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INVESTMENT MANAGERS

SOLUTIONS

Charts and Smarts® – November 2022

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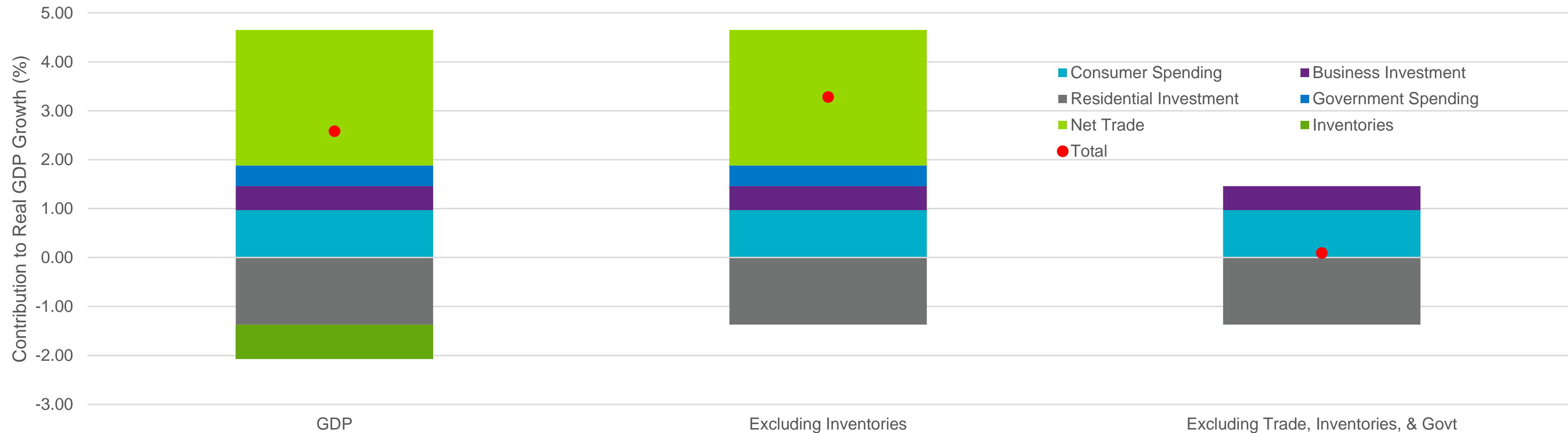
Breakdown

Contributions to Real GDP (Q3 2022)

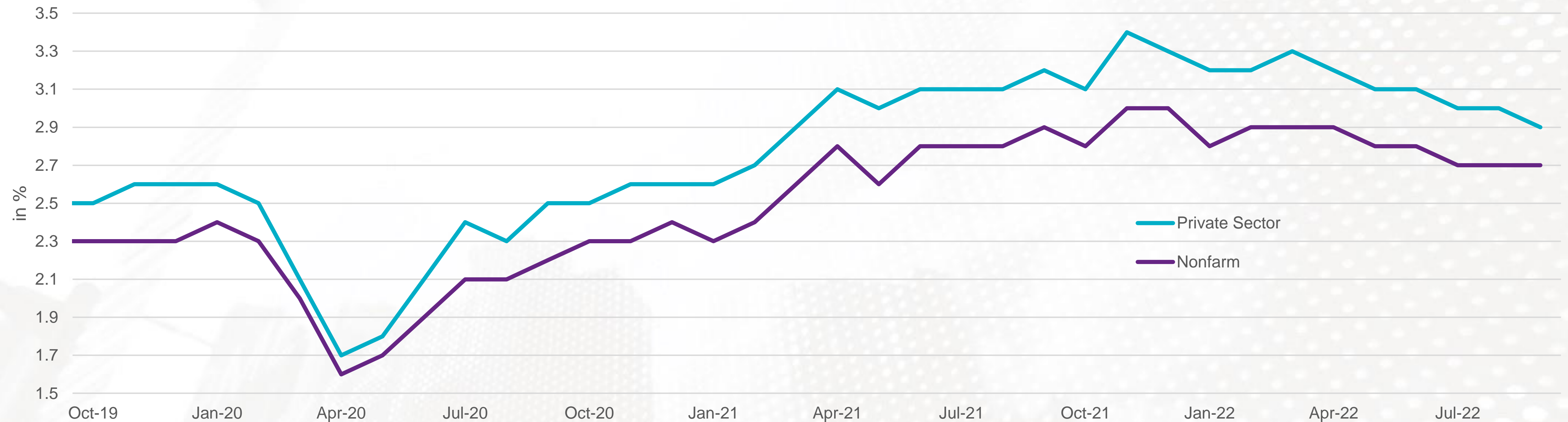


Powell's Checklist, once aimed at generating a robust and inclusive labor market, has all been turned on its head. With the Fed still very much a single mandate central bank, Powell and Company are focused squarely on guiding demand lower into better balance with still constrained supply. That means below-trend growth, labor market softening, and clear and convincing evidence that inflation is progressing back toward the 2% target. With the recent release of Q3 GDP, we can already see some modest progress toward the Fed's first objective. While real GDP bounced back into positive territory for the quarter after negative prints in the first half of 2022, the details showed a continued deceleration in growth momentum. Tailwinds from declining imports and resilient export growth were the key drivers of the 2.6% quarterly advance. But after stripping out the noise of net exports, inventories, and government investment and expenditures, final private domestic demand – the best predictor of future growth – posted a mere 0.1% advance over the quarter. The effect of higher rates is clearly being felt within the housing market, providing a material drag on growth while consumption and business investment moderate. The economy is proving far more difficult to soften than financial markets, which helps to reduce left tail outcomes, but economic growth is indeed beginning to cool, just as the Fed would like to see.

Source: Portfolio Analysis & Consulting, Bloomberg.

You Could Be Mine

Quit Rates (10/31/19–9/30/22)

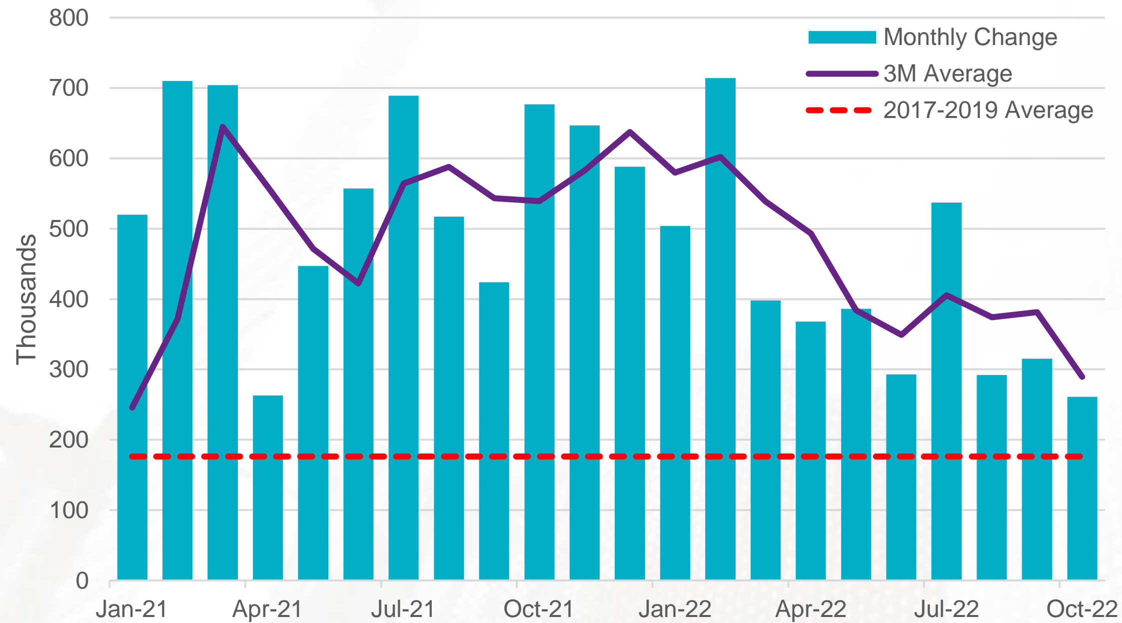


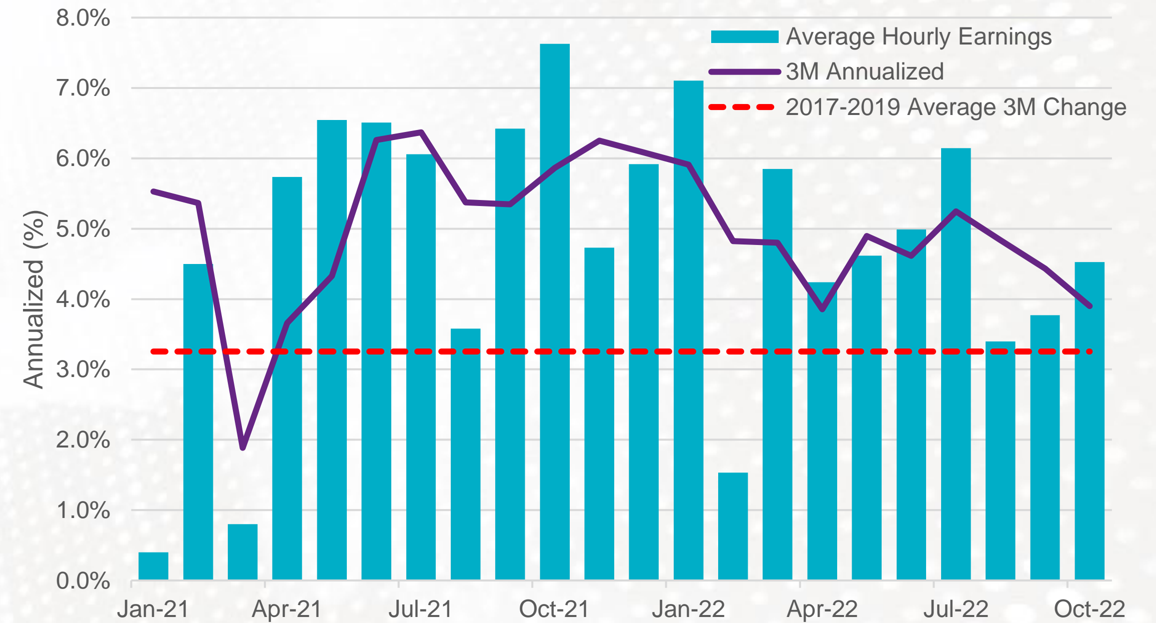
The second item on Powell's Checklist is arguably the most stubborn in the eyes of the Fed. While we are not in the throes of a wage-price spiral, the labor market is too tight and nominal income growth is simply too robust to be consistent with 2% inflation, hence the Fed's focus on a cooling labor market. While job openings have proven volatile in recent months, quit rates, a more reliable indicator of labor market tightness, have been steadily softening for nearly a year and have now retraced half of the surge from pre-crisis levels. Quit rates provide unique insight into job finding prospects, as higher rates reflect both high confidence and ability of workers to find new employment. Furthermore, job switchers tend to command much higher wage gains than job stayers, and the churn created via high turnover has contributed to decreased productivity; a double whammy that has undoubtedly exacerbated inflationary pressures over the past year. Easing quit rates continue to highlight a post-COVID normalization in labor markets which should help cool labor market tightness, ease wage pressures, and improve productivity without the necessity for broad labor market pain.

Source: Portfolio Analysis & Consulting, Bloomberg.

Patience

Nonfarm Payrolls vs Average Hourly Earnings (1/31/21–10/31/22)





More evidence of a normalizing labor market can be seen in payrolls and wage data. While claims remain well behaved and the unemployment rate hovers near 50-year lows, we've seen the pace of monthly job gains decelerate from the breakneck speed of 2021, as wage growth closes in on the pre-COVID trend. To be sure, while headline prints remain firm, signs of softening have begun to emerge as hiring freeze and layoff plans have increased and the Household Survey, which tends to provide early glimpses at inflection points, continues to deviate from the Establishment Survey. The lagged effects of the cumulative tightening we've witnessed this year may indeed translate into a softer labor market as the Fed intends, but for now, it remains remarkably resilient and continues to edge closer to pre-COVID rates of job adds and wage growth. While there's not enough cover for the Fed to shift its rhetoric to a pause, a downshift from 75 basis points in December is, in essence, a lock and further normalization in jobs prints in the months ahead, paired with any improvement in inflation prints, will provide an offramp to a pause. Although consensus continues to view a recession as inevitable, the strong but normalizing labor market buys additional time for the pipeline of disinflationary pressure to filter into inflation prints and increases the odds of a softish landing.

Source: Portfolio Analysis & Consulting, Bloomberg.

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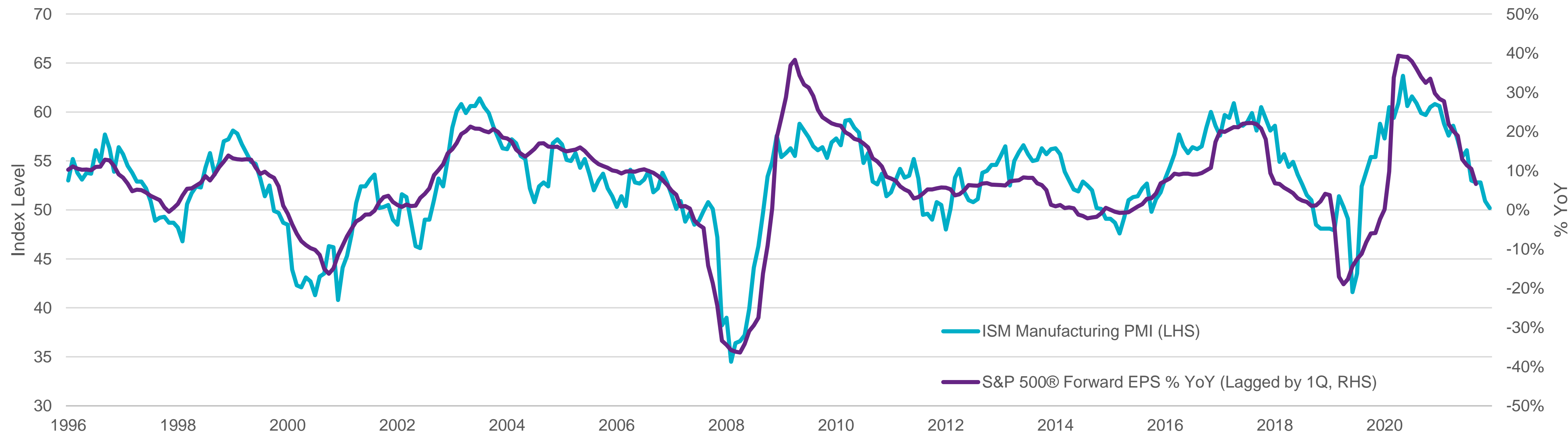
November Rain

Manufacturing Purchasing Managers' Index vs S&P 500® Earnings (11/30/96–10/31/22)

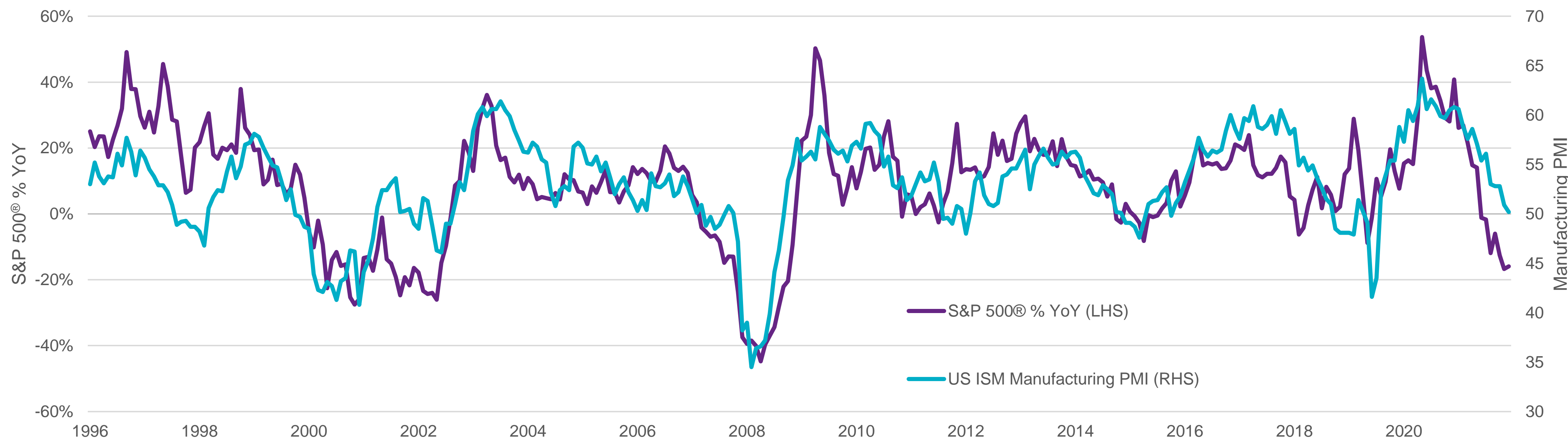


As we near the end of the Q3 earnings season, the verdict is looking much like the prior two quarters of 2022: some beats, some high-profile misses, but all in all, better than feared. To be sure, the bar was certainly lowered, but that fishhook profile has panned out, as is usually the case – estimates drift lower before actuals come in ahead of expectations. While we can breathe a sigh of relief for now, the focus is squarely on guidance and 2023 earnings. The prevailing narrative continues to be that the earnings shoe has yet to drop, and when those estimates are finally slashed, markets will see more downside. Historically, manufacturing PMIs have served as a fairly reliable leading indicator for forward earnings estimates, exhibiting about a one quarter lead. But, while growth momentum has certainly slowed, the tide may be beginning to turn as the economy has thus far proven less rate sensitive than many believe. We know well the impact of bullwhip effects through supply chains and the resulting bloated inventories, but recently, the ratio of new orders to inventory has begun to show signs of bottoming and an inflection higher, which tends to lead the headline PMI by two months. Earnings estimates may need to compress further, but those expecting a precipitous decline may be disappointed, particularly as the labor market remains resilient and positive nominal growth continues to support revenues.

Source: Portfolio Analysis & Consulting, FactSet.

Estranged

Manufacturing Purchasing Managers' Index vs S&P 500® (11/30/96–10/31/22)



Taking that PMI signal one step further, we can see that, unsurprisingly, the S&P 500® price index has also exhibited a tight relationship with PMIs. While PMIs have softened, a sizeable gap has opened up, with the 16% year-over-year decline for the S&P 500® suggesting further weakness ahead for growth momentum, and, with it, potentially further earnings downside. But as we've cautioned before, equity prices and not PMIs appear to be the explanatory factor here, with PMIs simply reflecting the decline in markets as opposed to the inverse. Furthermore, recall that PMIs provide a look into momentum, but not magnitude. Momentum has certainly cooled, albeit from high levels, but a large part of that decline has been the result of supply chain normalization that has seen supplier delivery times fully retrace their COVID era surge. Earnings may indeed be too rosy, but as we've noted in prior editions, markets bottom well ahead of the trough in estimates, and considerable downside has already been priced in, as evidenced by the S&P 500®–PMI gap. Further earnings downgrades need not necessarily translate to further equity declines as investors have already voted on their earnings estimate outlooks, despite a dearth of management guidance.

Source: Portfolio Analysis & Consulting, FactSet.

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