September 6th, 2016

Back to bad news being good for asset prices…
There is no other way to describe the ever growing schism between the real economy and financial asset prices, other than to acknowledge that the infallible belief on the part of investors in central banks (and their well of ever flowing monetary policy support never running dry…) far outweighs any indications of weakness in U.S. economic data. Yes, 'bad news is good news' for stocks once again, even in the face of comments from several FOMC officials at the recent Jackson Hole symposium that "the case for an increase in the Federal Funds rate has strengthened in recent months". This dichotomy was on full display last week with stocks registering moderate gains despite the weakest slate of economic data reports since the start of the year (remember January and February when stocks got off to their worst start to a calendar year in history).

This global central bank incursion into asset prices is reaching such a fever pitch that the European Central Bank is running out of qualifying bonds to purchase after adding corporate bonds to its QE policy back in March. Have a look at the front page of today's Wall Street Journal, where they're running with an article that suggests the next leg of the ECB's policy could include the purchase of equities (*Stock Buyers Hope ECB Will Jump In*), and why not – the Swiss National Bank and the Bank of Japan are already deep down this rabbit hole. Perhaps the catch is that neither of these central banks can claim these policies have been successful at meeting their intended objectives. What they have done is met their unspoken objective of propping up asset prices.

As for the Bank of Japan, expectations for their next move are all over the map when the BoJ meets at the end of the month, with many investors hoping that they don't disappoint. Call me a cynic, but only in Japan can the unemployment rate fall to 3.0% (the lowest level in more than two decades) while deflationary forces persist and their response is to continue to implement more of the policies that haven't worked. The issues plaguing Japan's economy aren't a mystery – excess debt, excess employment, and excess investment – and these issues are compounded by a poor demographic profile. What's troubling is that these very same issues are plaguing other developed economies, namely the U.S. and the EU, and the accepted prescription to counteract this illness is cheap money, which history has shown to be an ineffective remedy.

What is sustainable about keeping the price of money at zero percent? I guess they have to wait until every borrower that took out a loan at 1% rolls that debt into 0% financing – and then what?

I digress, back to the subject at hand and that's the recent spate of economic data which was headlined by Friday's disappointing employment report. The U.S. economy added +151k jobs in August (mildly below estimates for +180k) while the unemployment rate remained at 4.9%. The big question on all investor's minds is how this print shapes the Fed's view for their upcoming policy meeting. The +151k jobs created in August is well above the "breakeven pace" of between +80k and +100k cited by the Fed as necessary to soak up new entrants into the labor force, but is a step down from the three month average of +232k, six month average of +175k, and the year-to-date average of +182k jobs per month.

As much as the July payroll report was unambiguously strong, the August report was almost the complete opposite:

- The Household survey showed a weak +97k gain and the payroll-concept adjusted number (which places both surveys on the same footing) was down -128k.

- The work week declined to 34.3 hours from 34.4 during the previous 6 months – this 0.3% drop is equivalent to some 300k layoffs and could be a signal that corporations are trying to prune costs without immediately letting people go. The decline in the work week has been very broad across all industries.

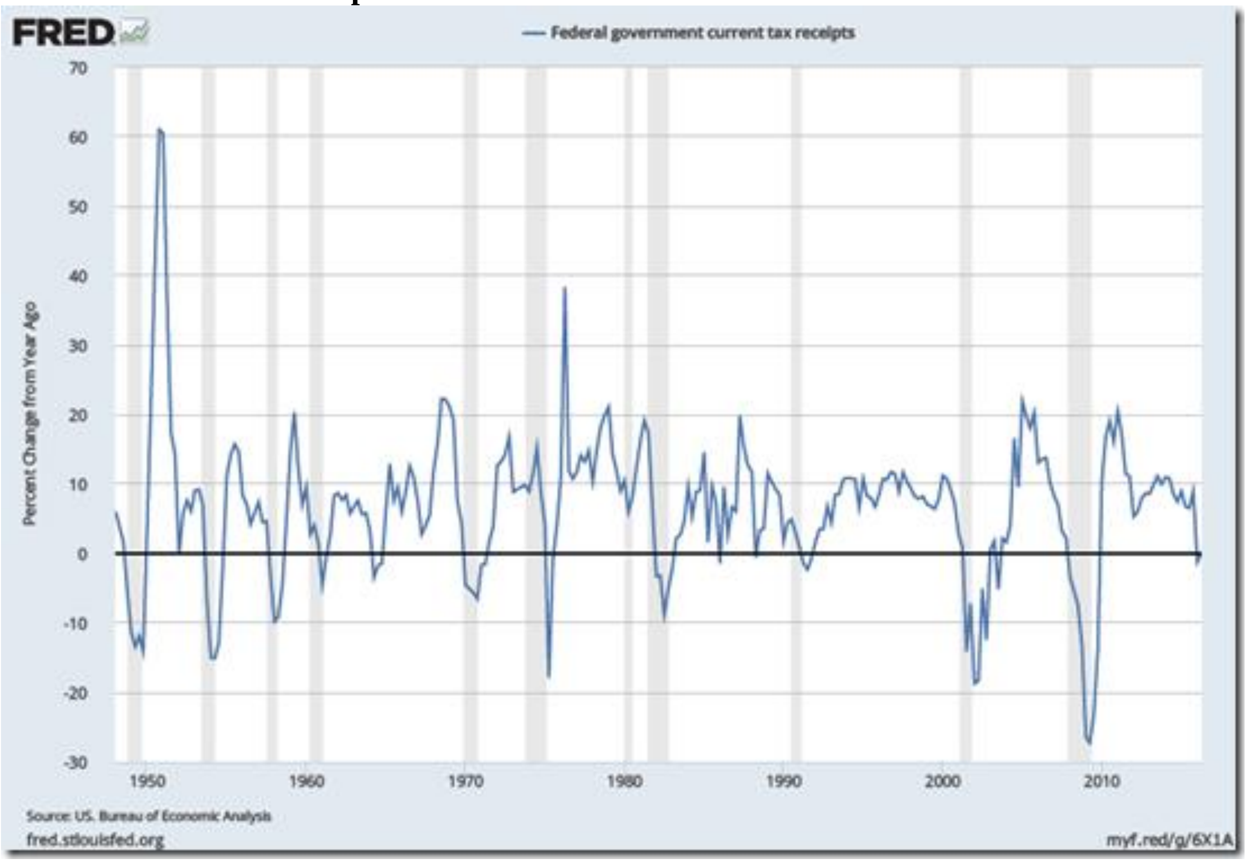
- Aggregate hours worked in the private sector are up 1.0% YoY and are in a sharp deceleration over the past 18 months. Before companies start hiring again, they are likely to simply lengthen the work week. Overtime hours peaked at the end of 2014 at 4.5 hours and have been stable between 4.2 and 4.3 since.

- Average hourly earnings rose only 0.1% for the second time in 3 months and are +2.4% YoY, down from +2.7% in July. Note here that "food service and drinking places" racked up the largest number of new jobs in August at +34k (23% of the total). These are the lowest paying jobs in the economy. So, aggregate weekly earnings, otherwise known as the weekly paycheck, are growing +1.5% YoY, down from +2.2% in February. From the Fed's vantage point there is nary a sign of wage pressure in this report and from a policy risk/reward viewpoint it's reasonable to think it might be challenging for Americans to sustain their +3.6% growth in nominal consumption of the past 6 months when their weekly income is rising at only 40% that rate.

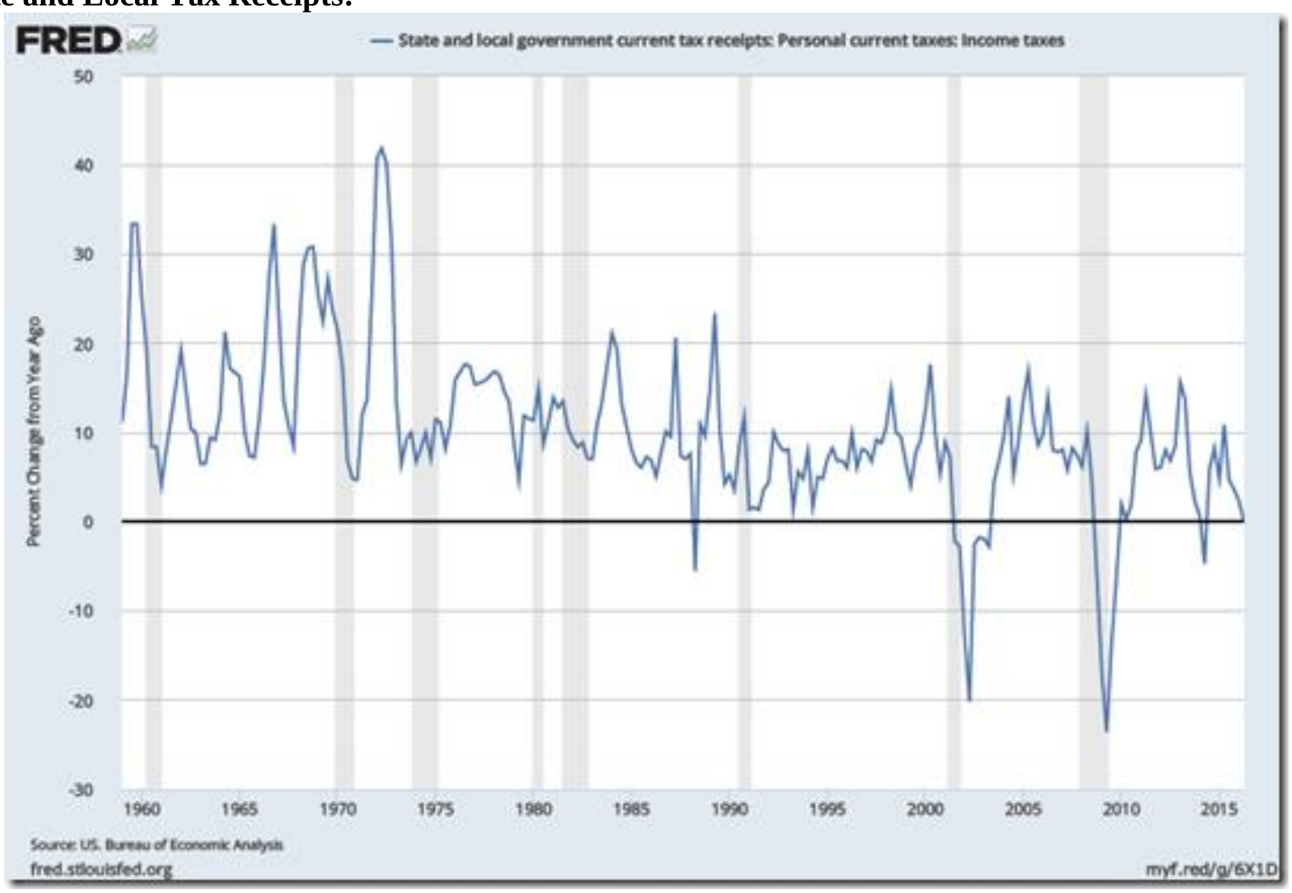
While the headline number of +151k in new jobs is in the wheel house of a level the Fed wanted, the guts of the report were soft across the board and probably gives them enough wiggle room to take a pass at hiking rates during their meeting from September 20th – 21st.

Before moving on from the labor market, I always like to look at other evidence within the mosaic of information used to measure the economy, and when cross checking the employment data I look to what is happening with Federal, State, and Local tax withholdings. The following charts don't paint an overly rosy picture when the year over year change in tax receipts is negative.

Federal Government Tax Receipts:



State and Local Tax Receipts:



As for the rest of the economic data reported last week it was a mixed bag and on the margin indicative of a modest downshift in the economy. On the positive side was the trade deficit narrowing with imports declining -0.8% while exports rose +1.9% (largely due to record shipments of foods, feeds, and beverages) which will give a lift to Q3 GDP estimates. In addition to the trade data the Consumer Confidence Index increased to 101.1 in August from 96.7 in July and was well above consensus expectations of 97.

The big disappointments last week were auto sales and the ISM manufacturing index. Auto sales in August declined by -3.4% year-over-year to 16.9mm units on a seasonally adjusted annualized rate (below estimates for 17.2mm). This print lends some credence to those predicting that auto sales peaked for this cycle in the second half of last year. Furthermore, this weak print is sure to weigh on the retail sales report for August which comes out later this month. One thing is for sure, and that is if this economy loses the consumer (which is the only thing keeping it going at this time) then all bets are off for this goldilocks environment investors find themselves in at the moment as recession probabilities will spike in the blink of an eye.

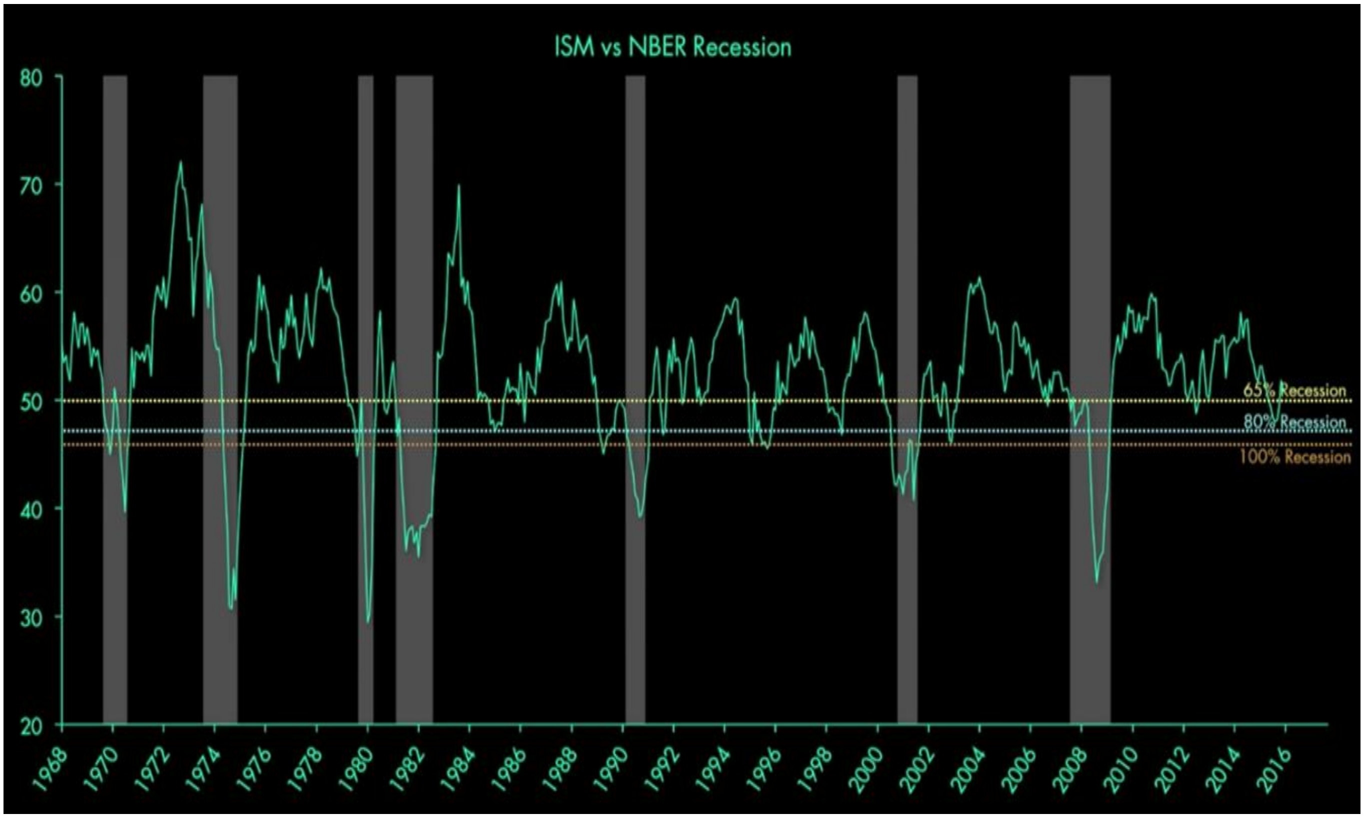
As for the ISM manufacturing index, it slipped back into contractionary territory at 49.4 in August from 52.6 in July and came in significantly below expectations of 52.0. The internals of the report were as bad as the headline suggests, with declines across every segment with the exception of new export orders which remained flat comparted to last month. I'll let the below table speak for itself in summarizing the deterioration in this data series from July to August while offering a couple points for context.

MANUFACTURING AT A GLANCE
August 2016

Index	Series Index Aug	Series Index Jul	Percentage Point Change	Direction	Rate of Change	Trend* (Months)
PMI®	49.4	52.6	-3.2	Contracting	From Growing	1
New Orders	49.1	56.9	-7.8	Contracting	From Growing	1
Production	49.6	55.4	-5.8	Contracting	From Growing	1
Employment	48.3	49.4	-1.1	Contracting	Faster	2
Supplier Deliveries	50.9	51.8	-0.9	Slowing	Slower	4
Inventories	49.0	49.5	-0.5	Contracting	Faster	14
Customers' Inventories	49.5	51.0	-1.5	Too Low	From Too High	1
Prices	53.0	55.0	-2.0	Increasing	Slower	6
Backlog of Orders	45.5	48.0	-2.5	Contracting	Faster	2
New Export Orders	52.5	52.5	0.0	Growing	Same	6
Imports	47.0	52.0	-5.0	Contracting	From Growing	1
OVERALL ECONOMY				Growing	Slower	87
Manufacturing Sector				Contracting	From Growing	1

Manufacturing ISM® *Report On Business*® data is seasonally adjusted for New Orders, Production Employment and Supplier Deliveries indexes.

Many analysts are quick to dismiss the manufacturing side of the economy, arguing that it represents less than 13% of total GDP which pales in comparison to the services side of the economy. That conclusion while factually accurate misses the more important point – and that is the tight correlation and cyclical ties the manufacturing sector has to the overall economy. In a nutshell the manufacturing sector has a more accurate track record at predicting turning points in the business cycle than its non-manufacturing counterpart. On this front, according to the history of the ISM-manufacturing data and a little modeling there is a 65% probability of a recession occurring when the ISM index falls below 50, with the probability increasing to 80% when it falls below 47, and a 100% probability when it falls below 46. So, this break below 50 is something worth monitoring going forward – at this point it's just a one-off, but it's definitely a trend worth monitoring in the months ahead.



So what have we learned from the latest data deluge on the health of the U.S. economy? Not much is new. The U.S. economy is stuck in neutral with growing indications that forward momentum off the spring/summer bounce is fleeting in a material way – an obvious confirmation of this is last week's productivity data showing real nonfarm business output growth stagnating at its long-standing 1% pace with pricing power hovering at the same 1% level (despite moderately accelerating unit labor costs) which is sure to eat further into an already challenging margin story.

This morning we learned that the service side of the economy weakened considerably with ISM non-Manufacturing plunging from 55.5 in July to 51.4 in August. This was the lowest print on this metric since February of 2010 which, like its manufacturing brethren, the weakness was across the board. It's an interesting world when you can observe the services PMI in the Eurozone coming in at 51.0 and at 51.4 in the U.S. with the former implementing QE (buying $80 billion in assets per month) and the latter looking to raise rates. Makes sense, right?

All that said, leading economic indicators are not yet flagging an outright recession signal, but nor can anyone confidently make the case that a meaningful surge to jumpstart floundering domestic demand growth is around the corner. Yes, I too see the Q3 GDP forecasts being increased to +3.0%, but does it really make sense to celebrate this forecast (keep in mind this is only a forward looking estimate at this time) after three straight quarters of 1% growth? Seems a bit ridiculous if you ask me.

Which brings me to the Fed and this game of cat and mouse they continue to play with capital markets. Since the Fed first hiked rates back in December of last year, they have been pivoting from guiding markets to expect a rate hike to then backing off at the last minute with any number of excuses. Here we are once again with the Fed talking tough about a potential rate hike at their September meeting – although the markets are calling their bluff with the Fed Funds Futures market pricing in only a 24% chance that they hike this month. I could highlight a long list of data points that don't support the FOMC's Pollyanna economic view (inflation running below target and the labor market not nearly as strong as it looks on the surface), but I want to focus on another quite telling data series – GDP and GDI.

Most investors are familiar with Gross Domestic Product (GDP) which measures the economy by what is produced. Gross Domestic Income (GDI) is closely linked, but it measures the economy by the income generated from that production. In practice GDP and GDI differ because they are constructed using different sources of information which causes their respective results to differ from time to time (sampling errors, coverage differences, and timing differences with respect to when expenditures and incomes are reported), but over time they converge to provide a similar overall picture of economic activity. Interestingly everyone tends to focus on the products side of the national accounts data, but ultimately the best measure of living standards is income.

With that being said, I think it is important for all to be aware of the environment the Federal Reserve is considering hiking rates into – you know, the one that has "strengthened in recent months" to justify a hike. On this score I have to say things look anything but strong.

Looking at the data on a nominal basis, GDP of +3.4% at an annual rate in Q2 is the sort of thing that has occurred only 13% of the time when the economy was in expansion mode (call it a 1 in 8 odds of this ever happening). Moreover, nominal GDP growth in the past three quarters is the weakest trend rate on record outside of an actual recession.

As for Gross Domestic Income (GDI) which totals $18.7 trillion, it advanced at a mere 0.2% annual rate in Q2. This was the third weakest quarter since the recession ended in mid-2009. Just check out the table below that traces the sequential growth rate in real GDI and real GDP over the last six quarters and you tell me if this looks like an economy that is strengthening?

GDI		GDP	
2015Q1	1.60%	**2015Q1**	2.00%
2015Q2	0.60%	**2015Q2**	2.60%
2015Q3	2.50%	**2015Q3**	2.00%
2015Q4	1.50%	**2015Q4**	0.90%
2016Q1	0.80%	**2016Q1**	0.80%
2016Q2	0.20%	**2016Q2**	1.10%

On a year-over-year basis the trend in GDI has slowed from +4.0% in Q4 2014 to 1.5% in Q4 2015, to 1.2% in the second quarter of this year. Never before has the Fed raised rates with real GDI growth as weak as 1.25% on a four-quarter trailing basis.

Yup, doesn't make much sense, does it? Don't worry – you're not alone. This data is consistent with the five-quarters-and-counting profits recession and a yield curve (10s minus 2s) compressing to its flattest level (76 bps) since November 2007. All deference aside to the arguments about the U.S. reaching full employment (because the unemployment rate is at 4.9%), but the broadest measure of unemployment (U-6) is pegged at 9.7% and has been at that level for six consecutive months. Not to mention the employment-topopulation ratio hovering around 59.7% which is a level that in the past was consistent with an 8% unemployment rate. Then you look at capacity utilization rates sitting below 76% which is materially below the 80% threshold that in the past constituted some semblance of sustained pricing power and inflation.

So yeah, I'm not buying for one minute the interest rate normalization view that the Fed is trying to sell. Furthermore, if they were to hike in September (given the precedence set by the reaction to last December's hike), doesn't that present a material risk of derailing whatever expansion we do have at the moment?

This is what the markets have sniffed out and why in the face of some pretty feeble economic data both stocks and bonds have rallied. For sure this pavlovian investment strategy where investors buy everything at every indication that the central banks will never tighten policy again has worked quite well since the February lows. But I must say, with equity valuations on a median P/E basis having moved beyond the extremes of the 2000 tech bubble some caution, restraint, and prudence is more than warranted.

Anytime you're making references and comparisons to the most expansive valuation levels in the history of the U.S. stock market in order to justify prevailing valuations, you have to also recognize the risk that corresponds with this razor thin margin of safety. To this point none of these risks have seemed to matter, but don't misconstrue the absence of something as implying that it doesn't exist. It's the risks that you don't see that hurt you, and when it does happen it unfolds quickly.

One of the most underappreciated risks to capital markets today is the growing positive correlation between stocks and bonds. Over the last thirty days this correlation has increased on the view that bad economic data and low interest rates around the globe will keep U.S. yields low and hence allow bond prices to appreciate. Likewise, bad data continues to perpetuate the belief that the central bank punch bowl will never be pulled away – and maybe it won't, but this hope trade has now pushed valuation levels to extremes. This time is not different – I can't find a period in history where stock prices and earnings have been negatively correlated for this duration of time – we're now talking about six quarters of declining profits coinciding with rising equity prices.

This doesn't mean that an expensive stock and bond market can't get more expensive, but understand that this is now as much a psychological move as it is anything else.

"Nothing so undermines your financial judgement as the sight of your neighbor getting rich."
- J.P. Morgan.

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