Market Insight: Leading Indictors Deteriorating

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Highlights

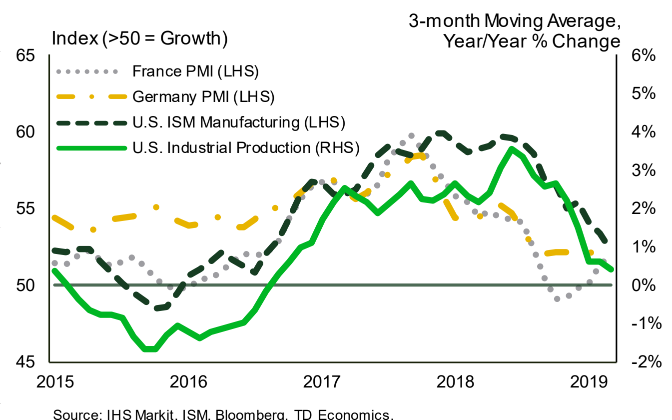
- The macroeconomic environment has been fluid over the last few months. Weakening international data have clouded the outlook and the decline in business sentiment has started to bleed into the broader U.S. economy.
- Our TD Leading Economic Indicator implies some persistence in below trend U.S. economic growth. Historically, the Federal Reserve has heeded this warning with interest rate cuts. We believe it will act again, with insurance cuts to its policy rate.
- This call for insurance cuts is less than what has been priced by markets through 2020. For the Fed to play through on the market's stronger view, there would likely need to be a more significant deterioration in the economy.

In the span of just eight weeks, the U.S. 10-year Treasury yield plummeted by 50 basis points, pushing below an important psychological threshold of 2%. This downdraft reflected the combination of falling inflation expectations, a greater risk premium related to an eroding global backdrop, and more dovish central bank communications. Importantly, this led financial markets to aggressively reprice the Federal Reserve's policy path. Depending on the day, data, and tweet, financial market participants generally leaned towards 100 basis points in Fed cuts by the end of 2020. Finally, a modest reprieve came on July 5th when a strong employment report offered financial market participants a sober second look at the degree of their dovishness. However, one strong report of 224K jobs is certainly not enough to materially remove the shadow hanging over the economic landscape. There are real risks to the expansion and the Fed will want to get in front of them. This leaves the question, how much monetary stimulus is needed to shore up confidence in the economic expansion?

The trend is not our friend

The answer to our question lies in the forces that first led to a fraying in market confidence. There's little doubt anymore that the global economy is mired in a sharp manufacturing slowdown, with successive bouts of trade friction further obscuring the outlook. This is most apparent in measures of manufacturing business sentiment, which have deteriorated steadily for months on end (Chart 1). It's also observable in the hard data through a collapse in global trade flows. Even U.S. industrial production has not withstood the headwinds.

Chart 1: Sentiment and Production on the Decline



Source: IHS Markit, ISM, Bloomberg, TD Economics.

Through every past business cycle, manufacturing sentiment

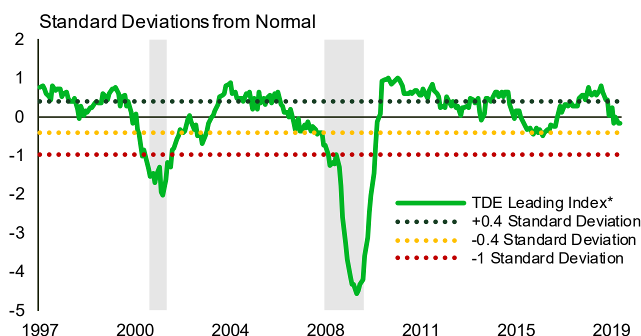
has been an important barometer for where the broader economy is headed. It doesn't always call it right when it comes to recessions, but it does a good job predicting the general direction of economic momentum due to its sensitivity to the external environment, along with supply and labor ties into the domestic economy. The key now is to assess whether this deterioration in manufacturing activity is spreading into other sectors of the economy.

To get at this, we turn to our TD Leading Economic Indicator (Chart 2), which captures the intersection of production, labor markets and consumer patterns. The aggregate index has a good track record paralleling and predicting overall momentum within the economy. The zero line captures the historical average performance of these indicators, and a push below that threshold means the economy has entered into a period of below-trend growth. We stand at attention when the index not only crosses the zero threshold, but at a minimum reaches -0.4 standard deviations from the norm. Doing so runs the risk of hitting a point-of-no-return, but still doesn't represent a finite outcome, as evidenced by the false-signal in 2016. Today, this index tells us that the negative sentiment permeating the manufacturing sector has indeed bled through to other segments of the economy, but not in a pervasive way, as of yet. An economic cushion remains, albeit thinner and warranting of some caution.

The Fed Response

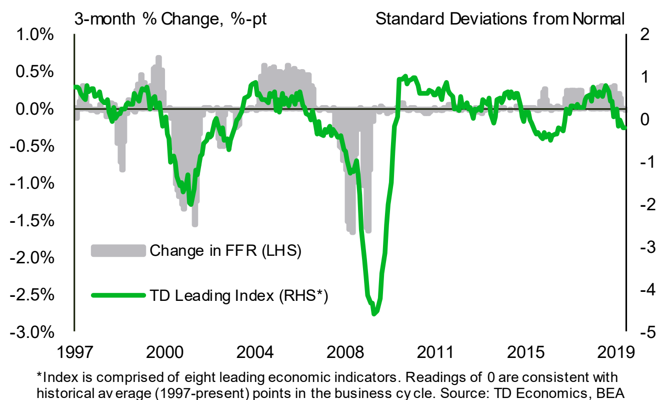
The warning signal inherent in our Leading Indicator now offers some clarity as to why Chair Powell took a more

Chart 2: TD Economic Leading Index



* Index is comprised of eight leading economic indicators. Readings of 0 are consistent with historical average (1997-present) points in the business cycle, while readings of -0.4 or +0.4 should be interpreted as one standard deviation below/above average, respectively. Source: TD Economics

Chart 3: TD Economic Leading Index

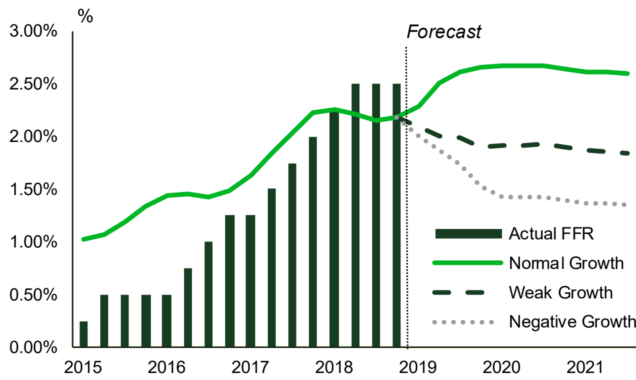


*Index is comprised of eight leading economic indicators. Readings of 0 are consistent with historical average (1997-present) points in the business cycle. Source: TD Economics, BEA

dovish stance at the most recent FOMC meeting on June 19th. The emphasis then was on the weakened global backdrop, coupled with more cautious domestic business investment behavior. In a low interest rate world, the Fed has less ammunition to combat a slowdown and therefore needs to act quicker when risks become elevated. We only need look back to 2015/2016, when Fed members acknowledged the risks to the outlook by hitting pause on an interest rate hike cycle that had only just begun with a single move. At the time, the upper bound of the policy rate was only at 0.50%, which was still very simulative and left little room for a cut. With the policy setting now at 2.50%, the Fed has considerably more scope to guard against emerging risks.

The only question is: how much do they need to cut? To assess, we simulate a number of economic scenarios (Chart 4). Should trade tensions and negative business sentiment ease, U.S. growth would keep chugging along around 2% and inflation would gently grind higher over the next year. In this scenario, the Fed would have more confidence that the economy remains on firm footing and a simple monetary policy rule would argue to leave interest rates unchanged. However, hindsight is 20/20 and a luxury that is not available. All the Fed can judge is current developments and the balance of risks. It's reasonable to assume negative sentiment will persist over the next year. In such an environment, we estimate that economic growth could head towards 1% by early next year. A precautionary rate cut of 50 basis points would help to bring growth back to the 2% mark. The alternative would risk a further deterioration in sentiment and having to play "catch-up" in shoring up economic momentum.

Chart 4: The Fed Response



Source: FRB, TD Economics

Now, if economic activity proves worse than we are expecting and heads towards zero (temporarily) within the next year, the counterfactual argues that a cut of around 100 bps would be justified to hold the economy closer to its trend pace in order to head-off that outcome. This view is closer to what the markets are pricing. At this stage, however, a 100 basis point cut would not reflect insurance, but more aggressive action to guard against the recessionary floor.

For this to materialize, we would expect to see a much deeper push lower in our Leading Economic Index below the -0.4 threshold. One key reason it has not done so is because the service side of the U.S. economy is proving resilient. Nothing drives this point home more than a U.S. consumer that is tracking in the 3-4% range in the second quarter.

Bottom Line

The next few months are crucial. The manufacturing sector in the U.S. is steadily decelerating and the erosion is happening on a quicker and larger scale internationally. Trade tensions are a major source of pain here. A period of trade stability combined with cuts to monetary policy would help stabilize business confidence. However, with each passing month where business confidence erodes and investment intentions become sidelined, the biggest concern becomes one in which the global economy is on a moving train that cannot be easily halted by the central bank.

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