Beneath the Surface

November 2022

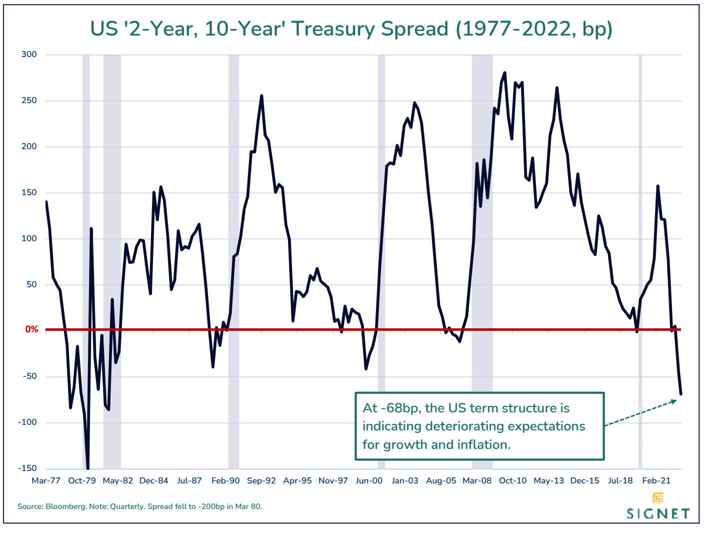
SIGNET

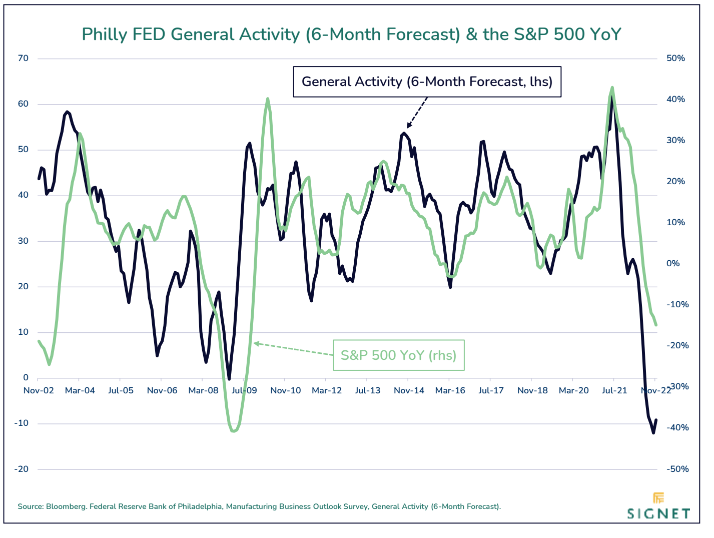
Leading Indicators Advocate Caution

- US third quarter (Q3) GDP came in positive and ahead of expectations at 2.6%, which followed on from the surprise negative prints of Q1 and Q2. Much like Q3, the Q4 GDP estimates, evaluated by 'nowcasting' analysis, currently appear stronger than originally expected. Lagging indicators, such as unemployment (duration of), loans, inventories and labour costs, are improving and are up 3.7% over the last six months, according to The Conference Board. These indicators often grab the headlines leading to talk of "recovery."

- However, the Conference Board's *leading* indicator index has fallen for eight consecutive months and is now down 3.2% over the last six months. Talk of some recovery is probably misplaced and misunderstood; the global economy is weakening rapidly, with the possibility that the US and other developed economies experience recessions in the near term. Further, China cannot be expected to 'bail out' the global economy this time around either; it has serious structural economic problems of its own to address.

- Chart 1 (left) highlights the difference between the 2-year and 10-year Treasury yields (spread) and is a useful leading indicator of recession. Specifically, an inversion indicates receding growth and inflation expectations, and often signals a market 'top' for risky investments. This looks pessimistic and suggests the Fed is tightening too far and too fast. Chart 2 (right) is another leading indicator, mapped against the YoY return of the S&P 500 (green). The Philly Fed Survey is a respected release and has a useful component looking at the expectations for general business activity in six months' time. The indicator has already breached the lows of 2008, and abruptly as well, and its trend might be associated with further weakness in the ISM data, earnings and – ultimately – asset (risk) prices.





- The Fed appears to be draining liquidity, via the monetary base, in phases. While this can lead to periods of market recovery in the core areas, and investor complacency perhaps, we maintain that the trajectory of 'liquidity' remains lower, especially as inflation expectations remain elevated. That's bearish. The initial impact of the draining of liquidity can clearly be seen in some of the more speculative corners of the markets: crypto assets, the new-age technology sector and residential property. Elevated commodity prices and the strength of the dollar only compound this liquidity problem, especially for emerging markets. While there is evidence of inflation beginning to roll over, the inflation dynamic remains uncomfortable for central bankers and – therefore – we remain cautiously positioned.

Therefore:

- Remain defensively invested. Fixed Income: there are opportunities to target quality and liquidity.
- Equities: target quality but there's no rush. Commodities: target precious metals.