ClearBridge Investments

Recession Indicators Update: Signals Change, Caution Remains

September 5, 2019

Key Takeaways

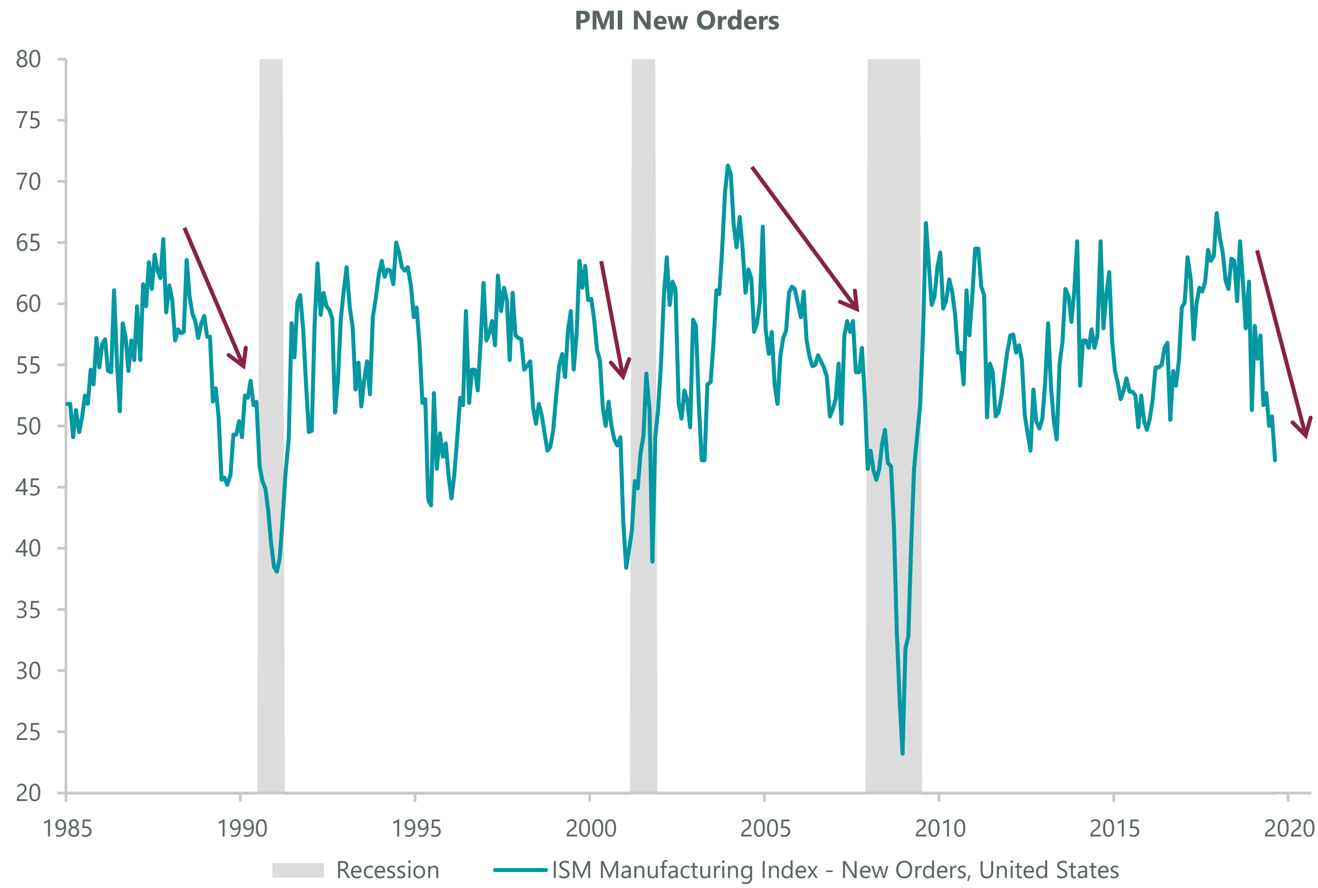
- Two indicators in the ClearBridge Recession Risk Dashboard have worsened: ISM New Orders to red from yellow following a weak August reading and Corporate Profit Margins to yellow from green following NIPA revisions and continued weakness.
- Job Sentiment strengthened to green from yellow as "jobs plentiful" responses saw their second-strongest increase on record and "jobs hard to get" returned to cycle lows.
- With two signals deteriorating and one improving, the ClearBridge Recession Dashboard remains unchanged with an overall yellow signal.

ISM Manufacturing New Orders Turns Red

The Institute for Supply Management's (ISM) Manufacturing Purchasing Manager Index (PMI) is a widely followed measure of U.S. business activity. This survey is synonymous with the business cycle, foreshadowing periods of increasing and decreasing economic activity. The headline figure fell to 49.1 in August, below the breakeven 50 level, signifying that the domestic manufacturing sector contracted for the first time in four years.

While many market participants focus on the headline ISM figure, our research has pointed us to the New Orders subcomponent, which tends to lead the broader ISM by several months. Intuitively, focusing on business pipelines should provide a good advanced reading on future activity, with the caveat that there can be more noise to this signal if some orders are cancelled or deferred. Typically, ISM New Orders fall below 48 in advance of a recession. This measure fell to 47.2 in August, tied for the weakest reading since the global financial crisis (Exhibit 1) and turning the indicator to red from yellow.

Exhibit 1: Manufacturing New Orders is Signaling Contraction



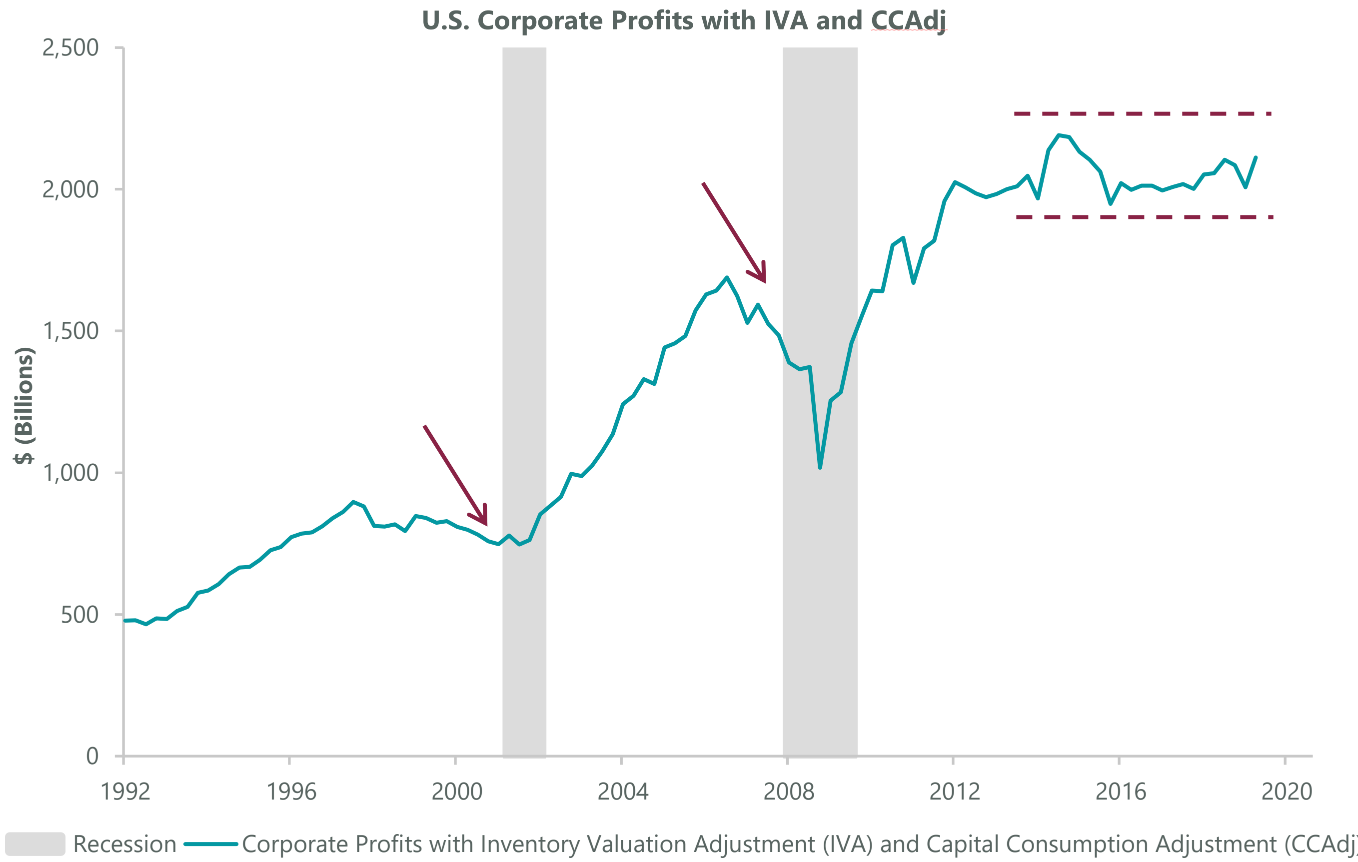
Data as of August 30, 2019. Source: Bloomberg.

Corporate Profit Margins Turn Yellow

The second signal on the ClearBridge Recession Risk Dashboard to change this month is Corporate Profit Margins. For background information on this signal, please see our 2017 blog. While margins for large and mega cap companies are holding up fairly well, margins for small- and mid-size businesses are coming under increased pressure. According to the NFIB Small Business survey, the cost of labor continues to be a major headwind for these smaller companies. In fact, 77% of Americans are employed by firms with fewer than 500 workers. For reference, the average company in the Russell 2000 Index has 3,679 employees. Not surprisingly, it is Main Street that drives the U.S. economy.

As a result of this dynamic, the National Income and Product Accounts (NIPA) profit margins (which the dashboard evaluates) are a much better barometer for the economy. This series saw a large downward revision to several years of data over the summer and has continued to soften more recently (Exhibit 2). As Main Street businesses are forced to cut back on spending to preserve margins, their suppliers may also be forced to curtail activity. Typically, firms reduce hours first before laying off workers due to the significant costs associated with hiring and firing. The good news is that unemployment claims (layoffs) in manufacturing-heavy states such as Pennsylvania, Ohio and Wisconsin are not yet increasing. However, weekly hours worked by the average manufacturing sector employee have fallen by 0.7 hours over the past year, and overtime has been cut by 0.5 hours while margins could also face pressure from increasing tariffs.

Exhibit 2: NIPA Profit Margins Could Come Under More Pressure



Data as of August 30, 2019. Source: Bloomberg.

Jobs Sentiment Improves, Back to Green

In late June, the Job Sentiment signal turned yellow after the fifth-largest leap in "jobs are hard to get" responses in the Conference Board Consumer Confidence Survey's history. Although headline consumer confidence took a nosedive in August — the University of Michigan's Consumer Sentiment Index fell from 98.4 to 89.8 — the Conference Board consumer confidence data looks much healthier. Specifically, "jobs hard to get" responses have fallen back to cycle lows, while "jobs plentiful" responses saw their second-largest increase on record. While the number of jobs created over the last several years was recently revised lower by slightly over 500,000 jobs, job openings still outnumber unemployed workers by more than 1.25 million, suggesting a strong labor market. Importantly, our Job Sentiment indicator has returned to its trend from the last several months, suggesting that the U.S.-China trade war has not materially impacted the labor market.

Exhibit 3: ClearBridge Recession Risk Dashboard

	August 2019	Second Quarter 2019	First Quarter 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.

With two signals deteriorating and one improving, the overall signal from the ClearBridge Recession Risk Dashboard remains yellow. It remains to be seen whether the economy worsens further into a recession or the current slowdown remains a soft patch. In the interim, we continue to believe that equity markets will see increased volatility as bulls and bears butt heads.

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