Global Economic Slowdown - Implications For US Stocks

August 12, 2015
by Gary Halbert
of Halbert Wealth Management

IN THIS ISSUE:

1. Another Ho-Hum Unemployment Report For July

2. The Global Economy is Slowing – Implications For the US

3. Policymakers Have Few Options to Spur Economic Growth

4. The Latest Implications For the US Equity Markets

5. The Costly Truth About the New Obama Energy Plan

6. Dodd-Frank Turns Five – Still A Very Bad Law

Overview

The global economy is rolling over to the downside for the most part. The question is, will this global slowdown take the US economy down with it? While no one knows for sure, that possibility simply cannot be ruled out. If the softening in the global economy leads to a slowdown in the US, that will almost certainly result in a weakening of our stock markets.

In my **March 17 E-Letter**, I recommended that investors in traditional “buy-and-hold” equity funds reduce stock market exposure (or hedge long positions partially or fully) due to increasing global risks at that time. I repeated that recommendation twice since then.

Since March 17, the S&P 500 Index has moved sideways to lower as of this writing. Could the US equity markets be setting up for a significant downward correction? It would be unwise in my opinion to rule it out.

The slowdown in the global economy and the implications for the US economy and our stock markets will be our main topic for today, but before we get to that, let’s take a quick look at last Friday’s unemployment report for July.

At the end of today’s letter, I will briefly comment on Obama’s new ***Clean Energy Plan*** which will raise electricity costs significantly, if enacted, and give you a link to the full story. I will also comment further on the Dodd-Frank law I wrote about in my **Blog** last Thursday.

Another Ho-Hum Unemployment Report For July

On Friday, the Bureau of Labor Statistics announced that **215,000 new jobs** were created in July. It also announced that the official unemployment rate remained at **5.3%**. The 215,000 jobs gain was about what Wall Street expected, but it was well below the number of jobs created in May and June – so call it **mediocre**.

Digging down in the report, the Labor Force Participation Rate was unchanged at **62.6%**, which remains at a 37½ year low. Average hourly earnings ticked up only **0.2%**, or about 5 cents, to $24.99, and are up only **2.1%** over the last 12 months. Among the hottest job categories last month were retail jobs (+36,000), healthcare (+28,000) and food service and bars (+29,000).

The fact that the July unemployment report was just so-so stimulated even more speculation regarding whether the Fed will hike the Fed Funds rate at the September 16-17 policy meeting. That decision could well depend on how the August unemployment report looks – which will be released on September 4.

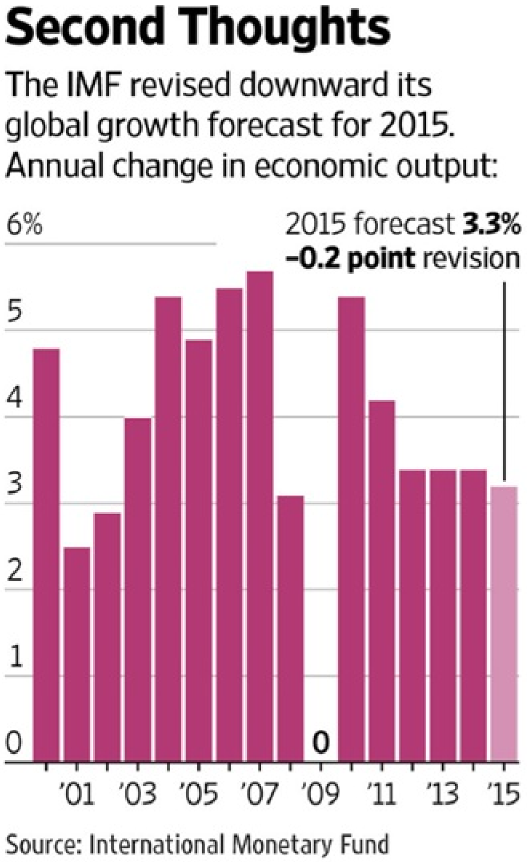
August traditionally is not among the best months for job creation and it could be lower than July's results, which would mean that new job growth will have declined for four months in a row. If that proves true, then the question is whether the Fed would hike anyway or push ***"liftoff"*** to the December policy meeting. Of course, there's no way to know.

Finally, here's a new economic indicator that should concern us. The Federal Reserve Bank of Atlanta has devised a new measurement of GDP this year that's proved quite accurate so far. While most economists expect 3Q GDP to rise around 3%, the Atlanta Fed's ***GDPNow*** forecast is only at **1%** as of last week. Hopefully, this weekly indicator will improve soon. I'll keep an eye on it.

The Global Economy is Slowing – Implications For the US

On the surface, the domestic economic landscape looks fairly benign. The US economy recovered in the 2Q with an initial GDP estimate of +2.3% (annual rate) following an upwardly revised +0.6% in the 1Q. The jobs market and the housing markets continue to improve rather steadily.

Consumer confidence, although down somewhat in the last few monthly readings, is still sharply higher since the late recession readings in early 2009. Consumer spending rose at an annual rate of 2.9% in the 2Q, up from 1.8% in the 1Q. All in all not great, but certainly not bad.



Globally, however, things are not so benign. The International Monetary Fund (IMF) projects global economic growth of 3.3% for this year, but that number now looks optimistic. In the 1Q, for example, the IMF reported that global growth came in at only 2.2% (annual rate), well below its forecast.

The 1Q shortfall, the IMF said, reflected an unexpected output contraction in the United States, with attendant spillovers to Canada and Mexico. One-off factors, notably harsh winter weather and port closures, as well as a strong downsizing of capital expenditures in the oil sector contributed to weakening US activity.

In Japan, despite a near 40% drop in the yen, industrial production is growing at just a 2% annual rate. Inflation is only at 0.4% year-over-year. The International Monetary Fund recently warned Tokyo that its debts are unsustainable and set to reach 300% of GDP by 2030.

In China, the PMI manufacturing activity index dropped to 47.8 in July, down from 49.4 in June, well below the neutral 50.0 mark for the fifth month in a row. Chinese factories are suffering their deepest contraction in activity since July 2013. Renewed declines in new work orders and new export orders have resulted in production being cut at its fastest rate since November 2011. Purchasing activity is falling at the fastest rate since January 2012.

The slowdown in China is clearly affecting the surrounding Asian economies. Singapore, Taiwan and South Korea are suffering industrial production contractions of 4.9%, 1.9% and 1.6%, respectively, on a year-over-year basis.

In Europe, despite aggressive QE efforts by the European Central Bank, lending activity remains tepid, and core inflation remains well below target at only a 1% annual rate. In Latin America, Brazil’s economy is plunging and Argentina and Mexico are also weak, with the Mexican peso plunging to a new low against the US dollar.

According to the IMF, global growth is set to slow this year to its weakest pace since the financial crisis, as mounting threats from China to the eurozone add to a long list of forces restraining the world economy. Last month, the IMF’s Chief Economist Oliver Blanchard concluded: ***“We have entered a period of low growth.”***

While the IMF for now still expects global growth to pick up again next year, the current bouts of turmoil underscore the fragility in the world’s economy, where anemic output in one region risks dragging down others across the globe.

Policymakers Have Few Options to Spur Economic Growth

Policymakers have fewer options left to respond to downside surprises with interest rates near zero, the IMF said. Likewise, the IMF noted that governments have pushed debt to dangerously high levels and central banks are constrained by the lower limits of rate reductions.

Weak growth, mountains of debt, stubbornly high unemployment and limited policy options are setting the stage for more market volatility ahead, including in China. ***“The post-crisis world is one of high debt and it doesn’t take much with these debt dynamics to go wrong,”*** Mr. Blanchard said. ***“We have to be ready to see other episodes of that kind.”***

Growth has repeatedly disappointed. Europe has only just narrowly avoided a third recession in five years, and emerging markets are on course for their sixth straight year of slowing growth rates.

While the turbulence in financial markets may not create the type of global economic contractions seen in the wake of the 2008-2009 financial crisis, Mr. Blanchard said ***“it will clearly lead to some uncertainty for a period of time.”***

In a world of weak growth, the US could serve as the leading driver of the global economy, but US prospects also have been downgraded. A 20% surge in the dollar’s value over the last year has weighed on exports as trouble overseas and the expectation for the Federal Reserve’s first interest-rate rise in a decade pulled investors out of emerging markets and back into America.

The strong US dollar, in turn, has caused trouble for many emerging-market economies and companies that borrowed heavily in greenback-debt. The prospect of higher interest rates amid weak growth is fostering investor concerns about the ability of many corporations and governments to pay back their obligations. That fuels capital flows back to the US, bolstering the dollar and again amplifying problems overseas.

Adding to the world’s headaches are falling commodity prices. Major exporters such as Canada, Mexico, Nigeria and others are seeing their growth rates slashed as prices continue to slump. Among advanced economies, Canada sustained the biggest downgrade, with the IMF now expecting the country’s economy to expand by only 1.5% this year, down from its previous 2.2% call.

The Latest Implications For the US Equity Markets

For now, the US stock markets appear to be in relatively good shape overall. The Dow Jones Industrial Average remains near 18,000, and the S&P 500 Index near 2,100 – thanks to a strong rally yesterday. Yet these markets have been stuck in a sideways trading range since March, and analysts worry that a Fed interest rate hike in September could spark a breakout to the downside.

And there are other reasons for concern. Factory orders here have expanded on a monthly basis only twice in the last 11 months. Excluding transportation, factory orders plunged at a **7.5% annual rate** in July, the worst since the recession in 2009. With America's manufacturing sector looking shaky, the risk is that a global stalling pulls us down, too.

While the US equity markets are holding within their recent trading ranges, other international indexes are faring far worse. For example, the MSCI World Index, which tracks large and mid-cap stocks across 23 developed nations, is **down over 7%** from its high set last summer. The MSCI Emerging Markets Index is **down 19%** over the same period.

And as noted above, we can't forget that commodities prices worldwide have plunged, which historically has been a precursor to recessions. The Power Shares DB Commodities Tracking Index Fund is **down 43%** over the last year.

Recent earnings reports from Exxon Mobil and Chevron remind us of the linkages between commodity prices, earnings growth and the overall stock market. Exxon reported a **52% drop** in 2Q earnings on a net loss in US upstream business. Over the last year, Exxon's earnings are **down 24%**. Chevron also reported weaker than expected results. Chevron earnings were **down 34%** from its high last summer. The overall Energy Select Sector SPDR Fund, representing the energy sector of the S&P 500, is **down 31%** year-over-year.

The chart below shows the close connection between commodity prices (CRB Index) and S&P 500 forward earnings (EPS). The former is falling at a 30% annual rate, while earnings growth has merely stalled. History suggests that this divergence won't last, which is probably not a good sign for the S&P 500 and US stocks in general. Time will tell.

The point is, **the US stock market is not an island** , nor can it ignore the above-mentioned forces and others for long. While I'm not ready to predict a new bear market, I continue to expect we're in for a significant downward correction soon.

In my **March 17 E-Letter**, I recommended that investors in traditional "buy-and-hold" equity funds **reduce stock market exposure** (or hedge long positions partially or fully) due to increasing global risks at that time.

My advice remains the same today for those not in professionally managed strategies that can move to the safety of cash (money market) or hedge long positions should the trend turn decidedly lower.

The Costly Truth About the Obama Energy Plan

Last week President Obama and the EPA announced the ***Clean Power Plan*** which mandates that power plants reduce CO2 emissions by almost one third by 2030 – despite the fact that CO2 emissions were the lowest in 27 years in 2014.

What President Obama failed to tell us is the fact that Germany has been trying to do an even milder version of the *Clean Power Plan* in recent years, and today the average German pays **three times more for electricity than the average American.**

To learn more, read this excellent article:

http://www.forbes.com/sites/alexepstein/2015/08/05/the-obama-clinton-one-two-blackout/

Dodd-Frank Turns Five – Still A Very Bad Law

That was the title of my **Blog** last Thursday wherein I lamented that this law which was meant to protect investors and consumers has done no such thing. A new independent report states that Dodd-Frank, now five years old, contains at least **27,669 rules and regulations.**

Even worse, the enormous cost of complying with this regulatory maze has led to the **closing of more than 1,200 commercial banks** since 2010 when Dodd-Frank passed – mostly smaller community banks that were the engines of local lending. And worse still, no new commercial banks have been chartered since President Obama took office.

A new article out today in *The Washington Times* further documents how Dodd-Frank has hurt consumers and left them with fewer choices. Americans need to know this! Here's what to do:

First, read my **Blog** from last Thursday (and subscribe if you haven't already). Then read this article from *The Washington Times* today:

http://www.washingtontimes.com/news/2015/aug/10/richard-rahn-financial-regulation-fives-consumers-/

Hoping it's cooler where you are,

Gary D. Halbert