Market News

Will the U.S. Manufacturing Recession Cause a Stock Market Crash?

The U.S. manufacturing recession is causing some investors to worry about their returns. But with quantitative easing back in the fold, betting against stocks is premature right now. | Image: AP Photo/Richard Drew, File

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TAGS

recession

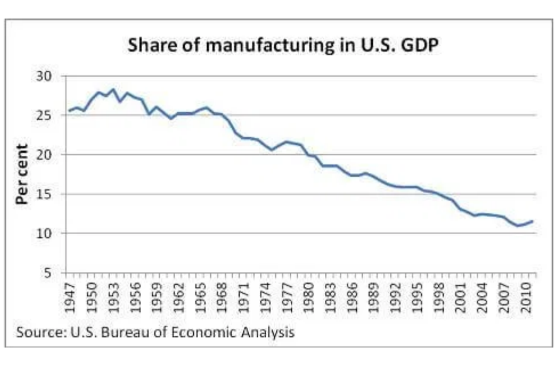
- The U.S. manufacturing recession is creating jitters among some investors, forcing them to question whether the downtrend will impact stocks and the broader economy.
- Manufacturing isn't as important to the U.S. economy as it once was so it's unlikely to spill over into other sectors.
- Betting against stocks when the Federal Reserve is printing money is not a good idea.

The U.S. manufacturing sector is in a recession and numbers for the month of October came in worse than expected. As per Federal Reserve, output at American factories fell 0.8% in October, missing expectations of a 0.4% drop by a wide margin. This was the worst monthly drop since May 2018 and marked the fourth consecutive month of decline.

Consistent contraction in the manufacturing sector has investors worried about a widespread recession that will send stocks lower. However, there are two good reasons to believe why recession fears may be overblown and betting against stocks may not be a good move right now.

Manufacturing Recession Won't Spill Over Into Other Sectors

Even before the October numbers came in, manufacturing accounted for the smallest share of the U.S. GDP in over seven decades. The sector was once a powerhouse of the U.S. economy, accounting for roughly a quarter of GDP in the 1960s. Its importance has been declining consistently and it makes up just 11% of GDP as per the latest data.



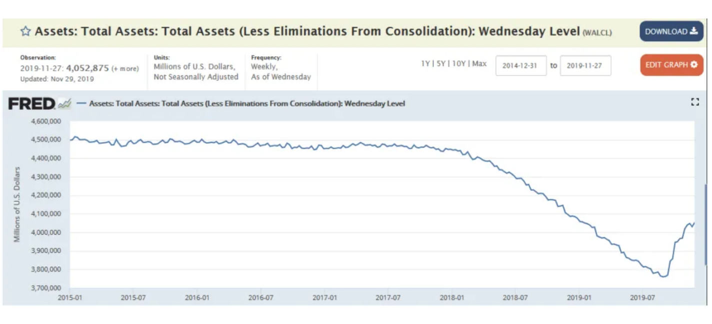
Manufacturing as a per cent of U.S. GDP has been declining consistently. | Source: Medium.com

Despite the recession in manufacturing, U.S. GDP growth came in at 2.1% in the third quarter, according to the latest revised estimates. That was higher than expected. The U.S. economy is expected to continue growing at a moderate rate.

The strength of U.S. economy in the face of declining industrial output highlights the diminishing importance of the manufacturing sector. The chances of the manufacturing recession spilling over into other segments of the economy and causing a widespread recession are quite low.

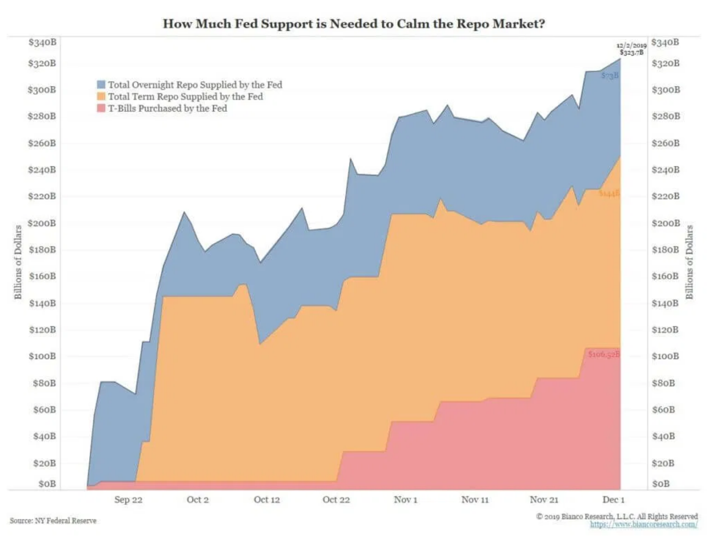
Stealth Quantitative Easing By the Federal Reserve

After a few quarters of quantitative tightening (QT), the Federal Reserve balance sheet is growing again. The central bank has been injecting liquidity into the repo market since Sep. 17, when the rate on overnight general collateral repo jumped from less than 2% to 10%.



Federal Reserve assets are growing at a rapid pace. | Source: St. Louis Fed

As of today, the Fed has injected $324 billion and the operations are expected to continue till the end of the year. The Fed is calling the expansion in balance sheet "technical measures" and not quantitative easing (QE). However, any expansion in central banks' balance sheet is QE by definition.



The Federal Reserve has injected $324 billion to stabilize the repo market. | Source: Twitter

While the long-term effects of QE on the economy are negative (as it punishes savers and causes bad capital allocation), it does lead to asset price inflation. Ever since the Fed started QE to "stabilize" the economy after the 2008 recession, stock prices have skyrocketed. In fact, there's a quite strong correlation between QE and stock prices, as evidenced below.

Stocks almost always move higher in face of QE. | Source: Stansberry Research

With the Federal Reserve printing trillions of dollars, some of them are bound to find their way into the stock market and drive prices higher. Since the stock market has become synonymous with the economy, any significant drop in equities will force the Fed to print more money and continue with its expansionary policies.

Going against the stock market in face of QE has historically been a losing bet. And unless trust in the U.S. dollar evaporates, there's no reason to believe this time is going to be any different despite the manufacturing recession.

*This article was edited by **Sam Bourgi**.*

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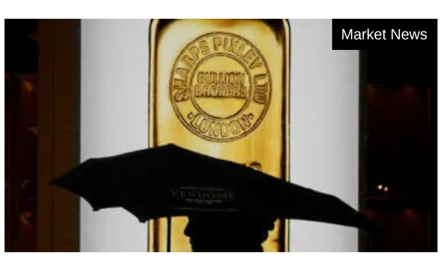

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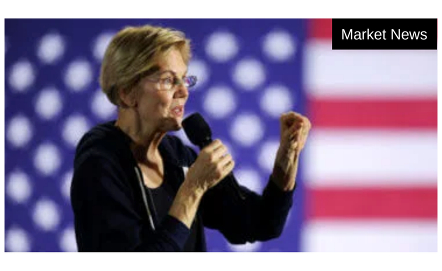

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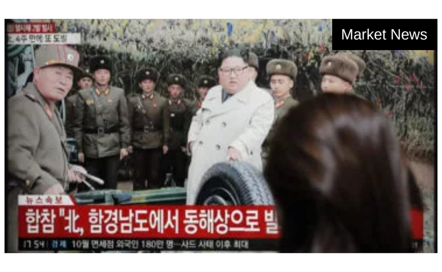

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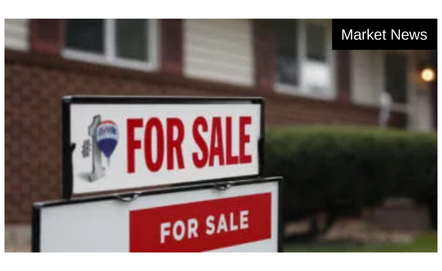

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