US Watch

RISK RETURNS

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Economics: Recent data underscore risk to growth

- **Slower employment, slower wages mean slower retail**
- **Wholesale and import data reveal beginnings of an inventory correction**
- **Fed policy swamps market pricing**

Markets: Assessing the impact of higher oil prices

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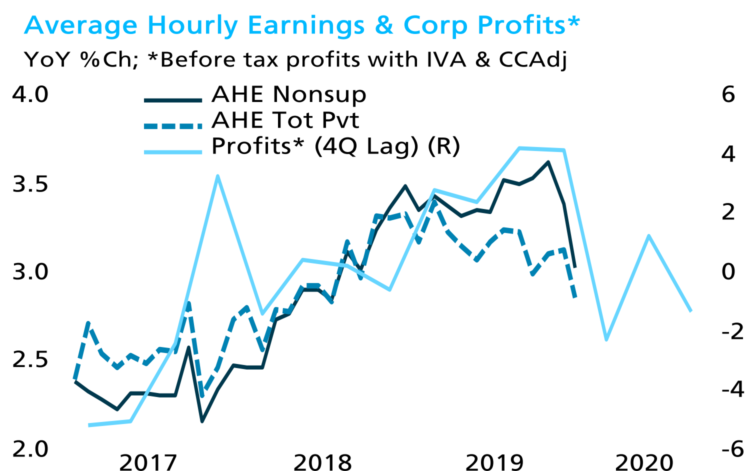
- **Our o/w equity, u/w bonds stance is appropriate for rising crude prices**
- **Risk-reward from positioning for a major escalation is not compelling**

Politics: Iraqi risk factor rises

- **We do mean Iraq, not Iran -- third parties can suck in the 'principals'**
- **Transmission channel to the US runs through equities more so than oil prices**
- **If chaos rises in Iraq, we see a material impact on the election**



Source: Refinitiv Datastream, TS Lombard

Economics: Recent data underscore risk to growth

- **Slower employment, slower wages mean slower retail**
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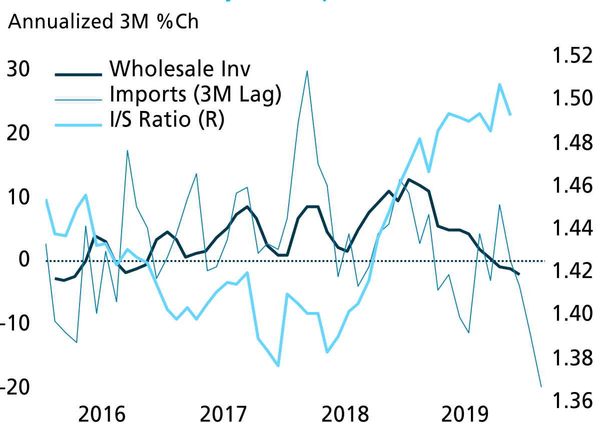
- **Fed policy swamps market pricing**

The recent run of data underscores our view that the economy will generate weaker growth in the first half of this year, certainly in the first quarter at least. Current indicators suggest around 2% real GDP growth QoQ in Q4 (we still believe growth comes in closer to 1.5%). Even if 2% turns out to be true, it will be a misleading indicator of momentum heading into the first part of 2020. We see in the November wholesale data the beginnings of our long-awaited inventory correction, also presaged in the drop of imports (see chart below left). Lower imports raise GDP, but a decline in inventory would be an offsetting factor. A string of factors is set to drag down Q1 growth: less stock building; weaker wage and employment growth, which will sap nominal retail sales; and Boeing's planned halt to production of its 737 Max aircraft (worth about 0.5% to QoQ real growth). **Market pricing has not indicated this slowdown. The Fed's sustained injection of liquidity, whether they choose to admit it or not, quashes the ability of market prices to reflect economic risk** because it keeps shorter-term yields low and frees up private capital to invest in something other than financing a $1trn budget deficit. In October and November, the Treasury sold nearly $300bn in net new debt while the Fed increased its holdings by $121bn, or about 40% of net issuance. Since November, the Fed has added another $102bn to its balance sheet (we do not yet have the Treasury data for December).

There are any number of ways to look at December's employment data, but, regardless of the reason for the drop-off in hiring, retail spending slows as a result. The optimistic view, likely shared by the FOMC, even after correcting for the seasonal mis-adjustment of the 33,000 increase in clothing store jobs, is that hiring has slipped back into a range that is still ahead of the pace of net entrants to the workforce – to be expected at this stage of the business cycle. We have also been making the point that wage growth will slow in the coming months because it follows weaker profit growth (see front-page chart).

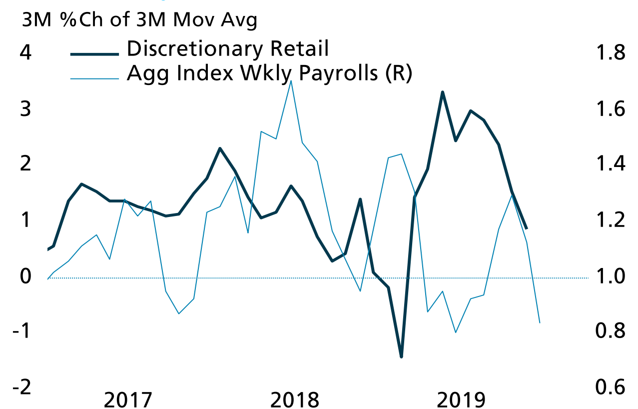
Taking this softening in pay together with the slower pace of hiring, the result is a more tepid rate of discretionary retail spending (the things we want rather than need). The chart below right shows how discretionary spending tracks the Index of Aggregate Weekly Payrolls for Production and Nonsupervisory Personnel (product of employment, wages and hours worked). The index has been growing more slowly since mid-2018, and now that the long-tail effect on spending of the December

Wholesale Inventory and Imports (ex oil for both)



Source: Refinitiv Datastream, TS Lombard

Discretionary Retail Follows Jobs and Income



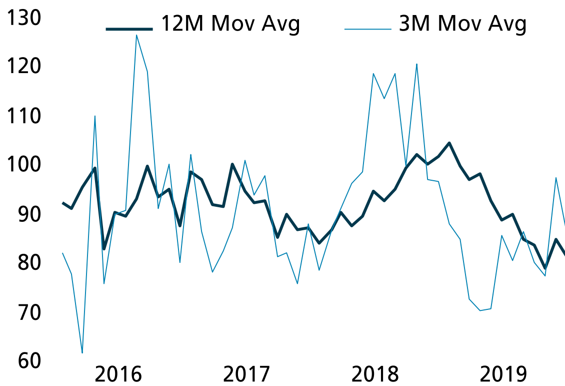
Source: Refinitiv Datastream, TS Lombard

2018 equity market price implosion and subsequent recovery has run its course, we expect spending to follow suit.

Recent hiring trends reflect a softer economy, not full employment, from our perspective. Tellingly, there are signs that the slowdown in manufacturing is leaking into the service sector. We see this in the chart below left, focusing on hiring in the service industries that are the growth engines of the US economy. The sluggishness in hiring is no surprise considering the deterioration in net orders, as surveyed by the ISM (chart below right). All the perceived gains in orders that occurred after Trump was elected have now evaporated.

Adj Service Sector Employment* Mthly Ch

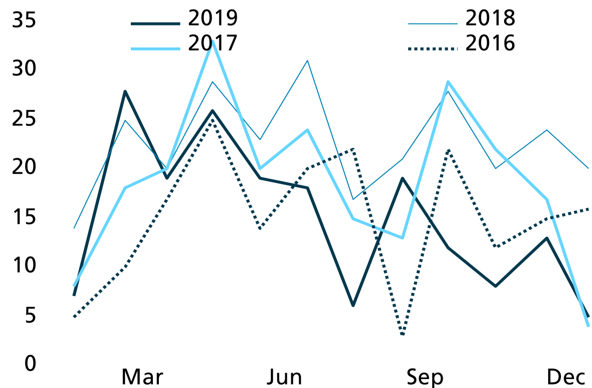
*ex healthcare, restaurants, retail (incl auto dlrs)



Source: Refinitiv Datastream, TS Lombard

ISM Report on Non-Manuf: Net New Orders

% Better - % Worse (NSA); Jan thru Dec

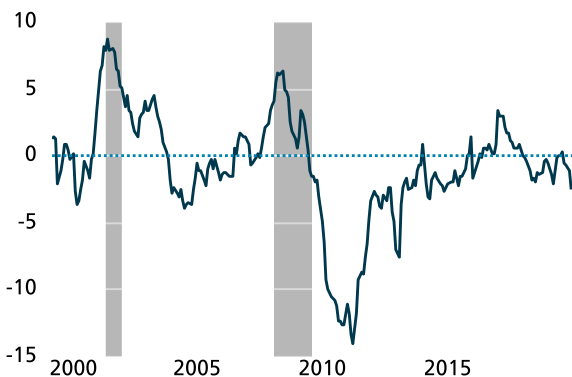


Source: Refinitiv Datastream, TS Lombard

Growth in revolving consumer is also falling further behind growth in wages. This ratio typically spikes heading into recession, or during periods of perceived economic stress (2016, for example), and falls through the recession and the early recovery. The current fall-off could be noise, but the slowdown in hiring may be making consumers uneasy that something is afoot and so unwilling to take on more debt at this time. Households' unwillingness to return to leverage is a major story line of this cycle (see chart below).

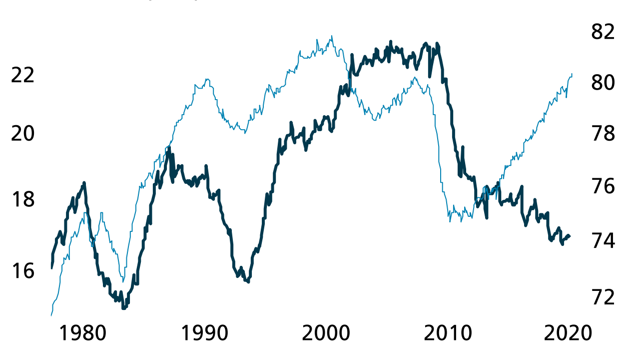
Growth in Revolving Credit less Total Wages

Difference in YoY % Increase



Source: Refinitiv Datastream, TS Lombard

Consumer Credit and Employment



Source: Refinitiv Datastream, TS Lombard

In sum, recent data underscore our forecast of weaker economic growth in the near term. We still hold that the economy will turn up later this year and that wage inflation will come back more quickly than anticipated. Where one can make a critical error in assessing the economy is by attaching market pricing to the expected outcome for growth. The Fed has quashed that market signal with its liquidity policies and looks to keep doing so through June.

Markets: Assessing the impact of higher oil prices

- **Markets have quickly dismissed the Iran-driven flare-up in oil prices**
- **Our o/w equity, u/w bonds stance is appropriate for rising crude prices**
- **A major escalation is needed to usher in a risk-off environment**
- **Risk-reward from positioning for a major escalation is not compelling**

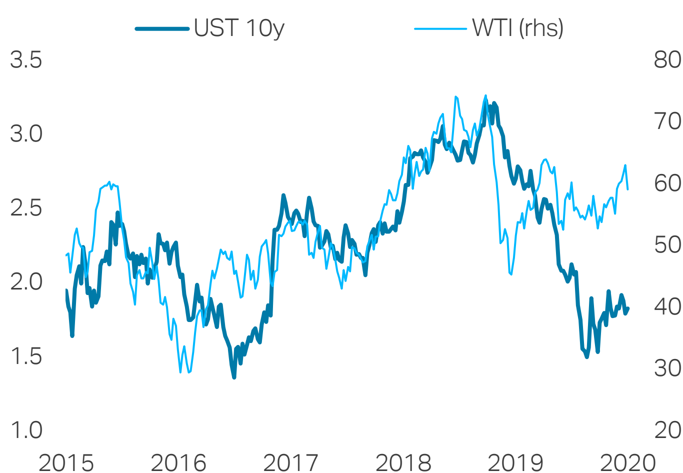
Flare-up in oil prices, not in rates. Tensions between the US and Iran have pushed up oil prices, which, if sustained, could eventually weigh on economic activity. Fortunately, so far the rise in energy prices has been just a flare-up (a bright dazzle followed by a rapid fizzle). Should oil start climbing again, however, the impact may not be as damaging as one may fear. An important mitigating factor would be that, unlike in 2018, dearer crude is not being accompanied by rising interest rates (bottom-left chart). A combination of the two would result in a significant drag on corporate profits and the economy; dearer oil by itself would be less harmful.

What if oil prices were to surge? Regime changes can alter correlations and betas over time, but US equities have largely benefited from higher oil prices in the past two years, having had a positive beta to WTI most of the time (bottom-right chart).

Unlike in other countries, the relationship between US stocks and oil is via the growth channel. The weight of the Energy sector in the MSCI US is only about 4% – the fourth lowest among major DM indices, larger only than Japan, Switzerland and Germany. This means that the direct boost to US stocks from higher oil should be minimal. Additionally, with the US having just become a net oil exporter, its economy is less sensitive to oil price changes than it used to be. It is therefore more likely that the direction of causality in the relationship between crude prices and economic activity is such that growth drives oil, not the other way round.

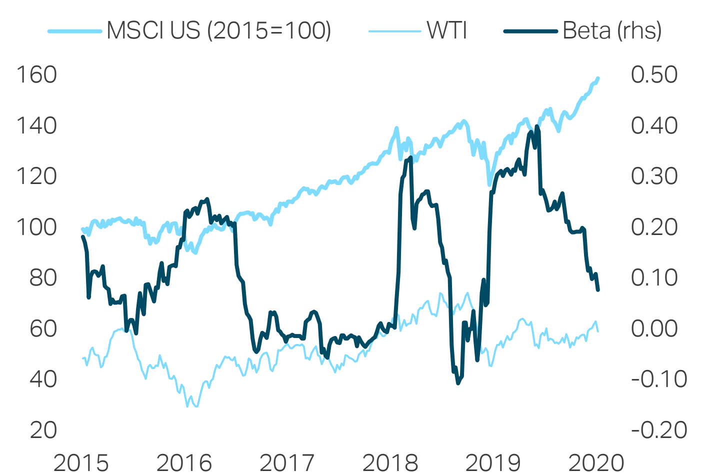
This effect is evident looking the shape of the oil futures curve, currently in backwardation. A backwardated crude curve is often a sign of investors judging that short-term supply disruptions won't necessarily result in sustained, long-term shortages. The spot price goes up, back futures less so. Middle East tensions are the cause of this pattern. In the last 12 months, however, the backwardation has owed as much to falling long-term futures as to rising spot (top-left chart on the next page).

Oil going up, rates better behaved



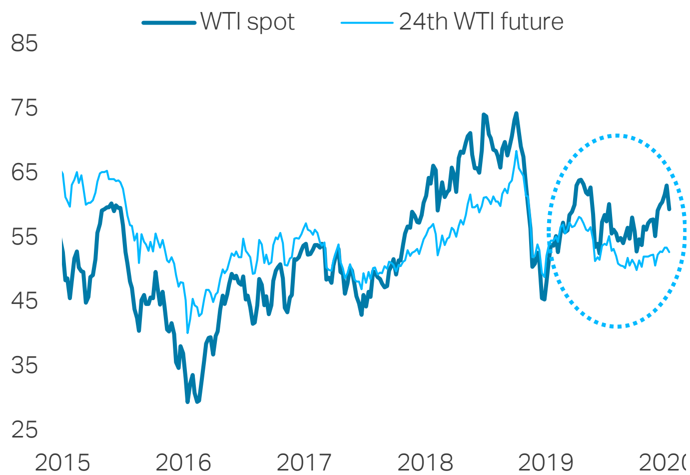
Source: Bloomberg, TS Lombard

Beta of US stocks to oil mostly positive recently



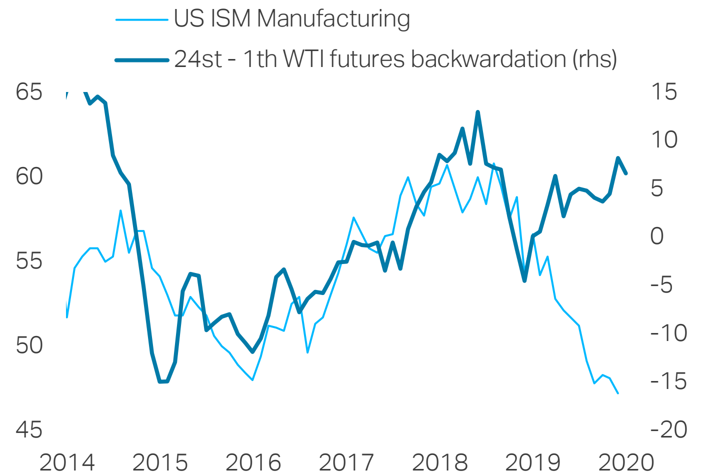
Source: Bloomberg, TS Lombard

Oil curve backwardation rose through 2019…



Source: Bloomberg, TS Lombard

…due to slowing activity, OPEC+ supply cuts



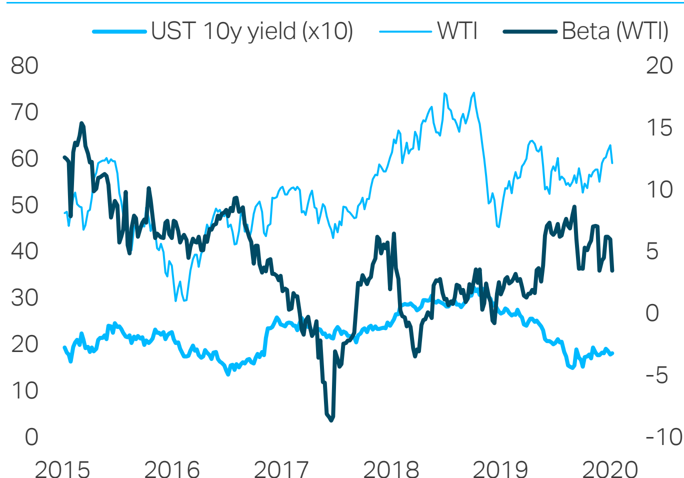
Source: Bloomberg, TS Lombard

The level of industrial activity tends to correlate positively with backwardation in the oil curve. When growth accelerates, crude supply struggles to keep up with rising demand, pushing up the spot price; as oil production is expected to catch up over time, correcting the near-term imbalance, longer-term futures prices rise more slowly. But increased backwardation over the past year has been driven more by slowing economic growth, which has dragged down long-term futures prices, coupled with support for spot prices from OPEC+ supply cuts (top-right chart).

In sum, US stocks shouldn't be too vulnerable were a shock rise in oil prices to materialise. But what about yields and the currency? A look at bonds shows what one would expect, i.e. that UST yields have a positive beta to oil most of the time (bottom-left chart). The impact is twofold, via the real activity channel – mentioned above in connection with equities – as well as through the inflation channel. As for the dollar, both beta and correlation to oil are minimal and negative, principally due to the fact that crude is mostly traded in dollars, making the two inversely related.

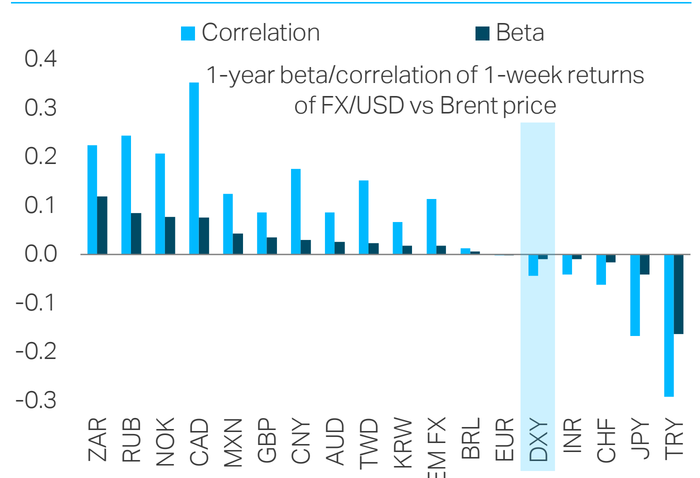
Overall, our current Asset Allocation stance of being overweight equities, underweight bonds seems well suited for a time of rising oil prices. Needless to say, this would not be true if a significant escalation of geopolitical tensions were to lead to a risk-off environment. However, we don't think the risk-reward of positioning for such a scenario is compelling right now.

UST yields' beta to oil positive too



Source: Bloomberg, TS Lombard

Dollar's sensitivity to oil minimal and negative



Source: Bloomberg, TS Lombard

Politics: Iraqi risk factor rises

- **No typo! We mean Iraq, not Iran**
- **This has to do with the way that third parties can suck in the 'principals'**
- **Transmission channel to the US runs through equities more so than oil prices – and, perhaps, this year's election campaign**

Much analysis of the 'Soleimani crisis' pays insufficient attention to the key independent variable: Iraq. Commentary draws naturally to speculation about the motives and goals of the principal antagonists.

- Pundits worry away at the implications from the assassination of the Iranian general possibly ordered in the heat of the moment by President Trump, without careful thought or consultation.
- On the Iranian side, it has long been clear that Tehran will not take lying down the Trump administration strangling its economy to bring about regime change, and/or Iranian capitulation in the regional struggle. The US 'strangle strategy' intensified last Friday with the announcement of yet more sanctions that, in particular, targeted Iran's steel industry. Steel is one of Iran's few important sectors that had until now escaped sanctions net. Last September's audacious drone strike on Saudi Arabia's main oil processing facility is a case in point. Now, in response to the assassination of its champion, Soleimani, what further escalation might Iran attempt: more aggressive attacks on Saudi Arabia and/or the UAE, subversion in Bahrain, or even terrorist-style attacks targeting senior American officials abroad?

Such imponderables presage plenty of flesh-creeping scenarios; but may also contrarily prompt a more sanguine analysis. There is considerable evidence that both Trump and the Iranian leadership wish to avoid an all-out shooting war. The latest – and notably cautious – round of tit-for-tat during the past week bears out this view. Iran's missile strikes on military bases inside Iraq used by the US avoided American casualties, and Trump's response was limited to the above-mentioned additional sanctions. The tragedy of Iran's accidental shoot-down of the Ukrainian passenger plane may also have the effect of further cooling heads. At any rate, judging by the round-trip of the oil price and other asset prices since the Soleimani assassination shock, financial markets appear to 'buy' this sanguine view.

Beware, however, unstable Iraq. There is no inherent fallacy in the sanguine view that both Trump and the Ayatollah have their own particular reasons to be cautious. The key risk factor stems from Iraq's chronic and ever-increasing instability, where US and pro-Iranian forces are like fencers duelling on thin ice -- focused entirely on each other even as cracks spread beneath their feet.

Recent history offers other powerful examples of antagonists sucked into unplanned conflict by breakdown in a third country for reasons unrelated to their own quarrel. The typical reason is bad governance and resulting public unrest. Take the case of Ukraine. Russia and, on the other side, the US (along with its European allies) have long been locked into a zero-sum rivalry for influence in that country. When Ukraine descended into civil conflict in late 2013-early 2014, both rival external parties accused each other of pre-meditated conspiracy. Such accusations were unfounded: Ukraine collapsed under the weight of its own, internal, flaws. That breakdown then, however, catalysed a full-on geopolitical confrontation between the external powers that neither of them had planned, with costs neither desired.

In similar vein, before the assassination of Soleimani, the Iraqi political system was on the brink of collapse. Last November saw a popular revolt against abysmal governance on offer from the sectarian coalition system in which, ironically, both the US and Iran have colluded as the country fitfully emerged from the civil war that resulted from the 2003 American invasion and occupation. Vast

leaderless crowds chanted "*we want a country*" and directed a good part of their anger at Iran, guilty by association with the despised system. Soleimani and his Iraqi Shia militia puppets set off the tit-for-tat cycle against the US in order to rebuild solidarity between the Iraqi people and Iran and thereby suck the air out of the protest movement.

Were Iraq to descend deeper into chaos, the US and Iran would almost inevitably come to blows in that theatre – if only, in a classic tail-wags-dog situation, as their respective proxies run amok. Here, then, would be a wildfire with the potential to set the entire Middle East ablaze. No other plausible scenario arising from the Soleimani assassination supplies the ingredients for a lasting oil price shock that hits global demand and kicks off a bear market in equities.

Transmission channels to the US from deeper chaos in Iraq consequently run through the equity market – and perhaps too the election campaign. The US now supplies its own domestic oil needs, and the economy needs less oil to generate GDP. The equity market is, as we have long noted, the lynchpin for US growth. As for the election, we look beyond Trump's motives to rally his base or Iran calculating its moves with a view to damaging Trump's re-election prospects. Instead, staying with the Iraqi wild-card theme, the timing of an Iraqi collapse is beyond anyone's control**. A terminal breakdown in Iraq could then set off a chain of events with material impact on the US election campaign – potentially for better or worse from Trump's own point of view.**

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