October 10th, 2016

The most lagging of all lagging indicators…
It looks as though economic momentum gained a little bit of steam heading into the last quarter of the year with most of the major data releases last week meeting or exceeding consensus expectations:

- The ISM Manufacturing Index increased to 51.5 from 49.4 (beating expectations of 50.4). The internals of the report were firmer almost across the board with the new orders, order backlogs, and production segments showing the biggest improvements while only two components (supplier deliveries and new export orders) registered a decline.
- The ISM Non-manufacturing Index surged to an 11-month high of 57.1 in September from 51.4 in August, handily besting consensus expectations for a print of 53.0. Like its sister report from the manufacturing sector the internals were quite constructive as new orders saw their biggest increase since April '09, business activity posted its third best increase on record and employment registered its biggest increase in the survey's history as it moved to an 11 month high. The breadth of improvement was strong as well with 14 of the 18 industries reporting growth which was an improvement from only 11 seeing expansions last month.
- Putting the two ISM surveys together pushed the composite ISM index to 56.4, its highest level since October of last year and meaningfully above the 51.2 print in August.
- Auto sales declined -0.7% to a seasonally adjusted annualized rate (SAAR) of 17.7mm units, but this was well above consensus expectations for a more precipitous slowing to 17.4mm. This should give a bit of a boost to retail sales when they are reported at the end of this week.

Capping off last week we got the BLS nonfarm payroll report which showed that the U.S. economy created +156k jobs in September, which was a bit shy of consensus expectations for +175k. Wages also came in a bit shy of consensus expectations (+0.3%) as average hourly earnings eked out a +0.2% gain and this kept the year-over-year trend in wages flat since June at +2.6%. The unemployment rate ticked up to 5.0% from 4.9% in each of the past three months and the low print of this cycle of 4.7% in May. The broad U-6 measure remained at a stubbornly high level of 9.7% and outside of the tick lower to its 9.6% low in June, this metric hasn't budged since February. This gauge continues to show that a lot of slack remains in the labor force and this speaks precisely to the lingering labor market slack references made by Yellen and Brainard.

One item Fed officials will not be encouraged by is the +354k new jobs in the Household employment survey all being of the part-time variety and then some as full-time employment dipped -5k in the first net reduction in headcount since May – recall that at that time very few people thought the Fed was going to move at all this year.

Here's how I would summarize the employment backdrop as we move into year-end:

- The overall labor market is ok (nothing more, nothing less) – the year-over-year growth rate is clearly decelerating (monthly job growth for 2016 is averaging a solid +178k per month, but this is down from the average monthly tally of +229k in 2015).
- The unemployment rate has been quietly rising to 5.0% from 4.9% over the previous 3 months and from 4.7% in May.
- The weakness in the manufacturing industry has yet to abate with manufacturing jobs declining -13k in September on top of a loss of -16k in August. Year-to-date: -58k.
- Services employment continues to grow as it added +146k jobs last month (94% of all new September jobs), but the trend in job growth for this segment is decelerating: +276k in June, +238k in July, +192k in August and now +146k in September.
- More than 78% of the new jobs created in the last year were in the relatively lower wages service sector – this is preventing a commensurate acceleration in labor income and pressures on inflation.
- On the plus side is the fact that all net new jobs created in the last year were full time.
- The labor force rose 1.9% YoY, its fastest growth rate since January 2007 and among the fastest on record since 1990. In actual numbers, 3 million Americans entered the labor force during the last 12 months, a spurt only seen twice since 1980.
- While these 3 million people entered the labor market, the economy created 2.4 million new jobs, up 1.7% YoY.

As a whole there were more positives than negatives in the September jobs report, and this likely keeps the Fed in play for a rate hike in December with market-based odds having nudged up to 64% from about 50% only two weeks ago. Look, none of us have any control over what the Fed does, but hiking rates into decelerating economic growth surely wasn't part of the strategy when the Fed kicked off this grand monetary policy experiment. My view remains that the case for a Fed hike is spurious at best and as such, given the extent to which central banks around the world have injected themselves into the mechanics of capital market prices, any monetary policy misstep has to be identified as one of the biggest risks for investors.

One of the biggest stories in markets last week was the steep slide in the British Pound which has broken down to new historic lows. At one point in over-night trading it was down almost -9% (not what you would expect from one of the oldest currencies on the planet and one that has been long viewed for its stability on the global stage) when it touched $1.18, which was the lowest in more than three decades. For sure this has a lot to do with the Brexit vote and Theresa May's comments that the U.K. would invoke Article 50 by March of next year, and in response other prominent leaders in the EU (France's PM Hollande was one of the most vocal last week) have come out with the view of making an example out of U.K. so as to dissuade any other regions from wanting to leave the EU.

Italy, take note as you approach your referendum vote on December 4th – you are unlikely to garner the empathy that the 'buyer's remorse' U.K. voters got from not fully understanding the ramifications of a Brexit.

It does seem to be somewhat counterintuitive that the U.K. equity market is one of the strongest stock markets in the world despite the fact that the Brexit vote injected so much uncertainty in the capital markets during the summer. Although, everything is relative as the Pound is also one of the worst performing currencies this year and me thinks there is still a lot of deferred consequences that will ultimately play out with the long-run economic footprint when all is said and done.

Stocks for the most part were pretty tame last week – the S&P 500 had its first losing week in three, but we're talking about a decline of -8 points on the week. Gold got absolutely hammered and the best I can conjure as to a reason why is the rumors that the ECB may be considering tapering its QE policy, and/or the fact that jewelry demand in India slumped to a four year low. Either way I still retain the view that gold is as good a currency as any in a world that is overrun with money printing, and a potential hedge to the possibility of a policy error by global central banks.

The yield on the 10-year Treasury note (a proxy for U.S. interest rates) moved back up to the high end of its 1.5% - 1.75% range, where a break-out above this 1.75% level (the 200-day moving average) would be significant from a technical standpoint. Nevertheless, this is likely another temper-tantrum on a short-term basis and my guess is that it will end with the same fate as the two dozen other bond market sell-offs we've experienced in this cycle – "lower for longer". While the rise in U.S. yields is consistent with what we're seeing in Europe and the shift by the BoJ in Japan to fix its yield curve at 0% at the 10-year part of the curve, at the end of the day it's fundamentals that drive yields and on this front it makes sense to fade this move higher.

I must say that I never thought I'd see the day when Italy – one of the most indebted countries in the world – would come to market with a 50-year bond issue and investors would be climbing over each other to buy the juicy 2.8% yield. I guess 2.8% in Italy relative to 50-year yields of 1.36% in France and 2.55% in Spain looks good, but we're still talking about a BBB credit rating with a negative outlook, and a troubled banking system – even if it is backed by the ECB.

I have to say that I continue to scratch my head when I see or read prognostications about the U.S. economy being in fine shape. Yes, it looks as though the early read on the September data shows a pick-up in activity from August, but do know that we're talking about an economy (based upon the data releases in the month of August) that was barely showing a pulse. Sure, we got a sizable bounce in some of the ISM diffusion indices, but keep in mind these are surveys that are driven as much by emotion and recency bias as they are by actual activity. Furthermore, as much as the ISM surveys surprised to the upside last week, it was quite a different picture than was painted by the competing Markit PMI surveys: Both the manufacturing and non-manufacturing surveys from Markit showed month-over-month improvement, but the gains were much more muted than what we saw out of the ISM.

The following is a timeline of comments from the Markit PMI survey since April, which seem to be pretty consistent with the on-going deceleration we are seeing in the labor market. Decide for yourself if this is at all consistent with the six-standard-deviation upside move we saw in the ISM non-manufacturing survey last week that got many economists all excited:

- April: "The rate of employment growth was the weakest seen since December 2015."
- May: "Weaker employment growth has now been recorded in three of the past four months, with the latest expansion in payroll numbers the slowest since January 2015."
- June: "The rate of jobs growth eased to its weakest for 17 months"
- July: "The rate of job creation picked up to its fastest for three months, but remained slightly less marked than the average since the current period of expansion began in March 2010."
- August: "The latest rise in payroll numbers was the weakest since the end of 2014."
- September: "Data signaled only a marginal increase in service sector payroll numbers, with the pace of job creation the weakest since March 2013."

One last thing I'll highlight in regards to the monthly jobs report and how worthless the absolute value of the headline print is as a signal for anything relating to what lies ahead for the economy: it is one of the most lagging of lagging economic indicators. How helpful was the +189k jobs created in March 2007 at informing investors that they were on the doorstep of the most severe economic recession since the Great

Depression? What about the +226k monthly jobs print in November 2000 – that likely didn't leave investors with the impression that a recession was only a mere five months away. In March 1990 job growth came in at +214k (the recession started in July), or how about June 1981 where the economy added +197k jobs with the recession beginning the very next month?

So go ahead and paint whatever narrative you want with the September jobs report, but the big picture take away should be that this print, like every other print since Q1 2015, is a confirmation that employment growth is slowing and looking ahead it appears as though the pace of slowing is going to pick up some steam into year end.

For anyone looking to get a handle on what is really going on with the economy they need look no further than Gross Domestic Income. After all, this is one of broadest and most encompassing metrics any of us has at our disposal as it tracks economic activity totaling more than $17 trillion in real terms. And what is the trend in growth for GDI you might ask? Well, it has slowed from +2.5% in Q3 last year, to +1.5% in Q4, to +0.8% in Q1 of this year and then declined -0.8% in the second quarter.

Looking at this data series on a year-over-year basis through the second quarter and you will see that growth has trended down from +3.6% in mid-2014, to +2.6% as of Q2 2015, and as of the end of Q2 2016 is running at +1.1%.

Maybe it's different this time and one would like to hope so, but there has never been an occasion in the past where the year-over-year trend in real GDI moderated to +1% in the mature stage of an expansion and merely stopped there. This deceleration in growth nor the rising probability of what happens next (a recession) shouldn't come as a shock to anyone given what we've seen out of other data sets over the last two years, where income growth, corporate profits, profit margins, employment growth, and consumption growth have all passed peak levels for this cycle and are currently in decline.

Why else do you think that the IMF came out last week and slashed its 2016 real GDP growth forecast for the U.S. to 1.6% from 2.2%, which follows in the footsteps of the OECD already having lowered its 2016 growth estimate to 1.4% from 1.8%? I recall only four months ago when all the talk was about the slowdown in Q1 and Q2 being an aberration and that the second half of the year we would see both a pick-up in growth and corporate earnings. Those forecasts look to be fleeting with the Atlanta Fed's GDPNow model forecasting Q3 growth to come in at 2.1% from a forecast as high as 3.9% in late-July/early-August. Its compadre model up at the New York Fed is forecasting GDP to come in at 2.2% in Q3 and 1.3% in Q4.

It goes without saying that the only time a 2-handle on GDP growth is celebrated is when it is preceded by three successive quarters of 1% growth – just for perspective.

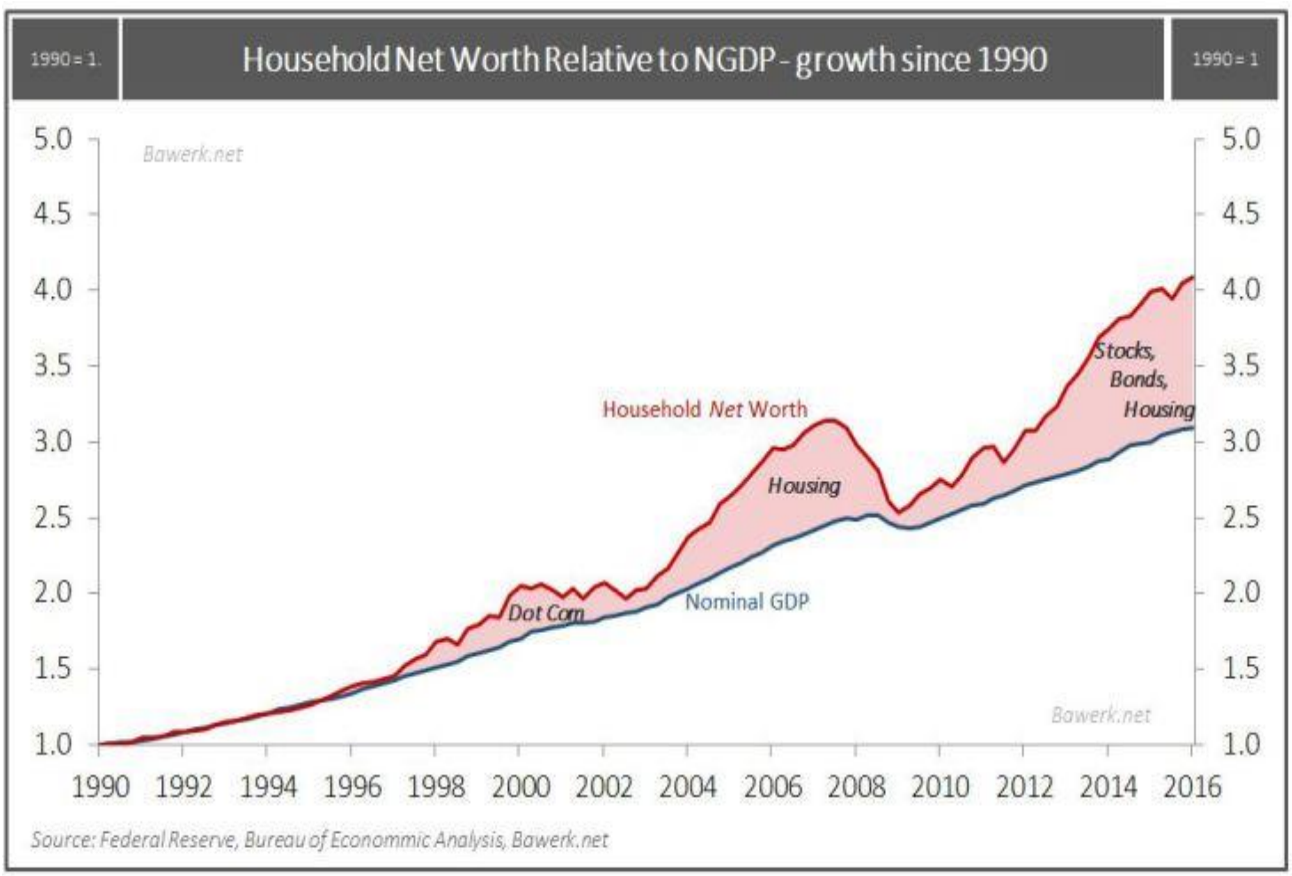
The trend in Q3 earnings estimates have been no different with consensus estimates at the beginning of the year expecting +8.3% year-over-year earnings growth and that has since come full circle to expectations for a decline of -2.1%. Now, companies have been beating analyst estimates by about +3.0% this cycle and if this trend were to hold up then Q3 could represent the first quarter of earnings growth since Q1 2015. If the recent pre-announcement warnings out of the likes of some pretty successful operators in the industrial space, such as Honeywell (HON), PPG Industries (PPG), and Dover Corp (DOV), are any indication then this earnings season might buck that trend.

What is most confusing about this weakening trend in the data for investors is the fact that asset prices have barely flinched – call it blind ignorance, obliviousness to the reality, or unfettered confidence in central banks, but Treasury yields seem to be the only asset pricing in any semblance of recessionary concerns. However, even the market signal from a 10-year Treasury bond yielding 1.75% (a mere 40bps north of its all-time low) is murky given that it likely is being suppressed by the low yield environment around the world.

Another variable keeping a lid on interest rates and global growth is the astronomical $152 trillion mountain of debt that the IMF reported is outstanding around the world. With this much debt outstanding just think of what a modest increase in yields would do the cost of servicing this debt load, thereby cutting into what feeble economic growth we already have on our hands.

Look, I take no pleasure in being a 'bearer of bad news' or a 'Debbie Downer', but I have to call it like I see it. As such, with the U.S. economy in what I consider to be in an obvious slowdown and for the most part hitting a wall in August, where every indicator either woefully disappointed expectations or moved into outright contraction, I think this uptick in the September data should be viewed with a degree of skepticism. Throughout the last two years each sign of softening and weakness in the data has been met with renewed bouts of dovishness on the part of the Fed. However, here we stand with a Fed that is itching to hike rates, after having pivoted from guiding expectations of four rate hikes this year and now we're down to less than 2/3rds odds that they even get one in before the year is up.

To me this looks like a lot of the Feds' accommodative maneuvering is used up, and if the September data proves to be yet another in a long list of false dawns then I think the risk to investors is asymmetric to the downside. It is difficult to look at any market today and argue that it is priced for even a modest degree of downside risk – stocks as represented by the S&P 500 are trading at valuation multiples that are 30-40% north of historical averages, high yield spreads are hovering near a very tight 480 basis points (relative to an average of 6.15%), housing values as gauged by the recent Case-Shiller home price index is inside of 1% of their all-time highs, and this has driven household net worth relative to nominal GDP beyond levels that are sustainable.



One of the most challenging parts of forecasting is getting the timing right – just as the most difficult part of a market cycle to trade is the last third of it, but what I do know is that there is no perfect indicator for forecasting a recession, and when the majority of indicators that have had the best track record at predicting recessions are all suggesting that the probability is rising of one occurring in the next 12-18 months, then I think it's prudent to take some defensive actions.

After all, it's been some time since the broad stock market made a new high, and quite frankly, it's a meager +3.5% higher than it was in December 2014 (that's nearly two years ago). So, Mr. Market appears to be sniffing out something.

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