Daily Note

HOW GOOD IS THE US ECONOMY?

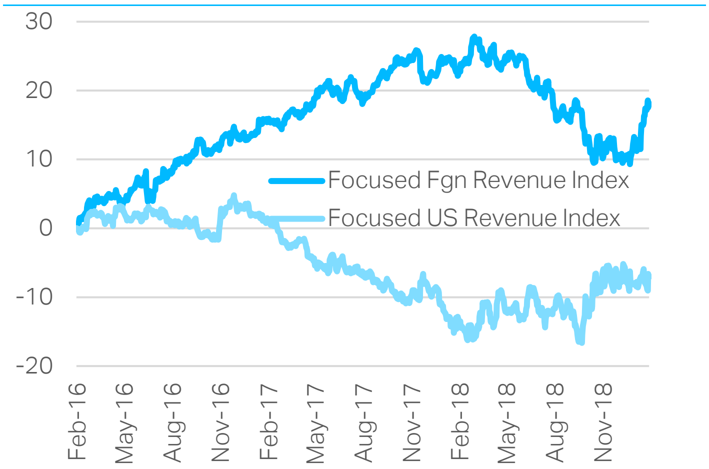
Steven Blitz

- **Equity investors favour firms with foreign revenue exposure**
- **Small businesses slow spending plans for hiring, capex and wages**
- **Has trend for unemployment claims and same-store sales turned?**

If the benchmark is continued expansion, then the US economy is "good enough". The slowing we pointed out late last summer is, however, becoming more widespread. Rising credit standards, a shift foretold by the shape of the short end of the yield curve, dictate a more sluggish pace of credit extensions and, in turn, a slower economy by the time summer rolls around. Perhaps most relevant to the view of how the domestic economy is faring is that investors continue to vote their funds in favour of firms with large foreign revenue exposure, as opposed to domestically oriented operations.

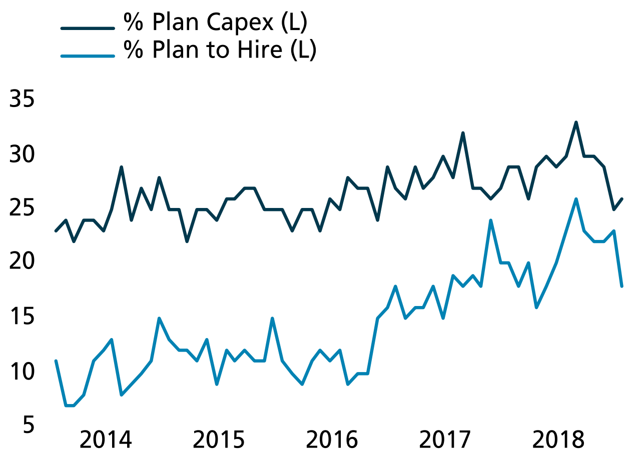
The equity market's dives and recoveries of the past several years owe primarily to shifts in the perceived earnings potential from outside the US, not within. The chart below left illustrates how, since the early 2016 market low, the cumulative relative performance of the S&P 500 Focused Foreign Revenue Exposure Index has far outstripped the S&P 500. At its peak the gap was close to 30%. The S&P 500 Focused US Revenue Exposure Index has, in turn, returned about 10% less than the S&P 500. The firms in these indexes are the top 25% most exposed to foreign or domestic revenue, as determined by Standard and Poor's. The foreign-focused companies derive nearly 40% of their revenue from abroad, compared to 32% for the S&P 500. These firms run the gamut in terms of industry, but the information technology, materials and energy sectors have index weights greater than those in the S&P 500. The constituents of the

Excess Performance vs S&P 500 (Feb 2016 to Date)
Cumulative Relative Performance (%)



Source: TS Lombard, S&P

Small Business Plans -- Hiring vs Capex



Source: Thomson Reuters Datastream, TS Lombard index with a domestic focus have 100% of their revenue in dollars and also run the gamut of industries. But, relative to the S&P 500, they are more concentrated in finance, utilities and real estate. Consumer staples and consumer discretionary carry less weight in both indexes than they do in the S&P 500.

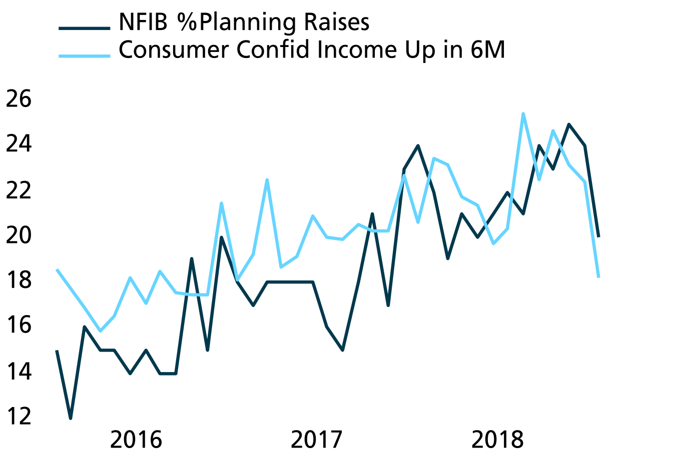
The January NFIB survey of small businesses, domestic to the core, also indicates some fracturing in their upbeat outlook. We see this in their reduced plans for capital spending, hiring and raising wages. The chart above right illustrates the declines in planned capex and hiring – declines that began last August. Plans are still well above pre-2017 levels, but our point is that plans are heading lower not that they are already soft. There was also a sharp drop in business plans to hike wages, 20% versus 25% in November (chart below left).

Consumers are very quick to pick up on changes in wage plans, as the Conference Board's January survey indicated with a sharp drop in the percentage of consumers expecting higher income in the coming six months (chart below left). This does not bode well for big-ticket spending. If this truly was an economy adding more than 300,000 jobs a month, wage expectations and plans to raise pay would not be falling.

Coming out of January, we expected a drop in unemployment claims owing to the return of government workers, but to date the rebound has fallen short. Further, Redbook same-store retail sales plummeted on a YoY basis for the week ending February 8 – after the shutdown and after the polar weather in the Midwest. When bad things happen, such as losing a job, people react much more quickly than they do when good things occur, such as being hired. This is why we tied unemployment claims and sales growth together in the chart below right.

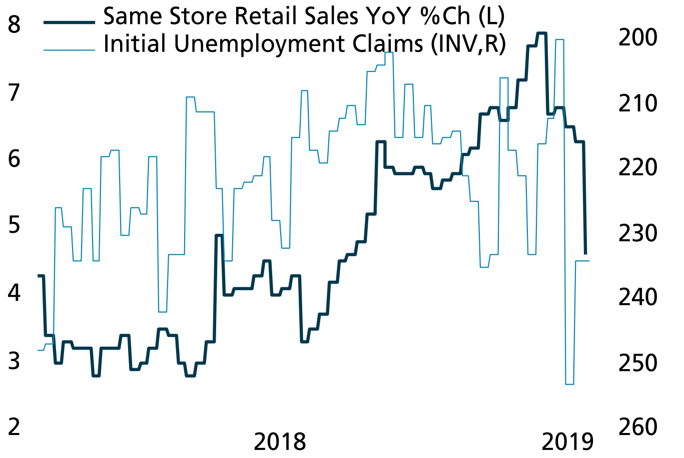
Real growth will slow this first quarter towards 2% QoQ, but because the reasons are transient (shutdown, weather, inventory), the Fed will keep to its 2.25%-2.50% federal funds rate. We do anticipate an "ease" by way of a technical adjustment to the pace of balance sheet reduction (QT) at the FOMC March meeting to help steepen the yield curve. Even with the recovery in the equity market, US Treasury yields, including inflation expectations, remain well below late 2018 highs. The two-year note still yields about the same as the funds rate – never a good sign for bank lending. In other words, the Fed still needs to act pre-emptively. The "real" slowdown in domestic growth is likely to come later this year - we think by summer - and that is when we expect the Fed to finally drop the funds rate by 25 basis points.

Wage Hikes: Business Plans, Consumers Expect



Source: Thomson Reuters Datastream, TS Lomb, Conf Board, NFIB

Retail Sales and Unemployment Claims



Source: Thomson Reuters Datastream, TS Lombard, Redbook, DOL