Sunpointe Investments

ILLUMINATIONS

Economic Review

August 2022

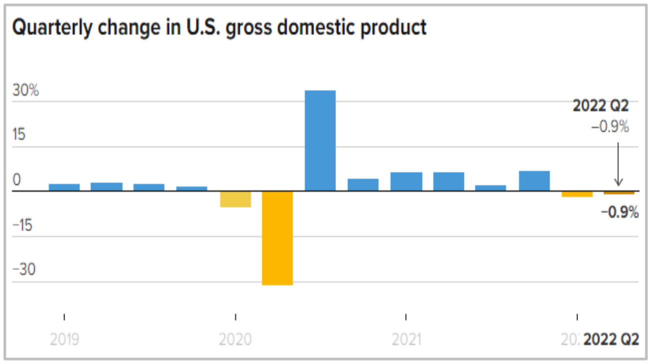
Labor market is sending mixed signals on the state of the U.S. economy

Hiring in July was far better than expected, defying multiple other signs that the economic recovery is losing steam . Nonfarm payrolls rose 528,000 for the month and the unemployment rate was 3.5%, easily topping estimates of 258,000 and 3.6%, respectively. The unemployment rate is now back to its pre-pandemic level and tied for the lowest since 1969. Wage growth also surged higher, as average hourly earnings jumped 0.5% for the month and 5.2% from the same time a year ago. Leisure and hospitality led the way in job gains with 96,000, though the industry is still 1.2 million workers shy of its pre-pandemic level. Professional and business services was next with 89,000. Health care added 70,000 and government payrolls grew 57,000.

The mixed picture continues for the U.S. economy with the strong August employment report offsetting other economic data points showing the economy may be slipping into recession. Monetary policy expectations have also shown recent volatility, but the strong August jobs report increased the expectation for another 75 bps rate hike at the Fed's September meeting. Employment can be a lagging indicator but hiring remains strong and while certain key companies have slowed future hiring plans, no significant mass layoffs have been announced. It is hard to imagine the U.S. being in recession with such a strong employment backdrop.

Are we in a formal recession?

The U.S. economy contracted for the second straight quarter during Q2, hitting a widely accepted rule of thumb for a recession. GDP fell at an annualized rate of 0.9% for Q2, according to the advance estimate, below the forecast for a 0.3% gain and a 1.6% decline in the first quarter. The decline in GDP came from a broad swath of factors, including decreases in inventories, residential and nonresidential investment, and government spending at the federal, state, and local levels. Gross private domestic investment tumbled 13.5% for the three-month period. Consumer spending, as measured through personal consumption expenditures, increased just 1% for the period as inflation accelerated. Inventories, which helped boost GDP in 2021, were a drag on growth in the second quarter, subtracting 2% from the total.

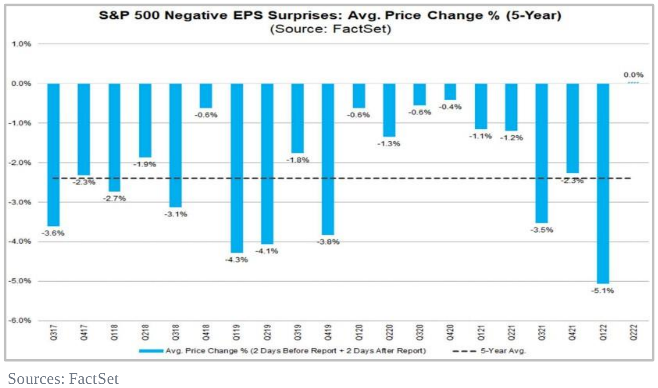


Sources: Bureau of Economics Analysis, CNBC

The ISM Manufacturing Index weakened slightly in July. The headline number declined from 53 in June to 52.8 in July with particular weakness in new orders, production, and prices. New orders and employment are now back in contraction territory, but production continues to see solid growth. Survey respondents continue to · cite inflation, lack of labor, and an economic slowdown as major headwinds. While manufacturing has seen a weaker pace of growth in recent months, the service sector remains robust. The ISM Services PMI increased from 55.3 in June to 56.7 in July. Business activity, new orders, and employment were all strong underlying components. Respondents continue to see strong momentum across their service businesses.

Q2 earnings once again outperform lowered expectations

Through 87% of the S&P 500's Q2 earnings season, the aggregate earnings growth rate has been 6.7%. 75% of S&P 500 companies have reported a positive EPS surprise and 70% of S&P 500 companies have reported a positive revenue surprise. Thus far, companies beating expectations have seen larger than normal jumps in their stock price while companies missing expectations have seen flat performance, perhaps signaling that much of the bad news is priced into stocks. Analysts are forecasting earnings growth of around 6% for Q3 and Q4 of this year and a full year number of 8.9%.



Sources: FactSet

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Consumption rebound drives Japan's Q2 GDP growth, BOJ monetary policy remains an outlier!

After growing just 0.1% during Q1, the Japanese economy grew at an annualized rate of 2.2% in Q2. The growth was driven largely by a 1.1% rise in private consumption, which accounts for more than half of Japan's GDP. Japan still faces uncertainty over rising COVID cases, inflation, supply chain constraints, and slowing global growth. Although the economy posted solid growth during Q2, Japan's COVID recovery has largely lagged other developed countries. Weak consumption has been the primary culprit of the weaker growth. The Bank of Japan has been a global outlier with its ultra accommodative monetary policy which differs from most other countries tightening policy to combat surging inflation.

PMIs show broad weakness in the eurozone economy at the start of Q3

The eurozone economy contracted in July, according to early PMI survey indicators, with output and new orders both falling for the first time since the COVID-19 lockdowns of early 2021. An accelerating downturn in manufacturing was accompanied by a near-stalling of service sector growth as the rising cost of living continued to erode the tailwind of pent-up demand from the pandemic. The latest eurozone composite PMI fell from 52 in June to 49.9 in July. The eurozone economy looks set to contract in Q3 as business activity slipped into decline in July and forward-looking indicators hint at worse to come in the months ahead. The eurozone economy did post economic growth ahead of expectations during Q2 at +0.7%.

China ekes out slight growth in Q2, but is the desperate PBOC interest rate cut signaling real weakness and downside risk?

China eked out GDP growth of 0.4% in the second quarter from a year ago, missing expectations as the economy struggled to shake off the impact of Covid controls. The Q2 reading was sharply lower than the 4.8% increase during Q1 and far below the 1% growth estimated by economists. On a quarterly basis, GDP shrank 2.6%. The Chinese government faces mounting challenges to keep growth steady, as the country contends with a sharp slowdown in activity due to Beijing's stringent zero-Covid policy, a bruising regulatory crackdown on the private sector, and a real estate crisis that is causing rising bad debts at banks and growing social protests.

China's central bank cut interest rates on August 15th as new data showed the economy losing steam last month because of renewed Covid lockdowns and a deepening property downturn. The PBOC reduced the main rate at which it provides short-term liquidity to banks, from 2.1% to 2%, and it also cut the rate of its one-year lending facility from 2.85% to 2.75% in order to maintain reasonable and sufficient liquidity in the banking system. Unlike many developed economies, China's core inflation (which excludes volatile energy and food prices) is rather tame, slowing to 0.8% in July as domestic demand remained weak.

The PBOC has been reluctant to cut rates due to concerns about risks associated with rising debt, inflation, and pressure on the yuan, but the risks were outweighed by the clear loss of economic momentum in July and early August. Both retail sales and industrial production missed expectations in July, and property investment by developers has dropped 6.4% YTD. Trouble in the property sector, which accounts for as much as 30% of China's GDP, is exerting significant pressure on the economy. Employment is another weak spot with joblessness among 16- to 24-year-olds hitting a record 19.9% in July. China is unlikely to hit its 5.5% growth target this year.