CreditSights

US Macro: Reassessing the Outlook

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EXECUTIVE SUMMARY

- **While the full impact of the coronavirus on the US economy is still unknown, we are revising down our GDP forecast for 2020 to 1.7% from 2.1%, as even a relatively benign outcome calls for weaker growth than we entered the year expecting.** We are revising down our view on real consumer spending growth to 1.9% and capex to 0.5%.

- **We update our CreditSights Macro index, which has decelerated sharply over the past few weeks.** We also include a view on the confidence measures we're tracking and ten different indicators we think can help assess recession risk.

Updated Economic Views

We update our view on the 2020 US outlook given the impact of the coronavirus. While nobody knows the extent of the effect, **we think even a more benign scenario calls for weaker GDP growth than we entered the year expecting. We are lowering our forecast for 2020 real GDP growth by 40bps to 1.7%, on weaker consumer spending and capex growth.** We think income growth will drop in the months ahead. If the impact of the coronavirus is limited there should be a rebound but not fully recoup the income drawdown, giving spending a fundamental reason to slow. We now expect consumer spending growth of 1.9% (50bps weaker than original forecast). Between the oil price impact, the potential hit to business confidence, and supply chain disruption the outlook for capex is also weaker than the start of the year. Manufacturers are going to be under strain in the months to come. The nascent restart of production in China is key. Therefore, we expect capex to grow just 0.5%. Housing will continue to benefit from low mortgage rates and will provide an important buffer for growth in the goods producing sector.

The magnitude and duration of the coronavirus spread in the US and whether global supply chains fully return to operations in the near term are unknowns. **The disruption represents a true recession risk** - something we think is seen in the bid for treasuries and risk off market moves. **But it is too early to deem the economy unable to recover from the slowdown it faces in the months ahead.** We'll highlight how we're tracking economic activity, assessing recession risk, thinking about the risk to households and the state of manufacturing below.

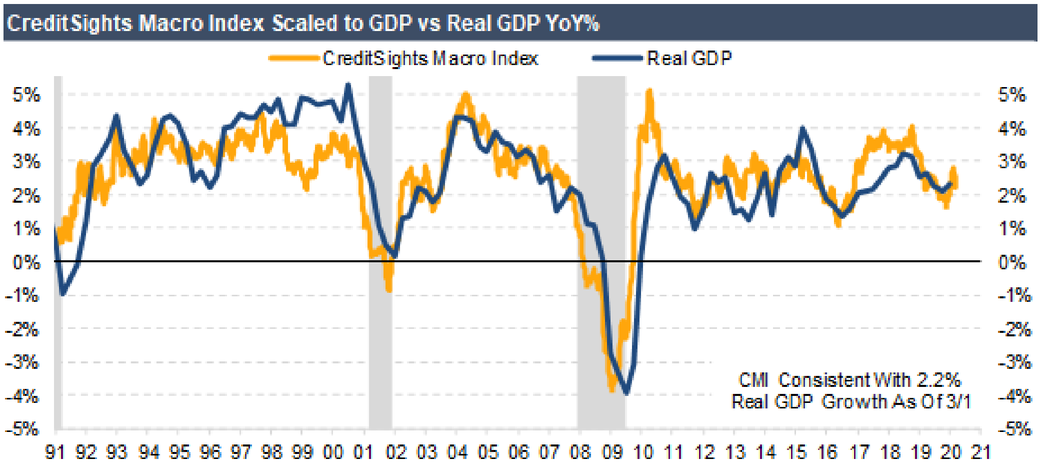
Updated Views on the Federal Reserve

We expect the Fed to deliver at least one more 25bps cut, likely due at their March 18th meeting. That could easily turn into two additional cuts and a discussion of potential unconventional easing measures if conditions worsen. The Fed will remain aggressive if the disruption from coronavirus trends towards substantial and long-lasting. **We think they follow the strategy described by NY Fed President John Williams in a July 2019 speech on monetary policy near the zero lower bound (ZLB):**

"Don't keep your powder dry—that is, **move more quickly to add monetary stimulus than you otherwise might**. When the ZLB is nowhere in view, one can afford to move slowly and take a "wait and see" approach to gain additional clarity about potentially adverse economic developments. But not when interest rates are in the vicinity of the ZLB."

Our view for additional easing from the Fed but 1.7% GDP growth is consistent with rates remaining low. UST yields could continue to test new historic lows in the near term as domestic case counts grow. Even if the economy rebounds as our base case currently calls for, the Fed is going to have a difficult time raising rates. We expect lingering recession fears will keep the 10Y yield in the area of its historic low, as the prospect of the fed funds rate hitting the ZLB weighs on rates across the curve.

Tracking Current Activity & Confidence



Source: BEA, CreditSights.

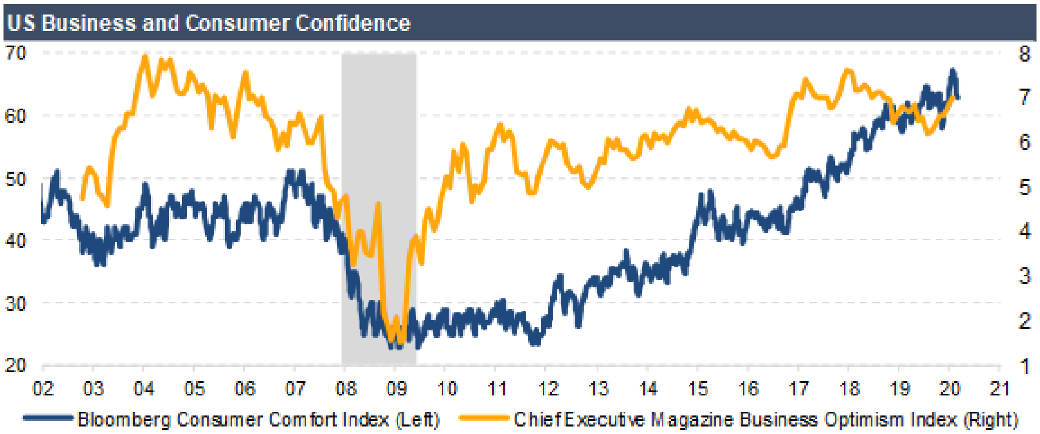
Other than the plunge in financial markets, it's mostly too early to see the coronavirus impact in monthly domestic economic datapoints. Our weekly CreditSights Macro Index had surged to start the year, peaking at a rate consistent with 2.8% real YoY GDP growth during the last week of January. Since then, it decelerated sharply, hitting a 2.2% GDP growth rate this week. Weakening components include consumer confidence, hotel revenue, unemployment claims, equity to treasury relative return, federal spending, and intermodal rail. Mortgage applications, real estate bank loans, and retail sales continue to provide strength. We expect the index will trend downward in the weeks to come, as measures like confidence and hotel revenue remain under pressure.

CreditSights Macro Index Component Z-Score

Week Ending:	12/8/19	12/22/19	1/5/20	1/19/20	2/2/20	2/16/20	3/1/20
Initial Unemployment Claims	-0.02	-0.24	-0.05	0.06	0.31	0.47	0.18
Johnson Redbook Total Retail Index	1.26	1.40	1.72	1.86	1.74	1.72	1.45
STR Revenue Per Available Room	-0.46	-0.11	-0.19	-0.62	-0.20	-0.51	-0.50
Bloomberg US Consumer Comfort Index	-0.15	0.06	0.25	0.57	0.78	0.63	0.21
Intermodal Railcar Shipments	-1.61	-1.61	-1.64	-2.00	-1.36	-1.34	-1.39
Steel Capacity Utilization	-0.10	-0.05	0.06	0.17	0.17	0.07	0.01
Baker Hughes Rig Count	-0.99	-0.95	-0.99	-0.94	-0.94	-0.96	-0.93
Chemicals Railcar Shipments	-0.77	-0.97	-0.86	-0.99	-0.43	-0.11	0.01
Mortgage Applications for Purchase Index	0.26	0.26	0.25	0.19	0.33	0.42	0.43
Real Estate Bank Loans	-0.09	-0.08	-0.08	-0.06	-0.01	-0.02	-0.05
Chicago Fed Adj. Finanancial Conditions	-0.02	0.00	-0.03	-0.03	0.01	0.02	-0.05
Relative Total Return S&P 500 to 10Y UST	0.23	0.59	1.01	0.96	0.69	0.58	0.28
Daily Treasury Statement Withdrawals	-0.02	-0.10	-0.18	-0.06	-0.25	-0.29	-0.66

Source: Department of Labor, Johnson Redbook, STR, Bloomberg, AISI, Baker Hughes, MBA, Federal Reserve, Department of Treasury, AAR, CreditSights. Green = strong, red = weak.

Weekly consumer confidence is one place where coronavirus may already be having an impact. The index we highlight below peaked at a 20 year high in January but has fallen for the past five weeks. The Chief Executive Business Optimism Index (our favorite measure of business confidence, see: **US Strategy: Contemplating Business Confidence**) continued to rally in February, hitting the highest level since 2018. The March reading will provide a glimpse of how businesses are assessing the damage to the outlook.

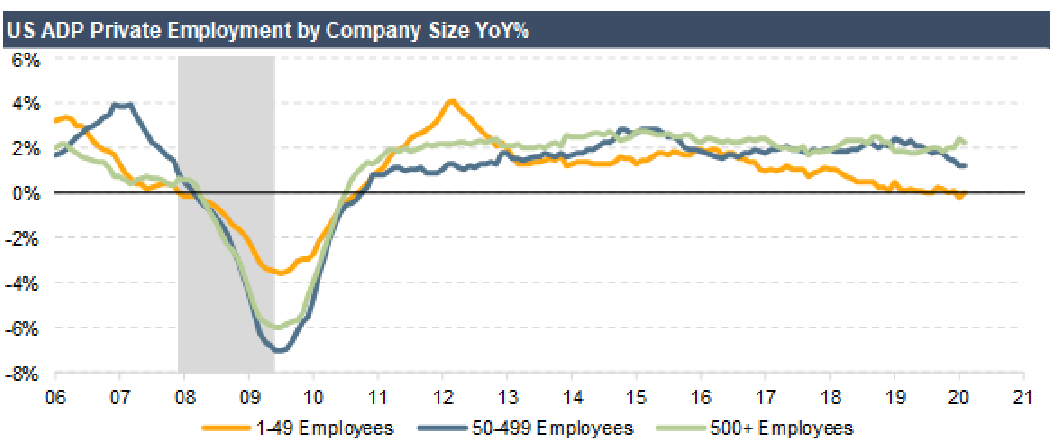


Source: Chief Executive, Bloomberg, CreditSights.

Assessing the Recession Risk

We entered this year with worries that weak corporate profit trends result in slower employment and capex growth. Disruptions from the coronavirus will exacerbate that slowdown. **A big risk we see is the impact on small businesses, which may not have the ability to handle a few months of cash flow disruption without cutting costs, laying off workers, or struggling with debt repayment.** As our Banks team highlighted, small and medium-sized enterprises "tend to have less financial flexibility, and this is likely where the real credit stress would show up" (see: **US Banks: Spinning Coronavirus Scenario Impacts**).

Firms with fewer than fifty workers employ 26% of the private sector according to ADP. Small firm employment has been basically flat YoY for all of 2019. Anecdotally, part of that is due to the tight labor market but we worry that small business employment could decline this year for demand reasons. Even if at-risk firms receive bridge financing, it adds leverage to a sub-set of the corporate sector that generally operates with lower profit margins. Weakness in the small business sector could cascade to the broader economy during an extended disruption.



Source: ADP, CreditSights.

Larger companies will be stressed as well, even if they are better equipped to manage the liquidity challenges from a sudden slowdown in the economy. Already, the economic recovery has been characterized by its tenuous enough grip on growth that has kept investment tame by historical benchmarks. With the outlook turning cloudy, that puts further limits on growth ambitions, at least for the period until companies have more comfort in supply chains and end-user demand. Further, corporate policies that have converged on grounding non-essential travel, and in some cases banning inbound visitors, will have a real economic impact on reduced economic activity and a slowed volume on closing deals (notwithstanding the benefits of videoconferencing). The labor market, which has been remarkably strong as it relates to job growth, will likely hit an air pocket. That will derive from a wait-and-see posture from CEO's on new investment and the simple mechanical challenge of how to interview and recruit amidst the viral risks.

The list below singles out ten variables that could indicate when the economy is hitting stall speed. None of these are perfect leading indicators for a recession alone. But taken together, they provide a useful view on the near-to-medium term outlook and recession risk. The majority currently signal go or caution with only two of ten in the red. For a fuller description and charts click the PDF below.

Recession Data Dashboard.pdf

Recession Watch Data Dashboard	Current Value	Previous Value	Signal
US Bank Lending Standards (Postive = Tightening)	-1.4%	4.6%	
AT Nonfin Corporate Profits YoY%	-5.2%	-2.5%	
Conference Board LEI YoY%	0.9%	0.1%	
4 Wk. Avg. Initial Jobless Claims % Ch. & Wks From Low	5.7% & 47	4.1% & 46	
Private Payroll Diffusion Index	58.7%	57.0%	
Unemployment Rate YoY Change	-30 bps	-40 bps	
Manufacturing PMI	50.1	50.9	
Non-Manufacturing PMI	57.3	54.9	
Chief Executive Magazine Business Confidence	7.00	6.59	
Consumer Confidence Present Situation YoY Change	-7.7	3.7	

Source: Federal Reserve, BEA, Conference Board, DoL, BLS, ISM, Chief Executive, CreditSights.

Consumer Spending - Demand Delayed or Demand Destruction?

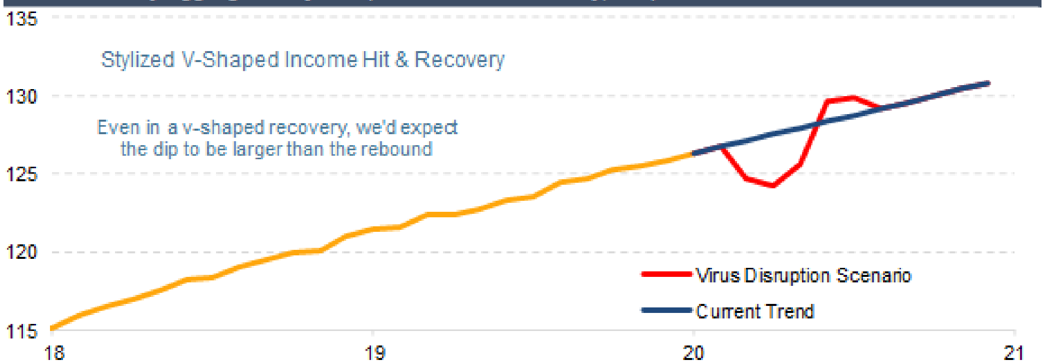
The virus impact on consumer behavior presents a demand shock to the US economy. Retail sales in February and March will benefit from preparation purchases, something already mentioned by companies like Target. But as the number of cases grows, there's likely to be less spending on discretionary services like travel and dining out. There could also be a hit to discretionary goods spending as well. Reduced levels of tourism, especially from China, will be felt by some retailers.

It's possible the pullback in spending presents a zero-sum scenario. Spending may be diverted to consumables or healthcare. Or money will be saved and then spent once the virus is contained (the v-shaped recovery). **But with the economy operating below full capacity for a few months as certain businesses cut hours or school closures force parents to miss work, there could be a loss of income in the months ahead that won't be fully recouped when activity recovers**. **That presents downside to total spending – demand destruction not just delayed demand.**

To illustrate what a v-shaped impact might look like, we modeled the impact on nominal personal income growth. We use aggregate weekly payrolls which is the product of private payroll employment, hours worked, and average hourly earnings. It allows us to proxy income by industry. We assume income temporarily falls for leisure & hospitality, retail, transportation & warehousing, wholesale trade, manufacturing, and other services. We chose those industries as we view them to be susceptible to supply chain disruption or consumers delaying discretionary expenditures. Though widespread school closings could lead to disruptions across industries as workers are forced to stay home to take care of their children.

The chart below imputes a reduction in income in March, April and May and then a rebound of pent-up demand in June and July. We think it would be difficult for the rebound to totally offset the drawdown, as there is limited capacity to make up for lost hours/income even when the economy is rebounding. The chart is meant to simply be illustrative – we don't know what the magnitude or duration of the income impact will be.

Private Weekly Aggregate Payrolls (Nominal Income Proxy, $bn)

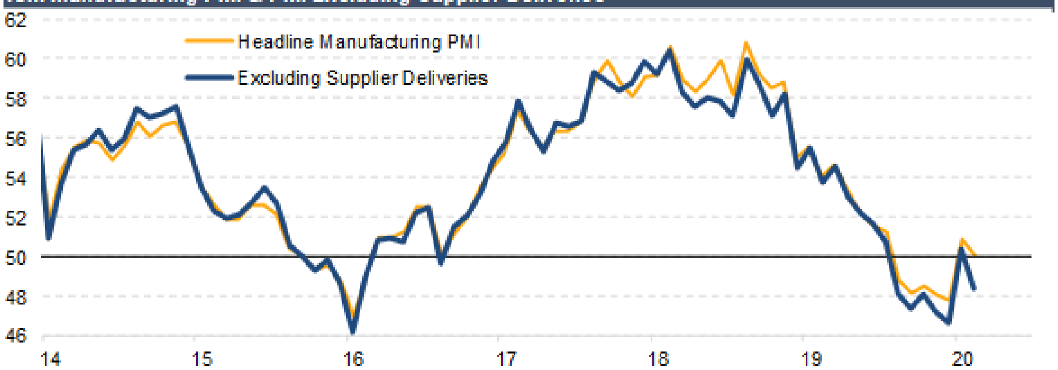


Source: BLS, CreditSights. Aggregate payrolls = product of average hourly earnings, average weekly hours, and employment. Assumes income drawdown & rebound for the following industries: leisure & hospitality, retail, transportation & warehousing, wholesale trade, manufacturing, and other services.

Given falling confidence and the disruption to income growth from the coronavirus, we revise down our expectations for 2020 real consumer spending growth by 50bps to 1.9% from 2.4%.

Manufacturing Rebound Supply Constrained

ISM Manufacturing PMI & PMI Excluding Supplier Deliveries



Source: ISM, CreditSights. Excl. supplier deliveries equally weights new orders, production, employment and inventories.

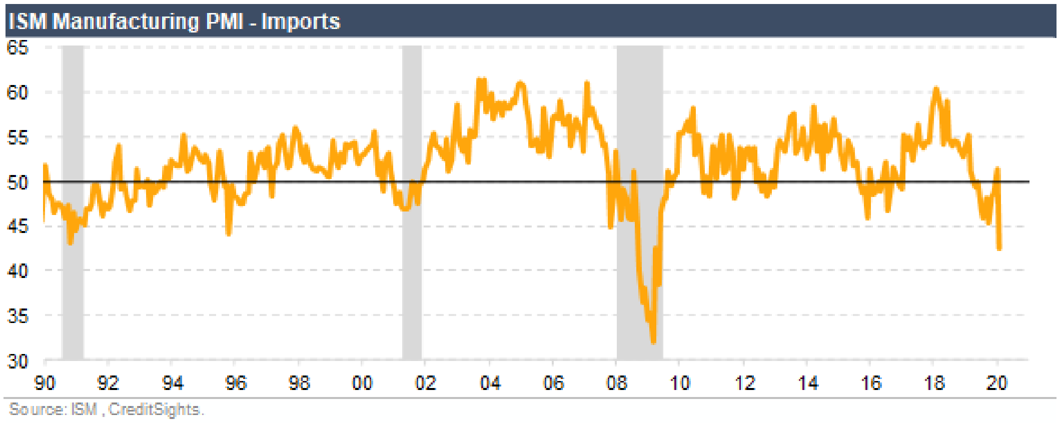
The impact of China's shutdown was readily apparent in the February ISM Manufacturing PMI reading. The headline index fell to 50.1%, a touch weaker than expected. While four of the five components were weak, supplier delivery times notably surged to 57.3%. That can normally be relied upon as a sign of economic strength as it points to suppliers struggling to keep up with demand. But with the coronavirus shutting down suppliers in China, it's a misguiding increase. If you exclude supplier deliveries, as we do above, the other four components average to 48.4%, down from 50.4% in January.

ISM Manufacuring PMI Heatmap

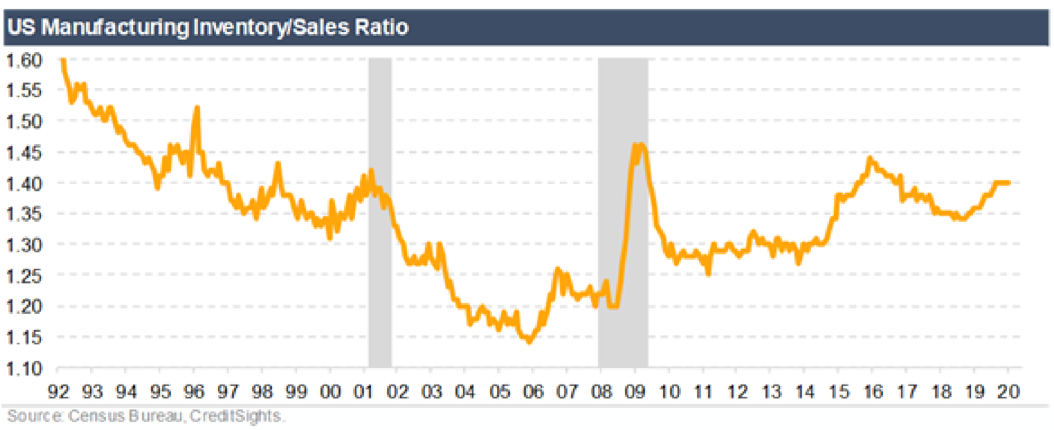
	Dec '18	Jan '19	Feb '19	Mar '19	Apr '19	May '19	Jun '19	Jul '19	Aug '19	Sep '19	Oct '19	Nov '19	Dec '19	Jan '20	Feb '20
Headline	55.0	55.5	54.1	54.6	53.4	52.3	51.6	51.3	48.8	48.2	48.5	48.1	47.8	50.9	50.1
New Orders	52.5	56.8	54.9	55.5	53.1	52.5	50.5	51.1	47.6	48.5	48.9	46.8	47.6	52.0	49.8
Business Production	55.3	57.0	55.4	55.1	54.3	52.0	52.4	51.3	48.9	48.4	46.3	48.0	44.8	54.3	50.3
Employment	56.2	55.2	53.2	57.1	52.4	53.1	54.3	51.3	47.6	46.5	47.9	46.8	45.2	46.6	46.9
Supplier Deliveries	56.6	55.5	55.3	54.9	54.8	52.5	51.2	53.5	51.6	51.3	50.1	51.7	52.2	52.9	57.3
Inventories	54.1	52.9	51.6	50.6	52.4	51.4	49.4	49.3	48.4	46.3	49.4	47.2	49.2	48.8	46.5
Customers Inventories	41.7	42.8	39.0	42.7	42.6	43.7	44.6	45.7	44.9	45.5	47.8	45.0	41.1	43.8	41.8
Price Index	54.9	49.6	49.4	54.3	50.0	53.2	47.9	45.1	46.0	49.7	45.5	46.7	51.7	53.3	45.9
Backlog of Orders	50.0	50.3	52.3	50.4	53.9	47.2	47.4	43.1	46.3	45.1	44.1	43.0	43.3	45.7	50.3
Export Orders	52.8	51.8	52.8	51.7	49.5	51.0	50.5	48.1	43.3	41.0	50.4	47.9	47.3	53.3	51.2
Imports	52.7	53.8	55.3	51.1	49.8	49.4	50.0	47.0	46.0	48.1	45.3	48.3	48.8	51.3	42.6

Source: ISM, CreditSights. Note: NSA = not seasonally adjusted. Value >50 indicates expanding activity. Intra indicator heat map
New Orders, Production, Employment, Supplier Delivieries, and Inventories are all a 20% weight in the headline index.

Supply constraints are also visible in the sharp drop in imports and inventories. Inventories hit the lowest level since September. Imports, shown below, are down to a level consistent with a recessionary periods. With reduced supply of goods coming into the country from abroad, manufacturers could run short on supplies and production may suffer in the months ahead as a result. Additionally, the domestic virus impact could limit production if workers need to stay home.



US manufacturing had been in the process of working through an inventory overbuild at the start of the year, with the inventory to sales ratio only starting to plateau over the past few months. To the extent that inventories are still somewhat elevated provides a small buffer to certain firms but certainly not all. Additionally, inventory tends to be elevated in the month of February as manufacturers consider the Lunar New Year holiday in China. On net, a deep decline in inventories is a risk and should show up first in the ISM figure, other manufacturing surveys, and freight traffic, as the hard inventory data are released with a substantial lag.



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