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Setting the table for a September rate hike…

Stagnant corporate earnings, deteriorating breadth, so-so economic data, and increasing expectations that the Fed will hike rates in September for the first time since 2006 weighed on U.S. equity markets last week as the Dow Jones Industrial Average lost 1.7% (closing lower in seven straight trading sessions) and the S&P 500 declined 1.2%. As of Friday's close the S&P is up 0.9% on the year with the Dow down 2.5% and the market internals have shifted to a risk-off posture with defensive sectors (Utilities and Consumer Staples) outperforming relative to their cyclical peers.

On the surface the major averages give investors the impression that all is well, but the damage is mounting with the internals suggesting that all is not well in stock land. Year-to-date (as well as over the last three, six, and 12-month intervals) the number of stocks hitting new lows has outpaced the number of stocks hitting new highs. Additional signs of weakness in the capital markets are the 'bull flattening' in the Treasury curve (over the past year the yield on the 2-year T-note has risen to 0.73% from 0.43% while the 10-year note has fallen to 2.18% from 2.41%), small cap stocks declining by almost 5% since late June, and the outperformance of low-beta stocks relative to high-beta stocks in recent weeks. If not for the bid put under the market due to M&A deal values running 51% above last year's levels ($1.38 trillion versus $915 billion) one has to wonder where the major averages might be trading.

The big news last week was the decent yet unspectacular July employment report. The U.S. labor market added 215k new jobs in July with net positive revisions of 14k over the last two months. This was a record 65th consecutive month of private sector employment growth and far outpaces the 51 consecutive months under former President Clinton. Job growth has averaged a solid 213k over the first half of the year and 235k over the last three months.

All in all this report hit all the numbers expected from the economist community: the unemployment rate held steady at 5.3% as did the labor force participation rate at 62.6%, and the broad U6 unemployment rate ticked down to 10.4% from 10.5% in June and 10.8% in May. Moreover, the details of the report were pretty solid with the diffusion index strengthening to 64.4 from 60.6, suggesting that job gains across industries are broadening out. The average workweek rose to 34.6 hours from 34.5 in June which lifted total worker-hours (aggregate hours) by 0.5% compared to 0.2% previously. Combine this with the 0.2% increase in average hourly earnings and aggregate income increased 0.7% in the month compared to 0.2% in June. The 4.9% year-over-year growth in aggregate income is the fastest pace since March and is a very solid level for the near-term outlook for consumer spending as it suggests that wage and salary income is due to accelerate.

From the viewpoint of the Federal Reserve this report 'sets the table' for a rate hike coming as early as September. The incoming data over the next month will determine whether or not the meal actually gets served at the FOMC's

September meeting, but the probability of a rate hike coming in September increased to a little over 50% following last week's economic data. Friday's employment report, at the margin, likely meets the FOMC's expectation of "some" further improvement in the labor market that they laid out in the most recent statement. Over the last couple of months the pendulum of 'data dependency' as far as the Fed is concerned has shifted from the data having to improve to a level that validates the Fed beginning the process of normalizing rates, to the data having to weaken enough to prevent them from hiking. There still remains one more employment report before the next FOMC meeting, but as far as the labor market is concerned if that payroll report is consistent with this one then that could easily tip the scales in the direction of the first hiking coming in September.

Without question the labor market is in solid shape, which continues to be validated by the lack of firings in the business community as employers focus their efforts more on retaining their workforce rather than having to go outside to hire and train new employees. Last week's jobless claims rose modestly for the second straight week to 270k from 267k the previous week and the 42-year low of 255k two weeks ago. Even after last week's slight increase the level of jobless claims remains near 40-year lows with the headline number now having gone 22 straight weeks of sub-300k readings and is the best streak since the early 1970's (back then the labor force was roughly 90 million strong compared to today's +150 million). This puts into context how impressive the run of sub-300k claims has been and substantiates just how solid the labor market is.

Beyond the labor market, the economic backdrop remains a mixed bag with less than half of the U.S. economic indicators managing to surprise to the high side of expectations over the last two months. Housing has been strong with homebuilder confidence at its highest level since 2005, but juxtapose that against weak manufacturing data with the ISM manufacturing index falling to 52.7% in July from 53.5% in June. Also on the positive side of the ledger is the surge we saw in the ISM non-manufacturing index from 56.0 in June to 60.3 in July, above expectations for a print of 56.2. This represents the highest level for this index since August 2008 and with the current make-up of the U.S. economy being roughly 2/3rds services and 1/3rd manufacturing, I for one much prefer how this data is coming in respectively for these metrics.

The combination of oil prices being cut in half over the last year (which has caused capex spending in the energy sector to come under the knife – contracting at nearly a 60% annual rate in the first half of 2015), weakening global growth – especially in the once red-hot emerging market economies, and the strengthening U.S. dollar have all done their part in muting the belief that an industrialized renaissance was underway in the U.S. Undoubtedly competitive balance in manufacturing is being recalibrated around the world where there will be winners and losers, but with GDP growth averaging 2.0% since this recovery began, and GDP growth averaging 1.5% through the first half of 2015, it's a safe premise to assume the U.S. has not been a significant beneficiary of this global rebalancing.

Now I don't play politics as I find pluses and minuses with both sides of the aisle, so I state this next fact with an agnostic view, but so far in this near seven year period of the Obama Administration we have not had one single year of GDP growth better than 3.0%. The best year of this recovery was in 2010 when growth managed to register a white-hot 2.5% pace (yes that was an intended healthy dose of sarcasm).

Auto sales continue to hum along at a brisk pace registering a seasonally adjusted annualized rate of 17.5 million in July with pricing remaining firm according to TrueCar estimates showing that average transaction prices have increased 1.8% year-to-date to $32,136. However, these results contrast with the recent decline in consumer confidence, sluggish retail sales data, and flat private sector compensation growth in Q2. It's fascinating that despite record high job openings and three decade low jobless claims, wage growth remains dormant.

And then there is the federal budget deficit, which is estimated to shrink to $425 billion for FY2015 – somewhat smaller than last year's $485 billion deficit. The deficit/GDP ratio should decline to 2.4% from 2.8% last year and will represent the lowest level since 2007 as well as coming in below the 40-year average of 3.2%. The budget deficit has been shrinking each year since it peaked above $1.4 trillion (9.8% of GDP) in 2009. While a lower deficit is good for the long-term solvency of the U.S. economy it has done little to support economic growth this cycle as revenues (mainly through tax receipts) have consistently increased since the recovery began while government outlays have remained roughly flat.

However a recent study from Brookings by Mochoruk and Sheiner titled “Fiscal Headwinds are Abating” argues that the restraint on economic growth from fiscal policy will dissipate going forward. They estimate that tight fiscal policy cut GDP growth by at least a percentage point in 2011, 2012, and 2013 and was a more modest drag on 2014. They suggest that in the second quarter of this year fiscal policy turned positive highlighting the moderate rise in government jobs and some pick-up in state and local investment as confirmation of this thesis. If this ultimately turns out to be a trend, then it will go a long way in providing a much needed boost to the continuation of the current expansion after several years of fiscal austerity. Admittedly, I find a bit of irony in the set-up of this possible outcome given it is coming at a time when the Fed is looking to exit its years of unprecedented monetary policy accommodation which in part were an attempt to offset the lack of fiscal policy support to a floundering economic backdrop.

It truly will be fascinating to look back ten years from now and play ‘Monday morning quarterback’ on how this economic cycle transpired. Undoubtedly recessions that stem from severe asset deflation and credit bubbles are distinctively different than recessions created from excess inventories, over capacity, and rising inflation. Going back and tracing the footsteps of the Great Depression you will learn that the economy troughed in ’32 then went on to robust growth for the next four years before the Fed stepped in and prematurely tightened.

Today it is not the Fed that is restricting economic growth but tight fiscal policy, a strong dollar, and too much regulation in the credit markets that have suffocated this economy and restrained it from sustaining growth above potential. Don't get me wrong – I look forward to the Fed normalizing interest rates, but I worry more about them tightening prematurely than going too late. After all, inflation is clearly not a problem with the Fed's preferred inflation gauge (PCE deflator) at a four year low of 1.3%, wages are hardly accelerating, and estimates show that the output gap remains near 2%. Lastly, practically every other central bank in the world (Brazil being the exception) is easing policy which risks the U.S. dollar becoming even stronger and further compounding the sub-par growth backdrop.

What I'm getting at is, if it ain't broke then don't fix it. Yes, there is a risk of asset bubbles permeating in capital markets, but the fall-out from these bubbles popping will be much easier to cope with if we have a more solid underlying economy on our hands. For now what we have is a feeble economic growth backdrop, strong employment, weak wage growth, strong housing fundamentals, low inflation, low interest rates, a strong currency, uneven global economic growth, floundering corporate earnings, and what appears to be a U.S. household that is fully invested in the equity market (in my opinion).

While I reserve the right to be wrong and I'm hopeful that this Fed can thread the needle of normalizing rates as well as they did with tapering QE, my skepticism is increasing that this next phase of Fed policy will go off without a hitch. That being said, with valuations across both the debt and equity market above historical averages, the margin of safety to cushion any near-term blow to investor's portfolios is razor thin. As such, I continue to believe it will behoove investors to remain prudent, understand the risk in their portfolios, employ some risk management hedges, and exhibit some patience, as the road ahead is bound to have some potholes.

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