Sunpointe Investments

ILLUMINATIONS

Economic Review

October 2022

September job growth remains strong, solidifying another 75 basis points from the Fed

September job growth was strong and largely in-line with expectations. U.S. employers added 263,000 new jobs to the economy last month and the unemployment rate fell to 3.5%. The expectation was for 275,000 jobs and an unemployment rate of 3.7%. The surprise drop in the unemployment rate was due to the decline in the labor participation rate. The broader U6 unemployment rate which includes discouraged and part-time workers, fell from 7% to 6.7%. In the closely watched wage numbers, average hourly earnings rose 0.3% on the month, in-line with estimates, and 5% from a year ago, an increase that is still well above the pre-pandemic norm but 0.1% below the forecast.

Despite the 3% increase in the Fed Funds Rate, job growth has remained relatively strong as companies face a massive mismatch between supply and demand that has left about 1.7 job openings for every available worker. That, in turn, has helped drive up wages, though the increase in average hourly earnings has fallen well short of the 8.2% inflation rate. After the hotter than expected September CPI reading, markets are pricing in 75 basis points rate hikes for both November and December. This would bring the Fed Funds Rate to a range of 4.50-4.75%.

Dichotomy continues between manufacturing & services; core inflation continues to be "sticky"; resilience in retail sales, durable goods

September ISM reports showed broad based weakness in manufacturing and services. The ISM Manufacturing Index fell from 52.8 in August to 50.9 in September. The main drivers of the weakness were new orders, employment, and supplier deliveries. Production was flat while the prices component fell. Companies indicated that while supply chains are still stressed, they are showing signs of easing. They also cited continued difficulty finding employees due to wage increases by competitors. The ISM Services PMI declined from 56.9 in August to 56.7 in September. Business activity, new orders, and prices weakened while employment strengthened. Although service sector activity weakened last month, it still sits at very healthy levels, perhaps highlighting the resilience of consumers.

The PCE index came in with a year-over-year (Y/Y) rise of 6.2% in August, down slightly from 6.4% in July. The index rose 0.3% month-over-month (M/M). The core PCE index, which excludes volatile food and energy prices, showed a 4.9% rise Y/Y and a gain of 0.6% M/M in August, coming in above forecasts on both counts. Headline CPI rose 8.2% Y/Y based on the September report with Core CPI increasing 6.6%. Both PCE and CPI inflation remain well above the Fed's 2% target with recent hotter than expected readings.

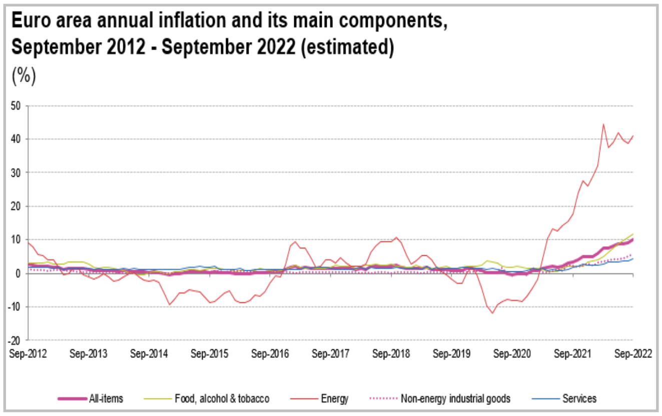
The headline retail sales figure for September was unchanged after an upwardly revised 0.4% in August. While the headline number was worse than expected, "core" retail sales which removes some volatile categories rose 0.4%. On an annual basis, retail sales growth slowed to a five-month low of 8.2%. New orders for U.S. manufactured durable goods declined 0.2% M/M in August following a revised 0.1% drop in July. Orders for non-defense capital goods excluding aircraft, a proxy for investment in equipment, jumped 1.3%, beating estimates and the 0.7% increase in July. Declines came from transportation equipment, fabricated metal products and non-defense capital goods.

Are earnings estimates the last shoe to drop?

As we enter the Q3 earnings season, analysts expect earnings growth of 2.4% on revenue growth of 8.5%. EPS has been revised sharply lower from the start of Q3 when analysts expected 9.9% growth. Energy, industrials, and real estate should see the highest EPS growth while communication services and financials are expected to be firmly negative. Earnings are forecast to grow 7.3% in 2022 and 7.9% in 2023. Earnings have not fallen much yet despite the weakening economic environment.

Eurozone recession appears all but certain based on PMIs and record high inflation; severe yen weakness resulting in inflation, albeit very low on a relative basis

The Eurozone economic downturn deepened in September, with business activity contracting for a third consecutive month. Although only modest, the rate of decline accelerated to a pace which, barring pandemic lockdowns, was the steepest since 2013. Forward-looking indicators, such as new orders, backlogs of work, and future output expectations, point to the decline gathering further momentum in coming months. Softening was seen in both manufacturing and services, with demand falling at faster rates in each sector as a result of the rising cost of living and growing gloom about future prospects. Eurozone inflation climbed to 10% in September, a new record high that has reinforced expectations for another significant increase in interest rates this month from the ECB. Inflation was driven mainly by volatile energy and food prices, but it continued to broaden, with virtually all categories from services to industrial goods showing increases.



Source:Eurostat

Inflation in Japan is the lowest among major economies, with the consumer price index rising 2.8% in August, compared with 8.3% in the U.S. and 10% in the EU. Abenomics may be the cause, but a lack of significant wage growth is adding pressure on consumers. While inflation is not a major concern on a relative basis, the weakening yen, which hit a 24-year low versus the USD, has driven up the cost of food and energy imports. Japan's economy grew an annualized 3.5% in Q2, but analysts expect it to have slowed in Q3 as slowing global demand and rising materials costs impact exports and consumption.

Source: Refinitiv

Mixed signals on China's economy prior to Xi's coronation; new COVID lockdowns show downside risks

Although the official manufacturing PMI unexpectedly strengthened in September, most other economic indicators in China showed weakness. China's official manufacturing PMI surprisingly grew in September to 50.1, up from 49.4 in the prior month and well ahead of subdued expectations. Meanwhile, the Caixin/S&P Global manufacturing PMI, a private survey of smaller factory activity, reported a contraction with a reading of 48.1. Subdued demand conditions and lower production requirements led firms to cut back on their purchasing activity in September, with the rate of decline the quickest in four months. COVID lockdowns were also cited as an explanation for decreased demand. China's official services PMI also declined to 50.6 in September from 52.6 in August. New export orders showed significant weakness in last month's report.

Brazil continues to outperform with big Presidential election looming

Brazil's polarizing presidential race will go to a second round run-off after no candidate achieved a majority of more than 50% of the ballot. Results showed left-wing candidate and former president Luiz Inácio "Lula" da Silva held a slight lead over right-wing incumbent President Jair Bolsonaro, but not enough to cross the threshold to victory. The runoff will be held on October 30th. Brazilian equities and the real outperformed as a result of the closer than expected election result. Investors are betting the leftist former President da Silva's narrow lead may pressure him to pivot toward the center before the second-round vote and prioritize market-friendly policies. Meanwhile, the incumbent Jair Bolsonaro's better-than-expected showing suggests he still has a chance to win in the second round, potentially providing continuity for investors.