960.04	1960.03	1
1969.12	1969.06	6
1973.11	1973.11	0
1980.01	1979.07	6
1981.07	1981.04	3
1990.07	1990.04	3
2001.03	2001.01	2
2007.12	2007.03	8
AVERAGE		3.45

Source: www.philosophicaleconomics.com

Manufacturing is already in a recession

As much as the US politicians want us to believe that the economy is no longer dependent 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.

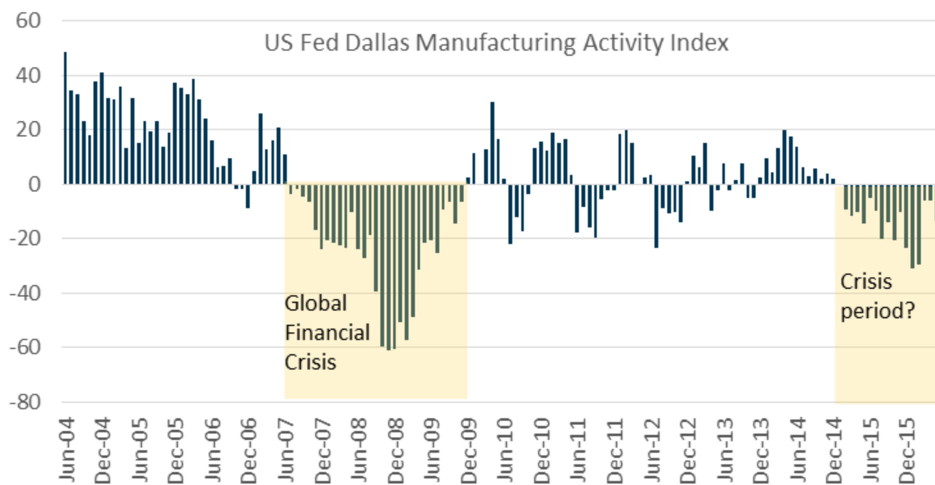
Figure 9: ISM Manufacturing PMI



Source: CEIC,PSR

Texas, the second largest state in US, is important to the nation's manufacturing output. The state produced $159 billion in manufactured goods in 2008, roughly 9.5 percent of the country's manufacturing output. Texas turns out a large share of the country's production of petroleum and coal products, reflecting the significance of the state's refining industry. Therefore, the Fed Dallas Manufacturing Index is a good gauge of the overall manufacturing economy in US and the index has been in the negative territory for the longest time, mirroring the GFC period.

Figure 10: US Fed Dallas Manufacturing Activity Index



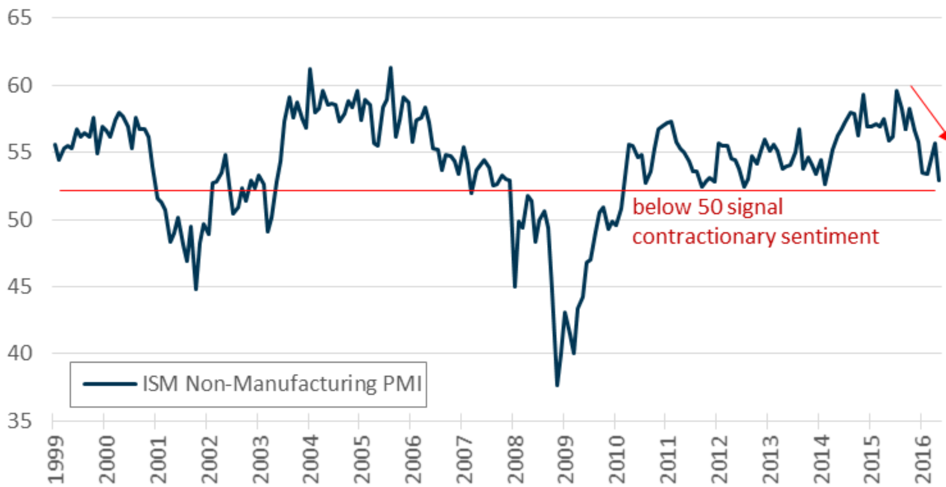
Source: CEIC,PSR

Service sector is not performing as well

The US government has continued to emphasize the important of its service sector as a major economic driver compared to manufacturing sector. However, since reaching the peak of 59.6 in July 2015, the Purchasing Manager Index for non-manufacturing business has witnessed a continuous downward trend.

Currently, both manufacturing and non-manufacturing indices are trending south, raising a red flag for the US economy.

Figure 11: ISM Non-Manufacturing PMI

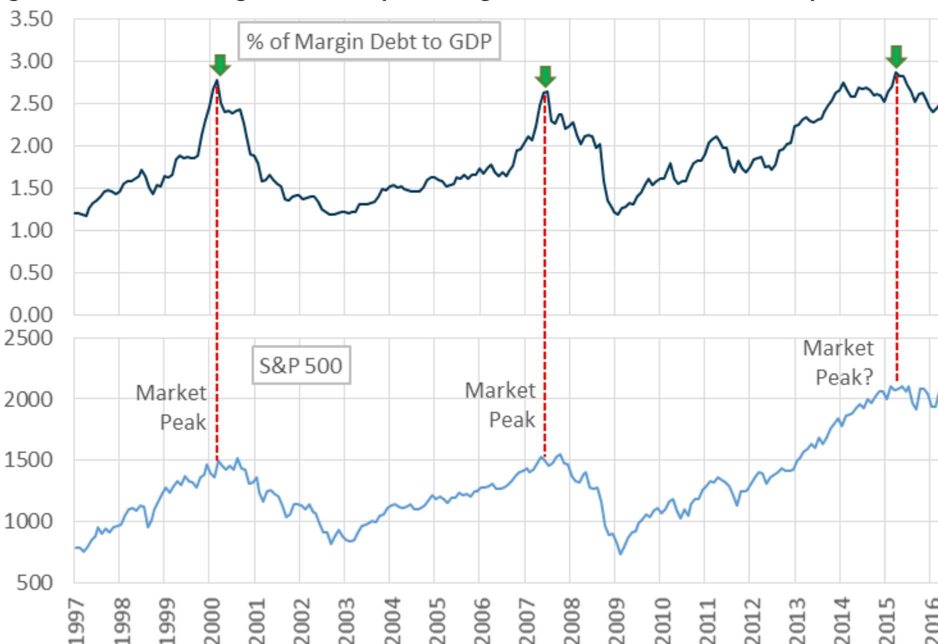


Source: CEIC, PSR

Margin Debt as a market peak indicator

We have also observed an almost perfect direct relationship between the peak of margin debt as a percentage to GDP to the S&P500. During the dot-com crash in 2000, margin debt rose to 2.78% of GDP in March 2000 before it started to drop. 5 months later, S&P 500 peaked and crashed as well. A similar scenario happened in 2007 when the margin debt peaked at 2.64% of GDP followed by S&P500 reaching its peak within the next 3 months. Fast forward to present time, we see margin debt peaked in April 2015 and the US equity market reached its all-time high in May 2015. If the correlation continues to hold, it would imply limited upside in this bull market since 2009.

Figure 12: Peak in margin debt as a percentage of GDP indicates market top

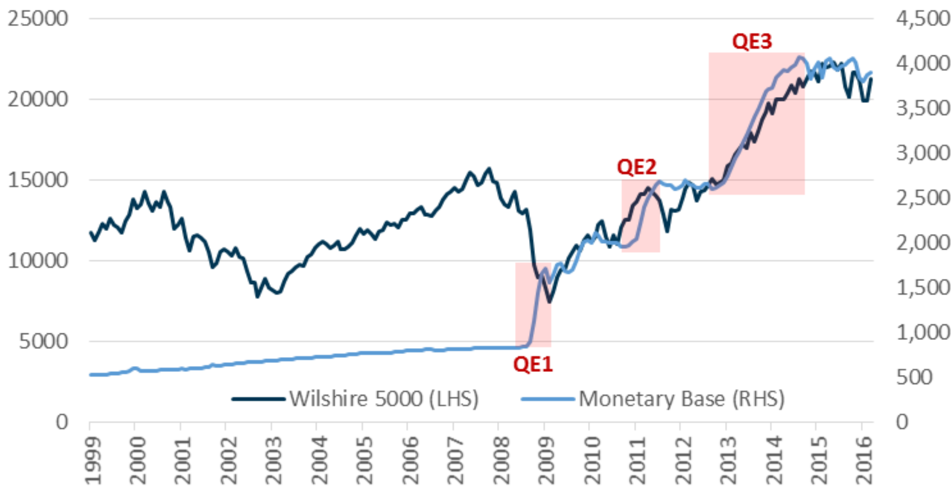


Source: CEIC,PSR

Equity market was fueled by an expanding monetary base

The relation between monetary base and the stock market, as shown in Figure 13, re-emphasized the fact that the equity market was fueled by easy monetary policy in the past few years. The expansionary monetary policy has created an asset bubble in the equity markets. The low interest rate environment driven by the Quantitative Easing (QE) has stretched the boom-bust cycle from a typical 7-year period. With the end of QE, the equity market (Wilshire 5000) has also peaked in May 2015 and trended sideway for the last 12 months.

Figure 13: Monetary Base & Wilshire 5000



Source: CEIC, Bloomberg, PSR

Conclusion

It is hard to be convinced that the US equity market is the best place to invest in now, or global equity markets in general for the matter. Economic data has proven that the shape of the economy is not well at all, as it prepares to face headwinds in the second half of the year. A second rate hike will probably happen in July and the presidential election in November will probably create even more uncertainty. The most likely candidate primaries, Hillary and Trump, from the Republican and Democrat parties respectively, have been running campaigns and advocating policies that cannot be any further apart. Businesses and corporates will be unwillingly to invest further until a clear leader is being elected. Therefore, this can only have a limiting effect on how far equity markets can progress without any fundamental improvement.

Furthermore, the uncertainty over Brexit will only causes more turmoil in the market. The event is earmarked to be more important than UK own government election. While a Britain exit will spell uncertainty for both the Eurozone and United Kingdom, a “remain” scenario should keep things status quo. However, as of today, the opinion poll have been neutral with a slight bias to remain.

All-in, we remain negative on US equities and equity markets globally. Unless we see significant catalyst or an exogenous shock, our view will remain for the year.

Figure 14: Upcoming major events

Date	Event
15 June 2016	Fed Interest Rate Decision
23 June 2016	“Brexit” Referendum
27 July 2016	Fed Interest Rate Decision (with press release)
8 November 2016	US Presidential Election

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