ClearBridge Investments

Recession Indicators Update: Trade Fears Impacting Commodity Prices

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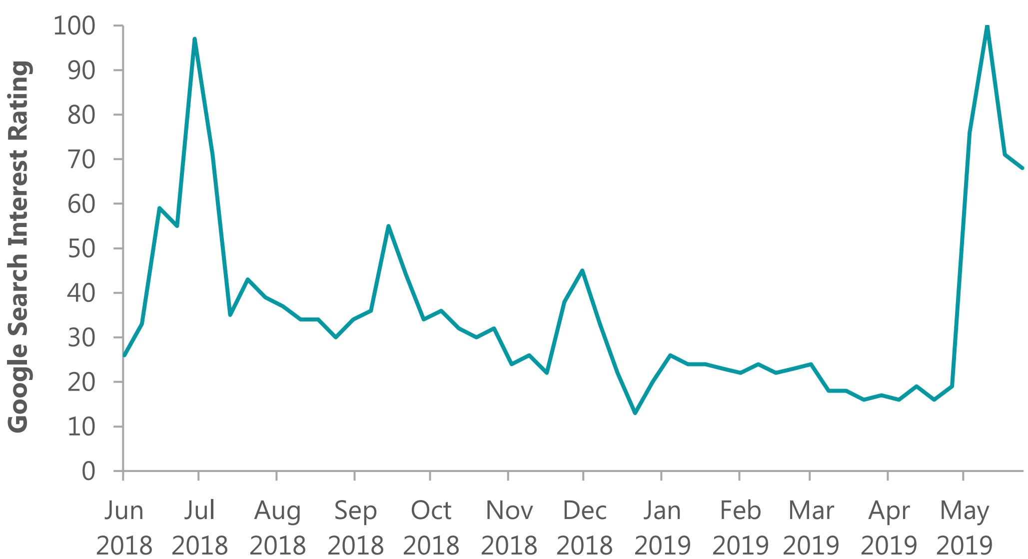
Key Takeaways

- The Commodities signal on the ClearBridge Recession Risk Dashboard has changed from yellow to red as increased fears of a trade war are weighing on commodity prices.
- Indicators such as Credit Spreads, Retail Sales, Job Sentiment, ISM New Orders, Profit Margins, and Truck Shipments could also be impacted by trade wars and have worsened while remaining green.
- The overall signal from the ClearBridge Recession Risk Dashboard remains "expansionary" however the risk of a recession has risen.

Trade Tensions Ratcheting Higher

Over the past several weeks, trade tensions have risen. The Trump administration has taken steps to implement additional tariffs on goods imported from China, Mexico, and India. Discussion of tariffs has gone mainstream, as shown by the recent rise in popularity of searches for the term "trade war."

Exhibit 1: Search Popularity for "Trade War"



As of May 26, 2019. Source: Google. Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means there was not enough data for this term.

With trade wars front and center and the S&P 500 approximately 5% off its recent high, many investors are questioning what the impact to the global economy and financial markets will be. So far, the economic impacts of higher tariffs have been fairly muted, on the order of a sub-1% drag to GDP. However, this is a fluid situation and it is our view that the most recently announced round of tariffs do not represent the end of the line. The total costs from tariffs have two components: the direct hit to GDP and their effect on both business and consumer confidence. While the actual tariffs implemented so far will shave less than 1% from GDP, the impact from lowered business and consumer spending is more difficult to quantify. As business confidence deteriorates, the marginal employee may not get hired or capital spending (business expansion) may be put on hold. A reduction in business confidence and spending was one of the key drivers of the 2001 recession.

Tariffs directly impact the U.S. consumer. Preliminary data from previous rounds of tariffs suggest that the consumer — not Chinese manufacturers and suppliers — bore the brunt of price increases. According to the New York Fed, the most recent round of tariffs (additional 15% tariff on $200 billion) could cost the typical household $831 annually. While this figure might seem manageable, the next $300 billion tranche of tariffs may lead to an even greater hit as tariffs are applied to more consumer products. With consumers feeling the pinch, their confidence and in turn spending, are likely to suffer.

While this certainly could drive GDP back down to its 2-2.5% trend, many assume that tariffs will immediately rise to the 25% rate. This does not have to be the case, and the administration may announce an extended schedule of the tariffs taking effect over several years. China would still feel the pain of tariffs as companies relocate supply chains while the U.S. consumer would feel less near-term pain.

The latest edition to the trade war saga is Mexico. Currently, the administration is asking for three concessions: better immigration enforcement on the Guatemala/Mexico border, targeting human smuggling rings and requiring Central Americans to file for asylum in Mexico rather than in the U.S. These demands are modest compared to the economic cost of tariffs. Mexico’s exports of goods to the U.S. account for a massive 29% of the country’s GDP. This is a much larger percentage than exports to the U.S. represent to Chinese GDP, suggesting a stronger incentive for quicker resolution.

Commodities Turn Red as Trade Wars Weigh on Global Growth Expectations

Commodities are one of the first signals on the ClearBridge Recession Risk Dashboard that we would expect to come under pressure as trade war fears rise. As tensions increase, global growth expectations fall. In turn, investors anticipate less demand for raw materials such as chemicals, copper or lumber, due to the slowdown in aggregate demand. Recently, commodities of various types have seen prices tumble, ranging from copper and lumber to chemicals, steel and even crude oil. As a result, the Commodities signal has turned from yellow to red. To learn more about the Commodities signal on the ClearBridge Recession Risk Dashboard, please see our February 4, 2019 Recession Indicators Update: Inflationary Pressures Building.

Exhibit 2: ClearBridge Recession Risk Dashboard

	May 2019	April 2019
Yield Curve	✖	✖
Credit Spreads	⬆	⬆
Money Supply	●	●
Wage Growth	●	●
Commodities	✖	●
Housing Permits	⬆	⬆
Jobless Claims	⬆	⬆
Retail Sales	⬆	⬆
Job Sentiment	⬆	⬆
ISM New Orders	⬆	⬆
Profit Margins	⬆	⬆
Truck Shipments	⬆	⬆
Overall Signal	⬆	⬆

Source: ClearBridge Investments.

As we look forward, increasing trade tensions could weigh on several additional indicators, such as Credit Spreads, Retail Sales, Job Sentiment, ISM New Orders, Profit Margins and Truck Shipments. While none of these indicators have changed, we have seen deterioration beneath the surface. Whether this is tied to trade or not, we believe the risk of a recession has increased as the economic backdrop has worsened at the margin. With that said, the overall signal from the ClearBridge Recession Risk Dashboard currently remains “expansionary.”

About the Authors

Jeffrey Schulze, CFA
Director, Investment Strategist

- 13 years of investment industry experience
- Joined ClearBridge Investments in 2014
- BS in Finance from Rutgers University

Joshua Jamner, CFA
Vice President, Investment Strategist Analyst

- 10 years of investment industry experience
- Joined ClearBridge Investments in 2017
- BA in Government from Colby College

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ClearBridge Investments
620 Eighth Avenue, New York, NY 10018 | 800 691 6960 | **ClearBridge.com**