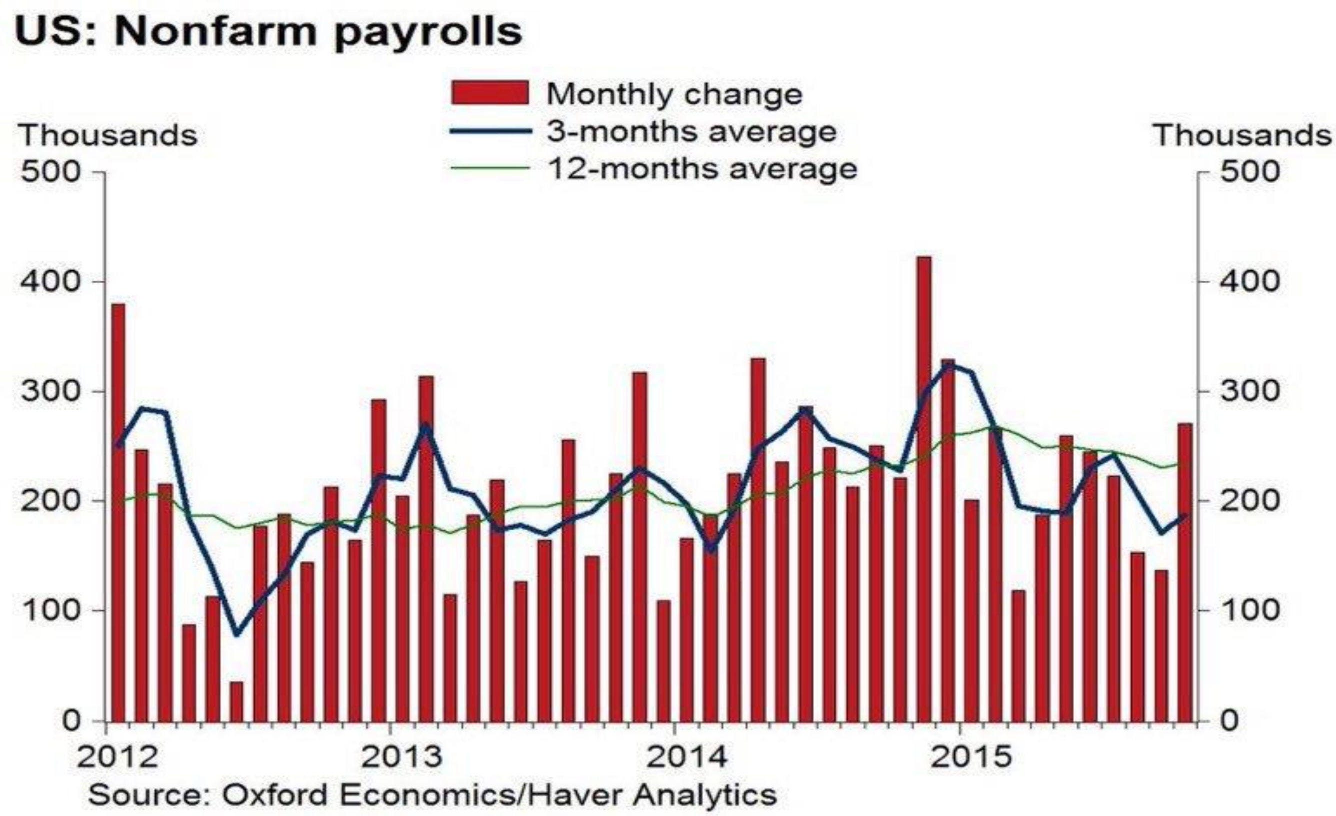
November 9th, 2015

Second level thinking…

Last Friday's U.S. payroll report was about as unblemished as one could have asked for: nonfarm payroll growth surged by 271k (the best monthly gain in 2015) with positive net revisions totaling 12k for the prior two months, the unemployment rate improved a tenth to 5.0% from 5.1%, and average hourly earnings surged 0.4% month-over-month. The trend in payrolls looks solid with the 3-month moving average of 187k and the 6-month average of 215k. However, do take note that the rate of change in the trend of job creation is decelerating where it looks as though job growth peaked in Q4 of 2014 (see chart below).



The decline in job growth isn't a harbinger that the current expansionary cycle is over, but given that we are in the 78th month of this expansion (handily surpassing the median 59 months of previous expansions going back to 1930) it should not come as a surprise that monthly payroll growth is moderating as the unemployment rate has been cut in half to

5.0% from the 10% peak reached in October of 2009.

Meanwhile, the drop in the unemployment rate was for good reasons as a 320k pop in household employment outpaced a 313k increase in the labor force. The labor force participation rate held steady at 62.4% but picked up on an unrounded basis to 62.426% from 62.356%. Lastly, the solid monthly pick-up in wage growth pushed the year-over-year rate up to 2.5%, which is the highest pace since July 2009.

It was the jump in average hourly wages to 2.5% on an annual basis that was the defining element of the report as this has consistently been the missing link in almost every payroll report since the Great Recession ended – "solid payroll growth, but how good can conditions be if there is no wage growth?"

Over the last five years the U.S. economy has added an average of 202k jobs per month – the best performance for the labor market since the Tech Boom in the late '90's and one of the best stretches in the post-WWII era – but this all occurred following the worst and longest downturn in the jobs market since the Great Depression.

Economists and academics alike have proffered ample research supporting the concept that once the unemployment rate falls to a level consistent with the non-accelerating inflation rate of unemployment (NAIRU), wage inflation should follow. Lo and behold, the 5.0% unemployment rate reached in October just so happens to match the Congressional Budget Office's estimate of NAIRU. Assuming the economy does not experience any significant weakening in labor market conditions over the near-term, it stands to reason that the unemployment gap will remain closed which is historically consistent with an acceleration in wage inflation.

All in all last month's jobs report more than offsets the weakness in the prior two releases and positions the Fed to hike rates in December. One item to note is that in the last three occurrences where we saw a closing of the unemployment gap – Spring 1998, Summer 1995, and Fall 2005 – the Fed was well into tightening cycles. In fact, the closing of the unemployment gap in both 1995 and 2005 happened to coincide with the peak in the Federal Reserve's tightening cycle.

Other economic data reported last week was, on the margin, constructive. According to Bloomberg, auto sales came in at 18.12 million units at an annual rate for October, which is actually up from 18.07 million in

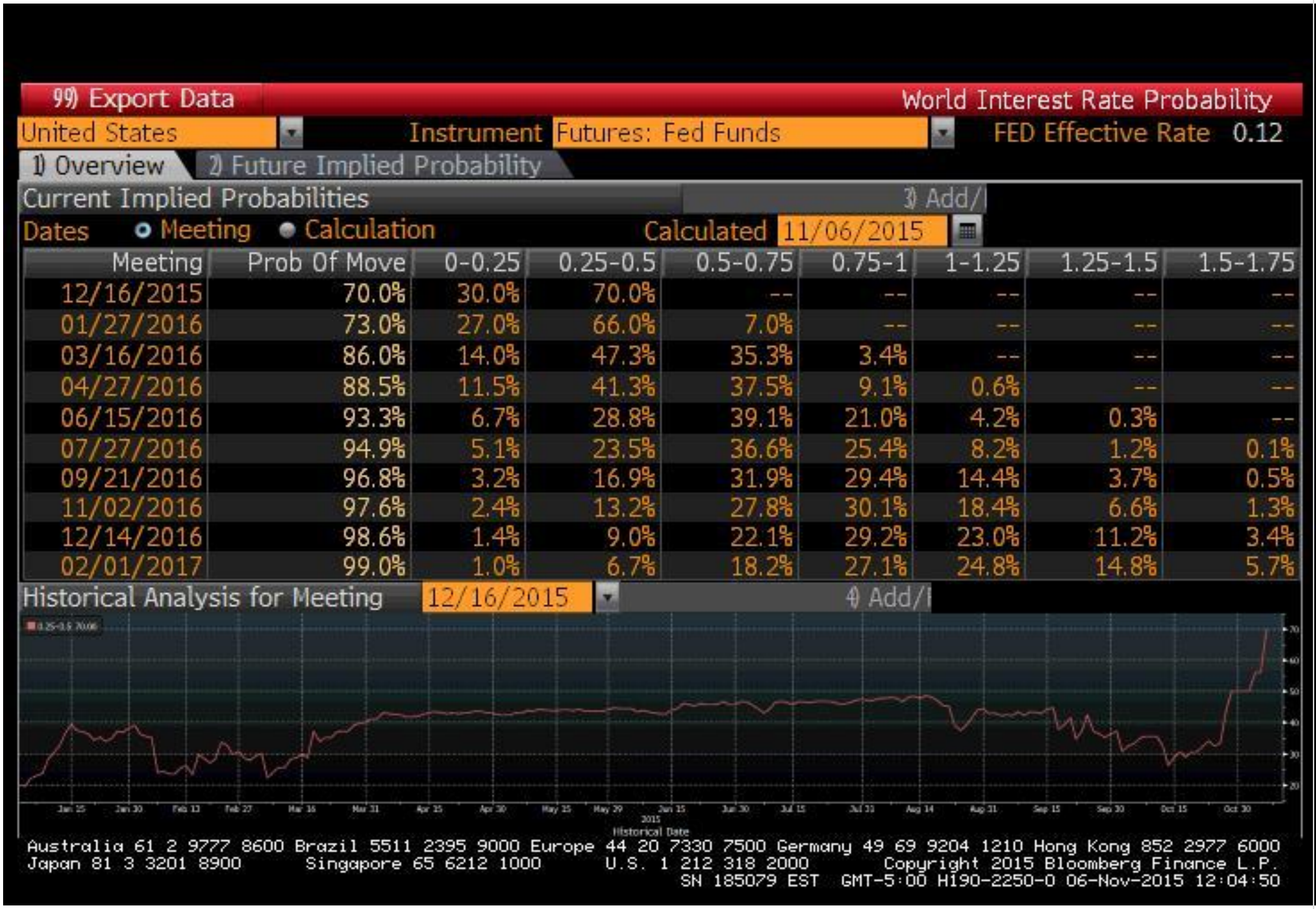
September. This is the best monthly sales pace since July 2005 when auto sales spiked above 20 million units and last month's tally represents the sixth best level since 1990 (it is also the first time since 2002 that we've seen consecutive months of sales above 18 million annualized units).

The ISM manufacturing index edged down to 50.1 in October from 50.2 in September, remaining just barely in expansionary territory and at its weakest level since May 2013. Without question the manufacturing sector is in a discernable decline in part as a result of weakness from abroad as well as the significant increase in the dollar. But history suggests that this is not a unique situation following a significant move higher in the dollar – go back to the Tequila Crisis in 1995 when the ISM fell as low as 45.5 or the Asian meltdown in 1998 when the ISM hit 46.8 at the low point – what both of these periods had in common: a material slowing in the manufacturing sector, a spike in the dollar, but no recession.

More than offsetting the weakness in the manufacturing sector is the strength in the service sector as the ISM non-manufacturing index rebounded to 59.1 in October from 56.9 in September. The strength in the report was broad-based with new orders rebounding, employment climbing to a three month high, and prices paid inching higher. Keep in mind that the U.S. economy is roughly 80% service based so the strength in this report is very positive news. The gap between the ISM services and ISM manufacturing indices is now at 9.0, which is the second highest reading on record and the biggest divergence since the high of the Dotcom boom back in February 2001.

Following the recent slate of economic data and stability coming back to the fore overseas, capital markets have moved to price in Fed lift-off commencing in December. This is most visible in the front of the Treasury curve as the two year T-note yield has gapped up to 89 basis points from 55 basis points just three weeks ago – testing levels we have not seen in over four years. This is also playing out in the currency markets with the DXY dollar index recently eclipsing 99 (its highest level since April). Recall that the last time we were at these levels, all the rage was about how material the impact would be on corporate earnings which, judging by the results from Q2 and Q3, these concerns were well founded as dollar strength has been a common scapegoat cited by management for earnings weakness. Also moving on the renewed belief that the Fed is set to hike in December is the euro which has broken below the $1.08 level as investor’s price in growing divergence between the Fed and ECB policies (also note that the 2-year yield spread between the U.S. and Germany has widened out to 115 basis points which is the widest it has been in nine years). A similar script is playing in dollar-yen which recently took out its 100-day moving average as it moved above ¥123.

Fed fund futures are now pricing in the probability that the Fed hikes in December at 70% from under 40% odds just over a month ago (see chart below).



Over the last week we've also had several officials from the Fed acknowledging that a rate move in December is a "live possibility". Perhaps the biggest risk to the Fed delaying a hike in December is that global markets push back.

While the global economy stands to benefit from the stronger dollar, clearly the risk is that oil, commodity prices and Emerging Markets (EM) decline significantly and take the U.S. equity market down like we saw in August and September. I have doubts that the Fed would start hiking rates in the midst of a correction in the stock market. However, there are a couple encouraging signs indicating that the financial markets may be more comfortable with a Fed rate hiking cycle at this time. Oil prices are holding up and in fact are more than 3% higher than on October 27th, the day before the last FOMC meeting, hence the Energy sector remains the best performing sector in the equity market over the same period of time (+5.80%). However, the CRB base metals index has sagged to the lows of the cycle, so it looks as though the headwinds and challenges facing commodities in general remain very much at play.

Additionally, while weakening, EM is holding up surprisingly well as EM equities are down just 1% over the same period of time where the probability of December liftoff rose to 70%. The gap between U.S. and EM equities remains the key relationship to watch, with the risk that EM is a leading indicator – if it begins to breakdown it could be a prologue to weakness in U.S. equity markets.

So the markets have come a long way from the anxiety ridden volatility it was experiencing a short six weeks ago, but to me that by no means implies that the risks investors face have materially dissipated. The S&P 500 is back to trading at 17.7x 2015 earnings and 16.5x what I believe to be aggressive forecasts for 2016 earnings of $125/share. Third quarter earnings season is nearing an end with the latest tally showing

EPS contracting about 2.0% for the quarter (+4.5% excluding the energy sector). Revenue growth is faring even worse as it is estimated to decline 3.7% for the quarter (+1.4% excluding energy).

On top of that, earnings fundamentals don't seem to be seeing much improvement as the three-month earnings estimate revision ratio fell to 0.67 in October from 0.83 – marking the third straight month of declines and its lowest level since April (data from BofA Merrill Lynch Global Strategy). The sales revision ratio has fallen to 0.55 from 0.66 (the lowest since May, and below its average of 1.0) as all sectors have seen more cuts than raises to sales forecasts over the last three months.

At a minimum we are looking at an equity market that is fully priced with limited upside over the near-term, notwithstanding the improved technical picture and positive seasonals. Bottom line is that valuations now pose the greatest constraint to returns over the near-term.

I found it rather interesting as I was listening to the commentary following last week's employment report where pundit after pundit was just raving about how great Friday's jobs report was (which I agree it was), but I found myself scratching my head wondering what I was missing as many extrapolated one month's data into the future forecasting that we are on the doorstep of a resurgence in growth. Trust me if this turns out to be the case I will gladly welcome it, but I find this conclusion to be more than a tad premature.

You see, what I encourage investors to not lose sight of is how the data evolves throughout a business cycle. Think of it as second level thinking or looking through what is easily visible on the surface. It's the process of thinking through where a variable could go rather than where it is or where it has been.

At the peak of an economic cycle many of the lagging economic indicators look the best, a la employment, the absolute level of earnings, consumer confidence, and consumption – to name a few. What we know today is that employment growth peaked in Q4 of last year and job growth does not accelerate when the unemployment rate is nearing full employment as is currently the case. As I discussed above, this is where payroll growth gives way to wage inflation and the overall level of employment plateaus. With more jobs comes increased consumer confidence, but we've also seen this variable peak in

January of this year. In the last two economic expansions consumer confidence peaked in May 2000 and July 2007 which coincided neatly with the top in the business cycle, but ten and five months, respectively before a recession began.

We also know that corporate profits peaked earlier this year and this delta in wage inflation, if it persists and isn't another head-fake, surely will prove to be an additional headwind for corporate earnings. Profit margins are already at cycle highs and companies are having a very difficult time finding revenue growth. Beyond wages eating away at profit margins, companies will also be plagued by the renewed appreciation of the dollar as the Fed sets the table to hike rates while central banks in the world's next four largest economies remain extremely accommodative.

The rise in the dollar is not only problematic for corporate profits but also a headwind for emerging markets given that nearly $9trillion in emerging market debt is denominated in dollars. Hence a surging dollar makes this debt load even more expensive at a time when these economies are wrestling with a crash in commodities, which for years has been a pillar to drive growth in these regions.

You see, even though we are 6 ½ years into this expansion the global economy remains vulnerable to a new crisis. China is in the middle of a tough restructuring of its economy and is a drag rather than a support to growth. Most major central banks already have zero interest rate policies (ZIRP) and big balance sheets, suggesting low ammunition to fight a crisis. And in many major economies, countercyclical fiscal policy is not an option for political reasons. As a result, while I do not see any recessionary shock on the horizon, I am quite concerned that if a recessionary shock hits, it will be very hard for policy makers to fight it off. The upshot is that while markets fixate on the December meeting, the critical question facing the global economy is whether the Fed can reload its interest rate ammunition before the next crisis hits. In particular, the Fed needs to both push inflation back to target and move the nominal rate closer to normal. If the Fed can't lead the way out of ZIRP, it is hard to imagine the ECB or BOJ succeeding.

What I'm getting at is that while we are only on the eve of the first rate hike by the Fed in this cycle, and while the history books show that at no time did a bull market end after the first rate hike, there are some unique circumstances that accompany this cycle relative to cycles of the past. Furthermore, I am of the view that we are closer to the next recession and bear market than we are to early stages of an expansion or bull market. I'm not crying wolf here as I do not believe either of these outcomes are in the cards in the near-term, but I do think this poses the biggest risk to investors because the markets are pricing in such a low probability of it occurring (keep in mind that the wolf did ultimately show up at some point). Hence, if the probability of such an outcome were to increase materially the capital markets would be in for a severe price adjustment.

So with the upside opportunity in stocks rather muted given high valuations and low earnings growth and fixed income markets offering low returns given low interest rates, I believe it is prudent for investors to look for areas in their portfolio where they can lower their overall risk profile, be it lowering overall equity exposure, going up in quality and market cap size within equities, minimizing exposure to below investment grade debt, adding exposure to non-correlated absolute return strategies, and carrying a moderately higher cash position.

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