Heartwood
Investment Management

12 February 2016

Investment Insight

Weekly Insight

US recession risks are rising but how likely an outcome?

When the Fed ended its zero interest rate policy in December, financial markets welcomed the move believing it to be a sign of confidence in the US economy. Very quickly, however, sentiment has turned, and investors are now questioning whether the Fed's policy move was a mistake, as markets discount an increasing risk of a US recession. But we need to ask ourselves, has the US economy fundamentally changed since December?

In short, we do not believe this to be the case.

1) We have known for some time that the US manufacturing sector is suffering under the weight of slower global demand, commodity price declines and the impact of a strong US dollar. These trends are not going to disappear quickly, as the energy sector adjusts to lower oil prices, China rebalances and the lagged effect of currency strength continues. Over the last month, manufacturing survey data has been less downbeat in aggregate. The Chicago PMI survey of activity bounced sharply into expansion in January and while other regional surveys underwhelmed, forward looking indicators across all of this data provided a few signs that the outlook is stabilising. Despite all the chatter about tighter financial conditions in the US, it is worth highlighting that the US dollar has actually weakened this year on a trade-weighted basis, which may provide some welcome relief to exporters in the coming months.

2) Consumer spending comprises two-thirds of the US economy and the services sector is a very significant contributor to growth. Although the overall trend of expansion remains firm, business activity slowed in January and there are concerns as to whether this represents something more sinister. We believe it is too early to make this assumption and take comfort from January's employment report. The US economy is continuing to create jobs, albeit at a slower pace given the maturity of the cycle, and the unemployment rate is at the lowest level since 2008. Importantly, wage growth, which has been disappointing in the post-crisis years, rose at a healthy pace of 2.5% year-on-year in January. If this trend can be sustained, then it will be an important underpinning to US consumer spending and the broader economy; not forgetting, of course, the boost to real disposable income from low inflation and lower oil prices.

Where does this leave Fed interest rate policy?

In her semi-annual testimony to Congress, the Federal Reserve's Chair, Janet Yellen, acknowledged external risks had increased, but remained optimistic that US economic growth could be sustained by ongoing labour market improvements and the recovery in the housing sector, which would both support domestic demand. She did not rule out an interest rate increase in March, contrary to the consensus market view of not expecting another move until mid-2017. However, Yellen did express more concern about the inflation outlook, which suggests that the Fed will be in no hurry to increase interest rates.

The Fed is walking a tightrope between being seen to show confidence in the US economy and at the same time acting to navigate against difficult global headwinds. The US economy is not yet in the doldrums. However, in recent years, markets have relied too heavily on central banks and it may be time for governments to pull the fiscal lever and add support - not just in the US but elsewhere. Our view remains that the US economy, while anaemic, continues to expand; however, we are watching carefully for signs as to whether recent financial market volatility starts to have an adverse impact on confidence in the real economy.

David Absolon
Investment Director

No.1 Kingsway, London WC2B 6AN. Tel: 020 7045 1320
heartwoodgroup.co.uk
Registered Head Office: London address above. Registered in England Number: 4132340

Part of the Handelsbanken Group
handelsbanken.co.uk