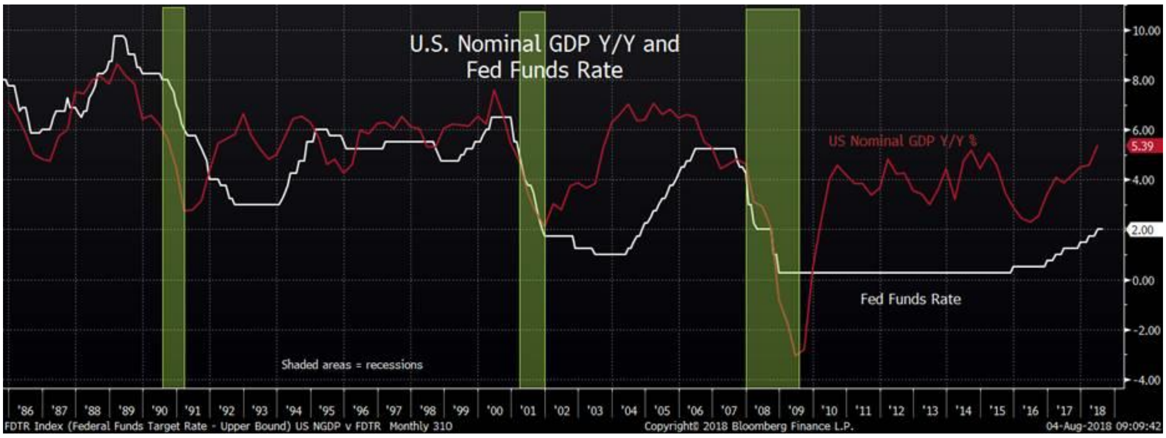
Has US Business Confidence Peaked?

5th August 2018

At the Federal Reserve Open Market Committee meeting last week, the Fed may have left rates unchanged (as expected), but they did give the impression that they thought the US economy was performing well. With nominal GDP growth now at its highest since 2006, it's easier to talk about the Fed being behind the curve, thereby risking a period of overheating. Furthermore, with Government spending on the up and tax cuts still fresh in our minds, we can certainly see why the Fed may be keen to keep tightening policy regardless of what Trump says. Our view remains that they will raise rates at each calendar quarter end and let their balance sheet run down until something bad happens.

Chart 1 – US nominal GDP growth and Fed Funds Rate



In terms of what we learned this week; we know that the employment data remains strong, but what piqued our interest was the decline in business confidence in both the manufacturing and services sectors. When discussing the big picture, we have recently focused on some of the leading indicators that will most likely deteriorate before stock prices and the economy do. Two that we have been monitoring are the US Manufacturing PMI and the Leading indicators index. These are plotted in chart 2 and it appears to us that both could be in the early stages of rolling over.

Chart 2 – US Manufacturing ISM and Leading indicators Y/Y % change

The main question is whether tighter US monetary policies with the prospect of further tightening to come is beginning to weigh on business confidence. Also, is it not a worry to the bulls that, considering business was the biggest beneficiary of the recent tax cuts, confidence is no higher than it was before the tax cuts were announced?

Along with tighter monetary policy, we have a stronger US Dollar and trade issues that could crimp growth in the quarters ahead, but it is important to note that the US economy is not about to go from boom to bust overnight. The key point is that, well ahead of the onset of recession business confidence, along with other leading indicators, is going to peak and rollover. We believe that the chances of a peak having already occurred are high.

Chart 3 – US GDP Growth and US Manufacturing PMI

But this is still early days, and we need more confirmation. For example, the Manufacturing PMI shown above only covers large companies. Small companies are very important within the overall economy, and within this group, confidence remains at very high levels.

Chart 4 – US GDP and NFIB Small Business Confidence Index

So in the months ahead, we are going to be watching business confidence very closely. Despite the best economy in over a decade and the best earnings performance (as measured by EPS) pretty much ever (outside of the early stages of an economic recovery), business confidence may have peaked in Q2 2018.

We would also note that stock prices themselves are one of the 10 components of the leading indicators index and the trend is still higher. The S&P bounced off the 2800 area last week and price is near record highs and comfortably above the rising 50 day moving average. From a trend perspective, we are constructive on the broad US index in the short term, especially as long as the 2800 level holds. Longer term, it would require a break of the 2600 area for us to move to a much more defensive posture.

Chart 5 – S&P 500 daily chart

From an equity perspective, our concerns lie in non-US markets which appear to be struggling (in US$ terms). Price appears to be at risk of rolling over, is below the 40-week moving average which is in the process of rolling over, and price appears to have just failed at resistance.

We think we have seen this play before. As US monetary policy becomes restrictive, capital retreats to the core, which in this case means US equities, whilst global markets begin to underperform. Our roadmap is that, as global equities continue to struggle, at some point this will spill over into US equities.

Chart 6 – MSCI World exc. US weekly chart

We don't know when this will happen, but as we have discussed before, if we are correct that the Fed keeps raising rates until something breaks, then investors need to be watching leading indicators very closely point. And as noted above, stock prices themselves are a leading indicator, and we are very open to the idea that global markets in this cycle will lead US stock prices.

So, as we see it, it appears that some of the leading indicators peaked in Q2, perhaps alongside year on year GDP growth as well. This thesis is in its early stages but needs watching closely. If we are right, and business confidence begins to deteriorate, we would look for consumer confidence to rollover (from very elevated levels), alongside housing data which may well have begun this process already. Last to deteriorate will probably be employment data with stock prices peaking somewhere in between.

This series of events should play out over a number of months; we would suggest the next 6 to 12 months. We will of course report on key changes as and when they happen.

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