macro scan

**Thursday, October 3rd, 2019**

Mark Orsley – Head of Macro Strategy

- ***Manufacturing continues to lead Services – the major risk now is a labor market deterioration***
- ***Evans shows Fed will quickly flip back from neutral to dovish***
- ***A quick look at other significant news: WTO, Bernie's heart, $0 commissions***
- ***What's behind the bullish reversal in equities***

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Today proved something we have been discussing all year; manufacturing leads services….every time. Therefore, the consensus thought that the service sector is going to hold up and that this is just a manufacturing problem is being proven false.

Therefore, going back to the "Anatomy of a US Slowdown" we can safely assume that trade wars took down the Manufacturing sector, the manufacturing sector took down the Service sector, the Service sector will take down the labor market, and then the labor market will take down the consumer. That's when we officially end this textbook economic slowdown which is now in the final stages.

It is not to say the world is ending or a major crisis is afoot; its just recession probabilities are increasing.

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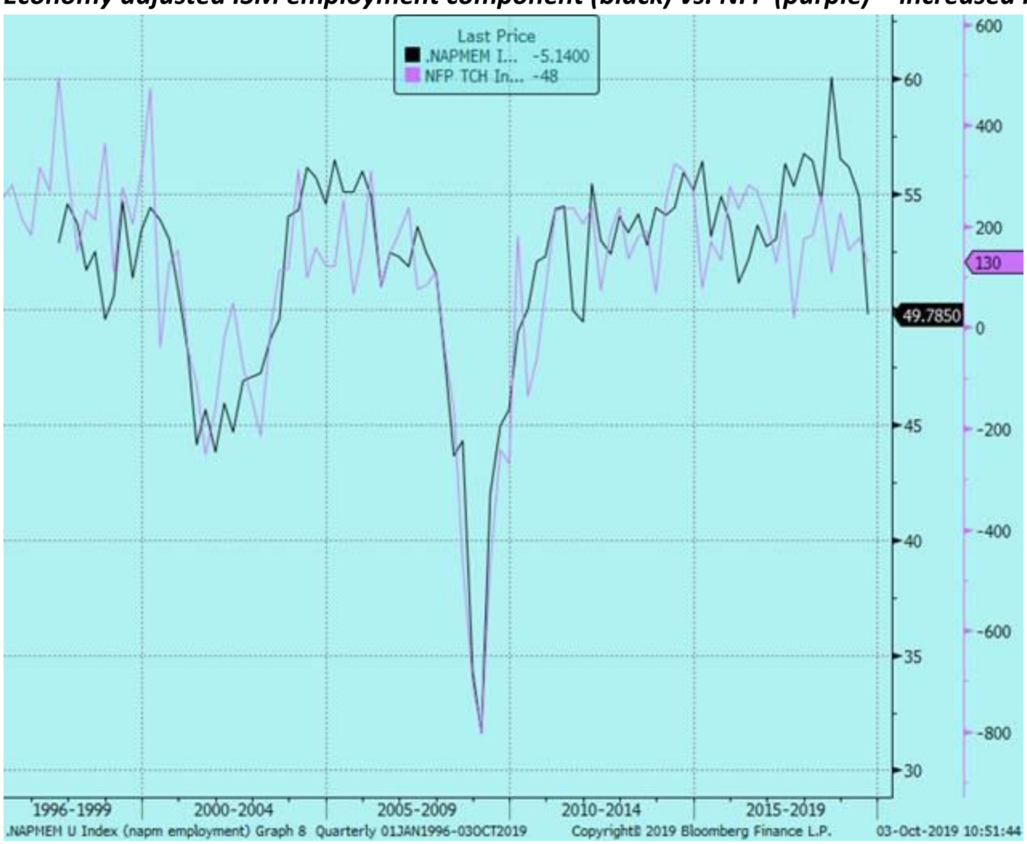
The main concern now is the trajectory of the labor data through the end of the year. I built an economy weighted index of the ISM Manufacturing and Non-Manufacturing employment index (both were very soft). It correlates well on a long-term basis with changes in NFP (81% correlation). **<u>It is suggesting that there is significant risk of NFP printing sub-50k in 4Q (I am not trying to predict tomorrows number, just the forward trajectory)</u>**.

***Economy adjusted ISM employment component (black) vs. NFP (purple) – increased risk of sub-50k NFP print in 4Q…***



The Fed is desperately trying not to cut rates again as they have indicated this is a "mid-cycle adjustment" previously and now using the refrain "insurance cut." The problem is some important data points are sinking through the 2016 lows so this is proving to be a deeper slowdown especially with no end in sight with Trade Wars (only solidified with EU/US tariff squabble).

That is why the Fed speak over the next couple days will be important (Clarida tonight, Powell tomorrow). We have already seen Evans flip back to dovish within three days.

**<u>The quick evolution of Evans:</u>**
Sept 30$^{th}$: *"After rate cuts, the Fed should leave policy on hold for some time"*
Oct 3$^{rd}$: *"ISM was a confirmation of FOMC view and I am concerned; open minded about the October meeting"*

Evans is sufficiently freaked out enough to pivot dovish in a matter of days. That was pre-ISM Non-Manufacturing also. Therefore, we have to conclude that other Fed officials will quickly pivot back dovish as well after attempting the neutral bias since September FOMC.

As stated before, Fed officials, who are stuck looking in the rear view mirror (per Williams this week), can never be taken at their word. They will respond quickly to the data deterioration theme and thus the market has put October cut probabilities back at 85% today.

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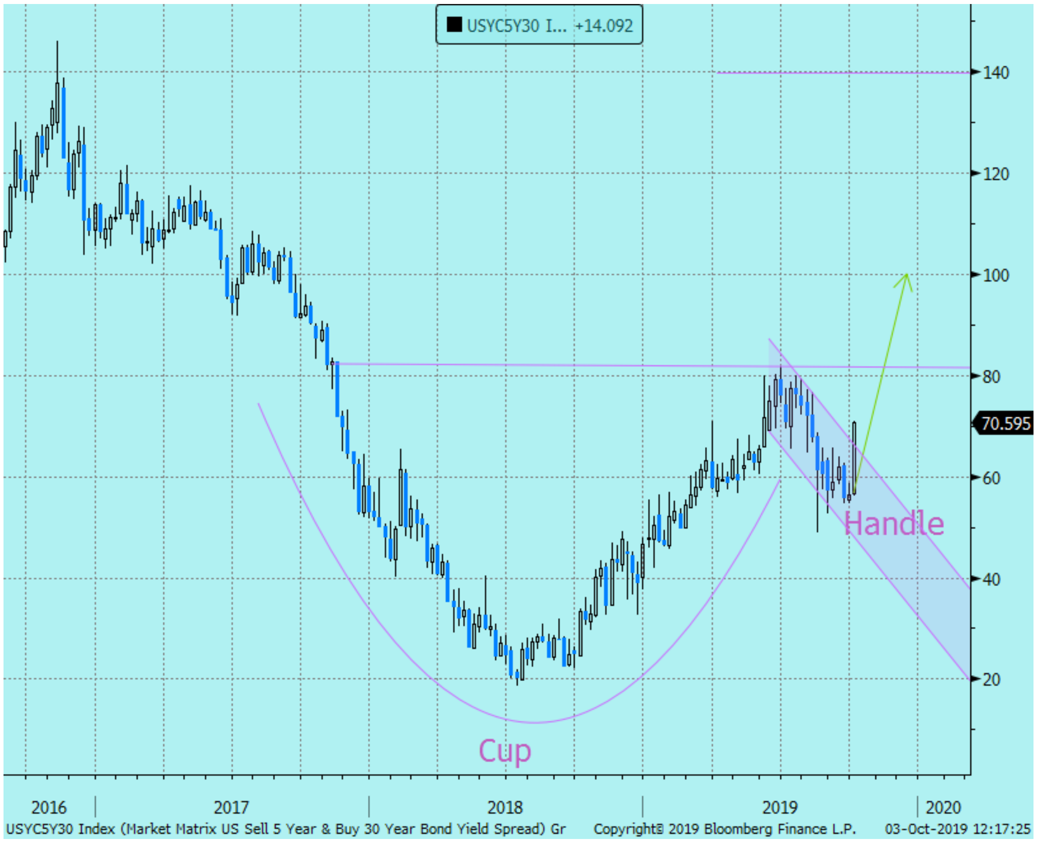
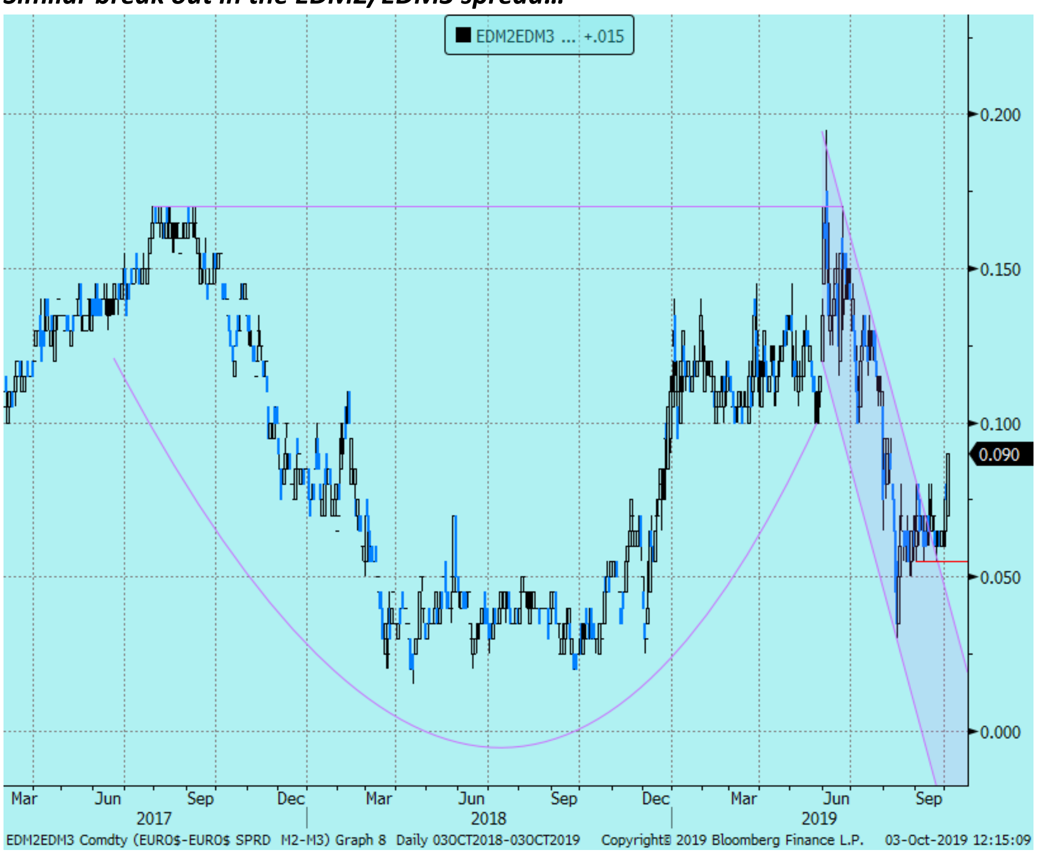
The technicals have obviously been cleaned up after the data deterioration theme won out this week. Even I am shocked how quickly the risk of a breakdown shifted back to a resumption of the rally in a matter of a couple days. The "bull flag" pattern is now back in play with a 99.15 target...

And you are once again getting the end of cycle steepening that we have discussed over the past week or so:

***US 5s30s is breaking out of its bear channel which is part of a bullish "cup and handle" formation…***




***Similar break out in the EDM2/EDM3 spread…***



Outside of the data deterioration theme (besides ISM weakness in US -> Sweden service PMI hitting 7yr low, UK Service PMI in contraction, EU Service PMI's mostly lower, German Leading Eco Institute cuts GDP outlook, Swiss KoF cuts GDP forecast), there are a few notable events taking place:

1) WTO allows US to impose tariffs on the EU – the absolute amount is pretty insignificant. However, the signally is poor. Allowing Trump to turn his sites on the EU is troublesome not only for Europe (nail in the coffin), but for the global economy already reeling from US/China tariffs.

2) Bernie's heart issues – lower odds of Bernie winning the nomination means higher odds for Warren's nomination. We know she is anti-financials, big tech, billionaires, and buybacks in general. Overall, this is not positive for risk assets, but we are a long ways away from the meat of the election cycle.

3) Brokers moving to $0.0 commissions – may seem just an interesting headline but think about the repercussions for something like fixed income: more money to the brokers who can sweep clients excess cash not being utilized into their portfolio to buy duration assets in order to earn yield. In this "dollar shortage" world, the brokers are starting to hoard cash.

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After a couple days of weakness, US equities are bouncing. To name a few reasons…

- The US will continue to benefit from the TINA mentality (there is no alternative), or in other words; the US remains the strongest region in the world – as bad as ISM week was for the US, EU is looking at recession.
- The GPIF's announcement that hedged foreign bond purchases now will be considered the same as domestic bond holdings means that global yields will keep declining (along with a number of other structural issues). Lower fixed income yields will make equities more attractive. In this world of yield scarcity, there are plenty of companies that yield more than UST's.
- The Fed put – the market is rightly front running the Fed's short visit in neutral land back to dovish.
- QE/LSAP/whatever you want to call it – it likely comes at the October meeting in order to front run year end financing issues. Meaning, the December meeting will be too late to deal with it so the Fed has to act in Oct.
- The Trump put – the market believes the lower equities slide, the more likely of some sort of China deal (likely a minor one, not a large scale deal)
- Technicals – support level came into play at the lower end of its channel…

Kind Regards,

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