November 2019

Headlines – There's Always More to the Story

Headlines are important—they condense complex stories into quickly digestible formats and convey concise messages. That said, when talking about the global economy, headlines often can be misleading; the qualities that make headlines a useful form of communication can be negatives, as well. The global economy is a complex system that can produce contradictory data at any given time. When the stakes are high, those underlying readings—conveyed by headlines—can drive investors to act on emotion rather than systematically evaluate the total environment and make decisions based on a holistic approach.

As we have discussed in previous quarterly letters, Highland's Diffusion Index helps navigate the noise of the headlines and focus on the analytical fundamentals.

The Diffusion Index provides context to the various headlines in order to understand the complete story; the Diffusion Index breaks down six major drivers of capital markets to inform investment teams whether we are in a risk-on, risk-neutral, or risk-off environment for assets. The goal of the Diffusion Index is to help anticipate protracted bull or bear markets and allow investors to adjust portfolios accordingly. It is not meant to anticipate short-term corrections in the market, as these are often hard to predict—and even harder to properly implement within portfolios.

While headlines about the trade war, the yield curve, or a slowdown in manufacturing may suggest the economy could be headed into a recession, the six major factors contributing to the Diffusion Index—and each of the 27 underlying factors—tell a different, more nuanced, account when reviewed in the total. Let's dive into the fundamentals in Figure 1.

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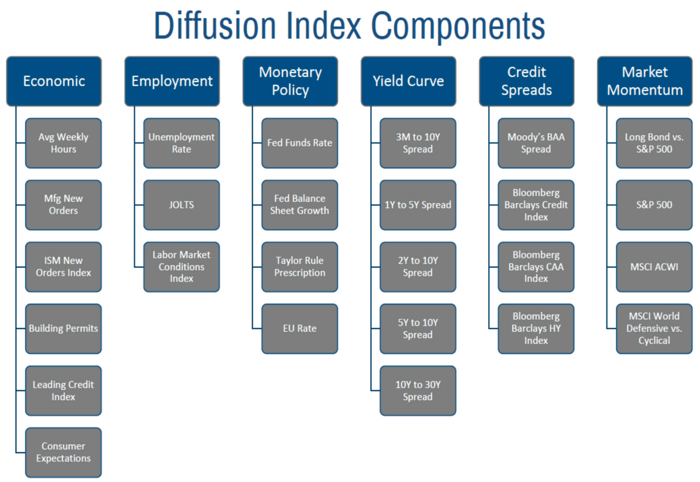
Figure 1



Source: U.S.: Highland Associates;

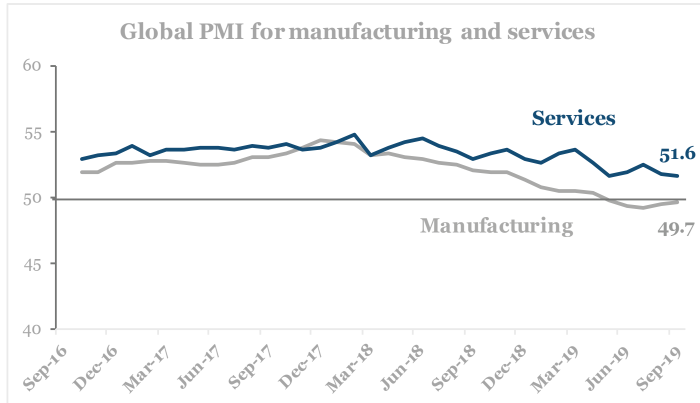
Economic Indicators: Close to Neutral, but Still Growing

The economic indicators used within the Diffusion Index measure business outlook, economic activity, and consumer expectations. Headlines have recently suggested economic indicators are flashing red. Instead our readings suggest there is more to the story: a stark dichotomy between the manufacturing and consumer economy.

Business Outlook

Recent headlines have focused on the decline in the U.S. Purchasing Managers Index (PMI). The PMI shows trends in the manufacturing and service sectors. Any reading below 50 signals contraction. In September, U.S. manufacturing PMI showed its lowest reading in more than 10 years at 47.8—which many attribute to the ongoing trade war and strength in the U.S. dollar. However, as service sectors continue to drive growth of the global economy, it is increasingly important to bifurcate service and manufacturing PMIs, which we show in Figure 2. Noticeably, both PMI readings are trending down globally, but services remain above the crucial 50 mark, indicating continued expansion. The fundamental idea here is that a modern economy driven by services is less dependent on the strength of manufacturing. Manufacturing will always play an important role in the global economy; however, a strong service sector can increasingly offset slowdowns in manufacturing.

Figure 2



Source: Highland Associates; Federal Reserve; FactSet

Headlines indicate that manufacturing is bearing much of the burden of the trade war. The effects of the trade war have shown in the decrease in PMI and average weekly hours worked (indicating slack in manufacturing capacity). However, durable goods' orders are trending positive, suggesting manufacturers are preparing for a turnaround due to pent-up demand.

While headlines may focus on a manufacturing slowdown, we question whether credit markets can power a turnaround. For that reason, we review the Leading Credit Index. Should manufacturers require additional CAPEX to service any pent-up demand, they will, no doubt, require additional borrowing. The Leading Credit Index compiles various financial market indicators used to represent lending conditions in the U.S. economy—negative readings suggest more propensity to lend. The latest reading of -1.09 versus the 10-year average of -0.71 suggests continued appetite to provide credit.

We agree with the headlines observing a slowdown in manufacturing. Is this the whole story? When looking at the whole picture, business indicators suggest the slowing global economy may be bottoming out, but we will continue to look for a sustained trend to confirm this.

Consumer Expectations

Despite recent headlines focusing exclusively on consumer confidence, the state of the U.S. consumer generally remains strong. Consumer confidence did recently decline month-over-month from a reading of 134.2 in August to 125.1 in September. But the September reading is still very high, matching readings from year-end 2018. With the strength in employment and observable wage growth, one could infer this decline in sentiment is being driven by the very headlines to which we are seeking to add context.

A second measure we check to determine consumer strength is building permits. Building permits are a leading indicator on the health of the U.S. housing market; they provide information on the number of new housing units approved during a given month. In September, that number was estimated at 1.39 million units, above the 1.29 million units for September 2018 and well above the 10-year average of 1.02 million. U.S. employment and demographics are supportive of further household formation, suggesting continued strength in the housing market.

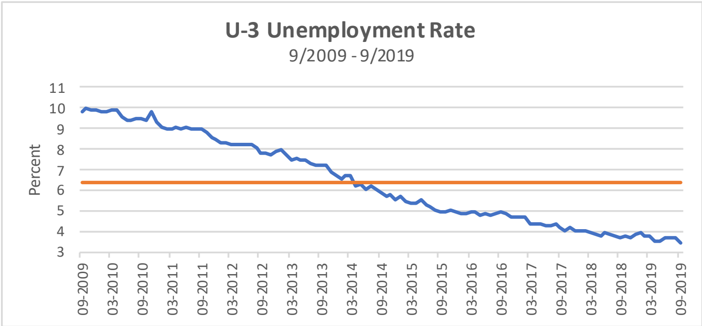
So, while headlines may focus on declining consumer confidence, there is little mention of the increased desire among consumers to build homes and form households. Our view is that the state of the U.S. consumer is strong

Employment Indicators: Firing on All Cylinders

Employment, which propels U.S. consumption, remains very strong. In fact, the U.S. labor market is as strong as it has been in recent history, but this labor market strength seems to be omitted from many of the headlines about the economy.

The current unemployment rate in the U.S. stands at 3.5%, down 20 bps year-over-year and down nearly 3% versus the 10-year average of 6.4% (shown in Figure 3).

Figure 3



Source: Federal Reserve

The Job Openings and Labor Turnover Survey (better known as the JOLTS rate) is indicating sufficient slack in the labor market. The October JOLTS reported 7.1 million job openings and a hires rate of 3.8%, outpacing the separations of 3.5%.

The consumer should continue to benefit from labor market strength, which is evident by the growth in real wages. The latest reading indicated 2.2% real wage growth year-over-year, which should continue to support the consumer and household balance sheets.

Monetary Policy: Accommodative

Since the Global Financial Crisis, monetary policy has been quite the attention grabber, leading to no shortage of headlines on monetary policy. However, the implications and context around these central bank moves are often lacking.

Monetary policy remains accommodative in almost all regions of the world. The ECB just cut interest rates and restarted an open-ended asset purchase program. China recently cut its required reserve ratio, which dictates how much banks must hold in reserves, thus freeing up capital.

Furthermore, the Federal Reserve ("Fed") lowered its target rate by a quarter point for the third time this year to 1.50% - 1.75%. The rate cut occurred while the Taylor Rule, a systematic approach to rate policy, is calling for a rate hike. However, the headlines would suggest the rate cut is an indication this economy is on the cusp of recession. Effectively, the Fed is ultra-accommodative when viewing the rate cut through the lens of the Taylor Rule. Further, the Fed has indicated a strong willingness to support continued growth. In Chairman Powell's press conference, he alluded that the Fed will be data-dependent and "will act as appropriate to sustain the expansion" if the trade war further weakens business output.

Yield Curve: Flattening

The inversion of the yield curve of the 3-month vs. 10-year continues to grab headlines. This inversion has led observers to believe a recession is imminent. However, when diving deeper into the story and looking at other measures for confirmation, such as the 2-year vs. 10-year spread or the 10-year vs. 30-year spread, it is apparent that the inversion is only in the most front-end of the curve.

A yield curve inversion certainly grabs attention as a headline, but a true observation of the market requires diving far deeper into the story. Historically, equity markets have fared the worst when the 2-year vs. 10-year spread has inverted by more than 25 basis points and remained at those levels for a few months. We still have a way to go until we reach those levels.

Credit Spreads: Volatile

Credit spreads are a barometer of risk sentiment, measuring the yield premium investors are willing to take over risk-free treasury securities. Typically, spread tightening indicates a period of economic expansion, and widening signals increased fear.

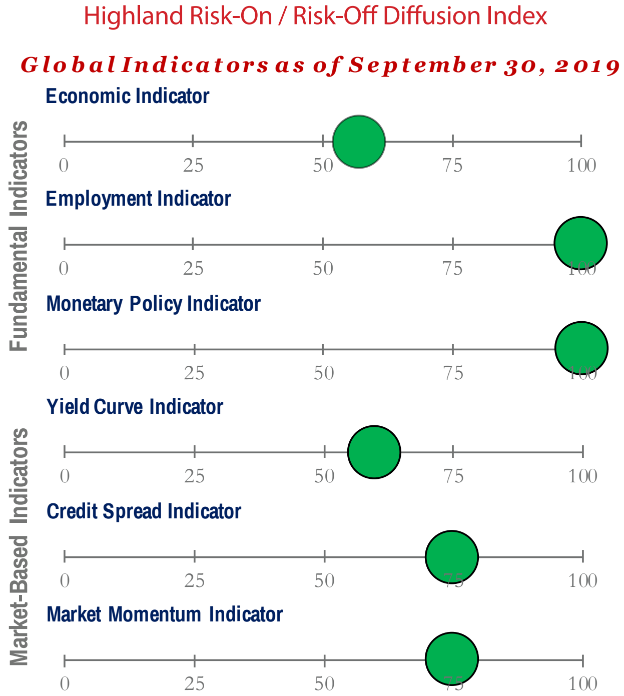
Year-to-date, credit investors have received a dual benefit from Fed rate cuts and credit spreads tightening. Credit investors have been paid for the risk this year, as evidenced by the fact that the credit portion of the Bloomberg Barclays Aggregate was up 12.5% YTD versus a 5-year average of 4.3%, as of October 18, 2019.

Recently, spreads have tightened across all of the Diffusion Index's indicators, excluding the Barclays CAA Option-Adjusted Spread. At this point, we do not see any severe mispricing. The recent tightening produced a spread of 415 bps by the BofAML U.S. High Yield at the end of September, which is only modestly below the 5-year average of 459 bps.

Momentum: In Favor of Risk Assets

Market momentum measures the trend in security pricing and is an indicator of investor sentiment and risk appetite. Momentum continues to favor equities over fixed income—outside of long-dated bonds, which have been propelled by duration in this rate-cutting environment. New money entering a market or sector can have a powerful, positive effect. Recently, we have seen this as investors rotated out of defensive stocks into more cyclical names, perhaps anticipating a turnaround in the manufacturing sector. We are watching this closely as this could portend both a regional rotation into international markets as well as a shift toward value stocks. We will continue to be mindful of developments here as our long-term strategic overweight to international continues to be at odds with our short-term tactical momentum reading. However, by using momentum to guide our tactical overweight to U.S. since August 2018, we have added substantial value for clients. Whether non-U.S. markets can continue to deliver depends on whether global growth will lift in 2020 due to less stress and prior policy easing taking effect. This will surely be the top question on investors' minds going into the new year.

Figure 4



Source: Highland Associates as of 9/30/2019; subject to change. Diffusion Index is a method of summarizing measures of the individual indicators listed above to indicate the proportion of indicators that reflect positively or negatively for risk assets. A Diffusion Index score of <40 is risk-off, 40-60 is neutral, and >60 is risk-on.

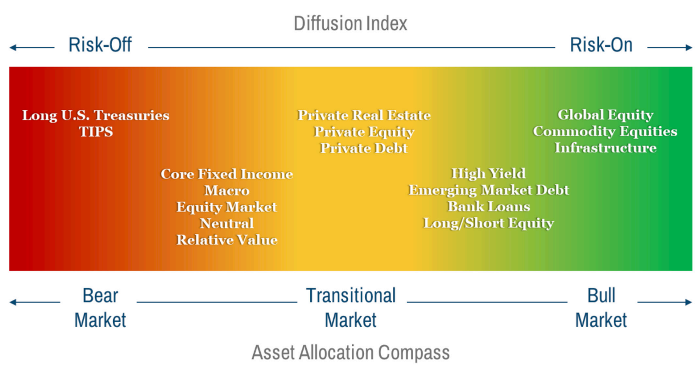
What About the Geopolitical Landscape?

Geopolitics continue to influence each of the above factors. There are no better "attention grabbers" than headlines focused on geopolitics. The trade outlook remains uncertain despite the October 11 announcement of a "Phase 1" deal and delays in further tariffs. Uncertainty in the Middle East, an imminent Brexit, and the upcoming U.S. election will no doubt play major roles in the headlines to come. No matter the headlines, our goal will remain intact: always give context to headlines and base our decisions on the fundamental data. While we are always mindful of the geopolitical landscape, we will seek to separate the knowable from the unknowable, the policy from the politics, and the deeper story from the headlines.

Conclusion

While headlines can be useful, the broader, more nuanced, story leads us to believe the market remains in a risk-on environment. Certain elements of the economy do appear to be weakening, but others suggest growth will continue, perhaps at a more measured pace. We characterize the current environment as slowing but growing. We remain vigilant in our monitoring of the economy and markets, recognizing the long bull run that risk-oriented assets have experienced. Eventually, when the fundamental data does indicate a market transition, we stand ready to help implement changes in client portfolios. Our asset allocation compass (Figure 5) remains our guide to implementing the allocation and strategy changes to navigate those risk-on, risk-neutral, or risk-off environments. But for now, we will keep reading the headlines, and working to understand the full story.

Figure 5



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