August 8th, 2016

Nobody ever said it had to make sense…

The U.S. labor market in July capped off the best two-month stretch of hiring so far this year with employers adding 255k jobs, well above consensus expectations of 180k coming into the report. In addition to the better than expected July tally both May and June saw positive upward revisions (May taken up to 24k from 11k and June increasing to 292k from 287k) which brings the 2016 tally for monthly average job gains to 186k – a modest slowing from the 229k monthly average pace in 2015.

Across the board this was very strong jobs report:

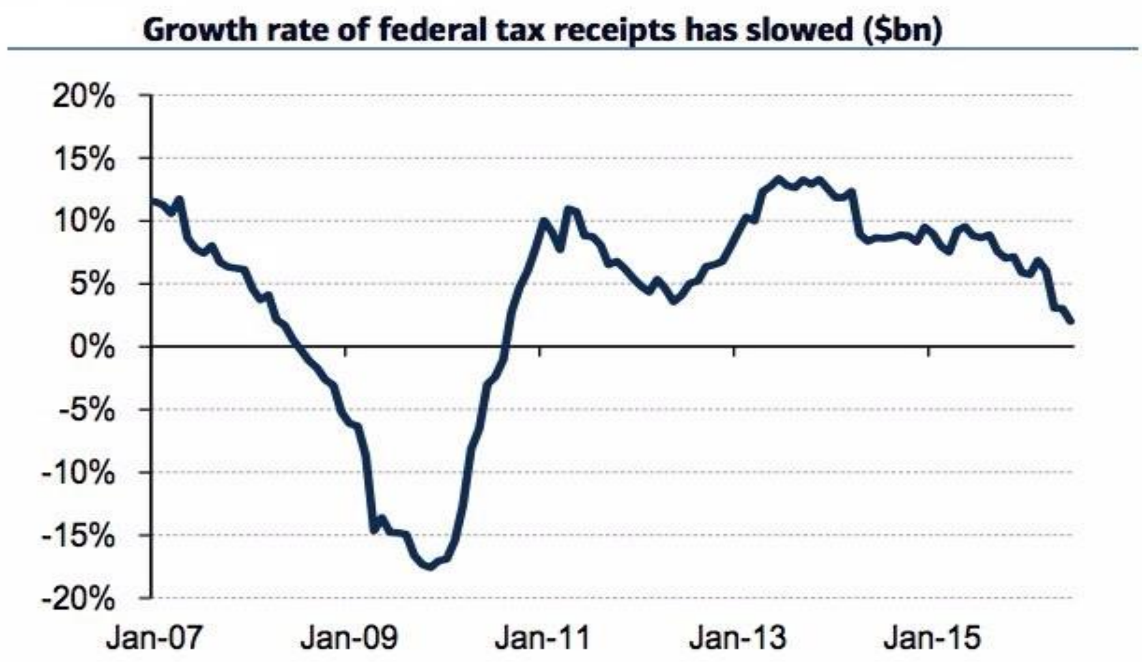
- The unemployment rate held steady at 4.9%, but for good reason as a 420k increase in household jobs was offset by a notable gain of 407k in the labor force. The labor-force participation rate (LFPR) has resumed an upward trend as it rose to 62.8% in July from 62.7% in June.
- Average hourly earnings increased 0.3% month-over-month which kept the year-over-year rate in wage growth at 2.6%.
- The workweek expanded from 34.4 hours to 34.5 – the highest level of 2016.
- The breadth in the job gains was widespread as confirmed by the diffusion index increasing from 61.8 in June to 63.7 in July (the highest level in this metric since Nov. 2014).

More jobs, longer hours, and higher wages – hard to ask for a better report card than that.

As good as the last two payroll reports have been they are far from enough to squash what remains a continued slow motion deceleration in the labor market. Keep in mind that employment is perhaps the mother of all lagging economic indicators and is typically one of the last major economic data points to buckle at the end of a business cycle expansion. What I'm referring to here is that even after the solid 255k jobs created in July and the 292k jobs created in June, the year-over-year growth rate of monthly job creation declined to 1.72% from 1.74% in June. Outside of the 1.7% level hit in May, July is the lowest year-over-year payroll growth rate since this metric peaked in February of 2015.

Many astute investors know the shortcomings of hitching their wagon or anchoring to one data point, which is why these investors are constantly surveying the horizon for additional data points to confirm or dispel their thinking. At the moment, with back-to-back months of strong payrolls all I hear emanating from the talking heads on bubble vision and the printed media periodicals is how much of an outlier the 144k April and 24k May jobs reports look like and how unrepresentative those data points are of the underlying strength in the labor market. You know what, on this point and in isolation when only looking at the BLS data, I'll humbly concede this narrative.

However, in addition to the decelerating long-term trend in the employment data what is causing me to pause and exercise some caution before blindly accepting the budding narrative that this employment cycle is on the cusp of reaccelerating is what we're seeing in the tax withholding data. Looking at the individual tax/withholding receipts data from the U.S. Treasury for the month of July showed that "withheld" receipts (tax and withholding payments that come straight from wage earner pay stubs) are down 1.0% year-over-year. A similar, yet more severe, erosion is underway for non-withheld tax receipts (this category includes independent contractors not subject to mandatory withholding) which are down 15% from July of last year and 6.5% from the start of the year. Below is a chart from BofA Merrill Lynch showing the trend in federal tax receipts over the duration of this expansion with the most recent reading at the lowest level since the U.S. economy exited the 'Great Recession' back in 2010.



Note: 12 month rolling change in federal tax receipts
Source: BofA Merrill Lynch Global Research, Bloomberg

The same story is playing out in the corporate world with corporate tax receipts down 11% since the start of the year, and if the current pace holds up throughout 2016 it will be the first negative comp since 2011.

When evaluating results like this in the same month of what is wildly professed to be a blowout jobs report, can you blame those out there scratching their heads? After all, if the cupboard is beginning to look a little barren in the tax man's kitchen, is it so much of a stretch to think that this is the case with the economy? What seems to be most plausible at the current time is that the U.S. economy remains mired in a sluggish, slow growth environment where GDP growth over the last three quarters has averaged roughly 1%. This is on the low side of what has been the most sanguine post-recessionary recovery in the WWII era, but it's also not falling off a cliff as many were penciling in during the first six weeks of the year.

At the moment the economists' community is putting pen to paper and publishing their estimates for a snap-back in Q3 with the Atlanta Fed's initial forecast for GDP to expand by 3.8% over the next three months. As with anything, you gotta start somewhere, but keep in mind only about 15% of the data that goes into this estimate has been reported thus far – so we have a long way to go before we can start considering this much of a pop to be a reality. Moreover, the Atlanta Fed – while having a well-earned following given its GDP forecasting accuracy – does have a roughly 250 basis point intra-quarter change in its estimate, so there's that to consider.

Which brings me to Q2 earnings season, which for the most part is running pretty consistent with what we've seen over the last several quarters: earnings continue to decline (but are better than beaten down estimates) and top line revenue is roughly flat.

Almost 85% of S&P 500 companies have reported results through the end of last week with earnings tracking a -4.3% year-over-year decline and sales growth registering a more moderate decline at -0.6%. The -4.3% earnings decline is better than the expected -5.5% decline penciled in by consensus when the quarter ended on June 30th. As you can see from the below table the breadth of the earnings contraction is broad with only three sectors reporting growth (Consumer Discretionary, Healthcare, and Telecom) and seven sectors seeing profits fall (no surprise being led by the Energy sector**).**

Q2 2016 QTD

SECTOR	SALES GROWTH (% CHG)	EARNINGS GROWTH (% CHG)	#REPORTED
S&P 500 (Aggregate)	-0.6%	-4.3%	433 / 500
Energy	-24.2%	-81.6%	37 / 37
Materials	-7.4%	-8.8%	26 / 27
Industrials	-1.0%	-2.1%	65 / 68
Consumer Discretionary	8.0%	12.8%	54 / 83
Consumer Staples	0.8%	-0.4%	27 / 36
Healthcare	9.8%	6.2%	49 / 57
Financials	0.0%	-5.2%	91 / 92
Information Technology	-0.1%	-2.3%	54 / 67
Telecom	9.6%	3.5%	5 / 5

For the first quarter of 2016, the actual year-over-year earnings decline reported by the S&P 500 was -6.7%. So, Q2 is a sequential improvement (as in, less negative) but is still a contraction for what now amounts to five quarters in a row. Many investors have taken solace in the view that Q1 appears to be the trough in the earnings recession and that a steady improvement towards earnings growth started in Q2. However, it looks as though those expectations for positive earnings growth may have to be put back on the shelf with Q3 estimates now falling back into the red to the tune of -1.7%. For the fourth quarter of 2016, the estimated earnings growth rate is 5.7%.

If the forecasts for Q3 and Q4 turn out to be accurate then calendar year 2016 would end up being the second consecutive year-over-year earnings decline and the first time this this has occurred since CY 2008 (-25.4%) and 2009 (-8.0%). While on the surface that sounds pretty horrible, the level of earnings decline in 2015 and what is expected for 2016 doesn't come close to the colossal plunge experienced in the last recession. So don't be too quick to jump out of this airplane (with or without a parachute) as we're nowhere close to what was taking shape in that environment.

Where this lack of economic and earnings growth does become problematic is valuation levels, which for U.S. markets have expanded from a trailing P/E of 17x to 23x since 2011. This bull market in U.S. equities that just won't stop has pushed valuation levels relative to the 'Rest of the World' (RoW) to some historically extreme territory. On a Cyclically Adjusted Price-to-Earnings (CAPE –which uses a 10-year average, not current EPS) basis the U.S. stock market trades at 26x compared to 16x for RoW – this is a 58% premium in U.S. equities and well above the 34% premium reached at the peak of the late 90's bull market. I'm not just cherry picking the CAPE valuation metric, as it's a similar story on many other valuation calculations – P/B, P/E, EV/EBITDA… But the divergence in performance for U.S. stocks relative to international equity markets has grown into quite a disparity when you consider that the S&P 500 is now 38% above its 2007 peak. This compares to the FTSE 100 being roughly flat over the last 16 years, the Nikkei 225 remains 59% below its 1989 peak, the EuroStoxx 50 Index is 32% below its 2007 highs, and Emerging Markets are still down 35% form their previous highs.

Why this is happening – well your guess is as good as mine, and that's not to say one cannot understand and comprehend the growing consensus narrative that is percolating out there: central banks remain highly accommodative keeping interest rates nailed to the floor and increasing liquidity to the capital markets at the first sign of trouble. What's more is that central banks have now moved into a position where they are becoming a dominate buyer in both stock and bond markets. For example, Merrill Lynch's Global Research team issued a report last week suggesting that since the ECB started buying corporate debt and with last week's announcement by the BoE to start buying corporate debt that nearly 45% of the global fixed income market is now comprised by central bank buying.

Not to be one upped by the ECB and the BOE, we learned last week that the Swiss National Bank has been one of the largest purchasers of U.S. equities so far in 2016. In its 13-F filing they disclosed that they added $7.3billion to its U.S. equity portfolio in the second quarter and has increased its total U.S. equity holdings by 50% (from $41.3 billion on December 2015 to $61.8 billion as of June 30th) in the first half of 2016.

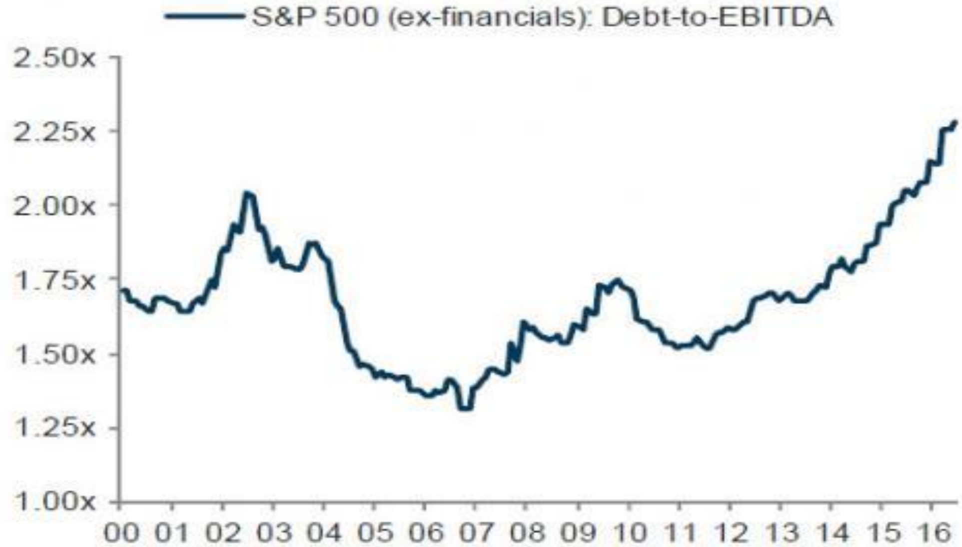
All of this unprecedented and experimental central bank policy action is both fascinating and frustrating. Frustrating in the manner that it is causing asset prices to become further removed from long-standing fundamental relationships. For example, financial theory posits that increased debt and leverage on a corporation's balance sheet can increase the company's economic value. However, when this increased debt level exceeds a level that optimizes a company's capital structure it becomes counterproductive as it raises the cost of capital demanded by investors due to the increased risk profile that coincides with the higher debt burden.

So let me parlay history, academic theory, and present day capital markets into making a cogent point about the growing divide between fundamentals and market prices. A prominent feature of extended bull markets is higher levels of leverage, as measured by the ratio of debt to equity. The history books show that it has become a common occurrence in every late-cycle bull market since 1980 to see a rise in the debt-to-equity ratio for corporations. Advances in debt and more efficient use of capital structures are obvious ways for companies to offset the economic malaise that sets in toward the end of business cycles and continue to drive stock prices higher. It is when companies stop borrowing because they become more cautious on their capital structures or credit markets tighten that bull markets fail to get extended.

Total debt for non-financial companies in the S&P 500 has increased by more than $1tn since the beginning of 2010. This has fueled the surge in payouts... Companies in the S&P 500 have a cash flow deficit of approximately $150bn per year that must be funded in the investment grade credit market to maintain the current level of share repurchases. While this may be a sustainable amount given the easy conditions and low rates in high grade credit, the days of accelerating growth in borrowings are likely in the past, in my opinion. This is because some important measures of debt sustainability, such as the ratio of debt-to-EBITDA are already elevated, as can be seen in the below chart. The median debt-to-EBITDA ratio of the non-financial companies in the S&P 500 has reached 2.3x, a measure unmatched since 2000, which is the earliest year that we have reliable data.

FIGURE 9

Debt-to-EBITDA ratios are at the highest point of this century...



Source: Haver Analytics, Thomson Reuters, Barclays Research

Given this growing debt burden it is of little surprise to see that business bankruptcies increased by 9% from Q1 to Q2, are up 23% in the first six months of the year and 25% higher than this time last year. For sure, the majority of these bankruptcies are in the energy and materials space as result of the multi-year decline in commodities markets, but defaults have started to broaden out into other sectors.

Just so we have this straight: global debt levels at all-time highs, U.S. corporate debt levels at all-time highs, global interest rates at or near all-time lows, U.S. stock market at all-time highs, U.S. equity market valuations at their second richest level in history, economic growth is stagnant, corporate earnings are contracting, profit margins are falling, potentially polarizing elections ahead (U.S., Germany, France)… what could go wrong?

That is what has made this year so fascinating to observe – investors could have been spot on when forecasting the economy yet way off when incorporating that view into their investment positioning. Think about it for a moment – how many market prognosticators had it in their forecast that GDP growth would be 1% over the first six months of the year, corporate profits would decline in Q1 and Q2 (making it four quarters in row following declines in Q3 and Q4 last year), interest rates around the globe would succumb to all-time lows, the U.K. would vote to leave the E.U., the Fed would shift from guiding to four hikes in 2016 to maybe just one now, and the ECB, BOJ, and BOE would all up their QE policies? Let me help you with this – no one had this forecast.

And if they did, there is little to no chance they would have expected both risk assets and safe haven assets to rally like they have so far this year:

- S&P 500 +6%
- MSCI All-cap World Index +4.7%
- Emerging Markets +12%

- Long-term Treasuries +22%
- Investment Grade Corporates +6.5%
- Junk Bonds +6.5%
- Emerging Market debt +9.5%
- Gold +25%

Go figure – nobody ever said investing had to make sense.

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