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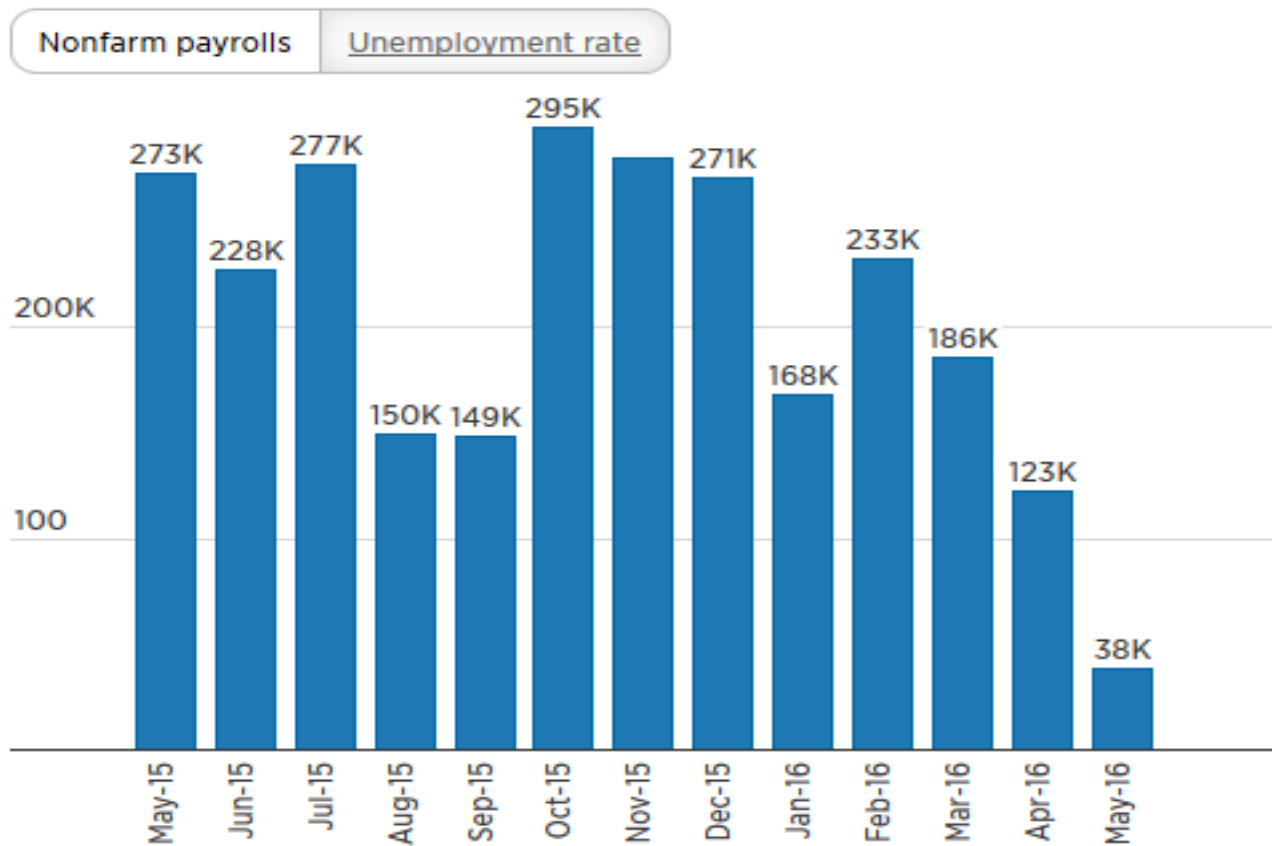
The Fed's got this?...

There is no way to sugarcoat it, the May BLS labor report was a giant stinker. The most constructive takeaway is that the U.S. economy had positive job growth, but for anyone measuring the rate of change in the data (i.e. growth rates) this report marked a significant blow to the theory that U.S. economic growth is on the precipice of reaccelerating.

Nonfarm payrolls rose a paltry +38k in May (well below the consensus estimate for +160k) in what is the weakest result since September

2010 – recall back then the Fed was moving aggressively to launch QE2, not raise the Fed Funds rate as is the case today. On top of the modest +38k in new jobs created in May we got -59k in downward revisions to the previous two months (something we have not seen since June of last year). A discernible pattern has emerged in the pace of job creation this year, and it ain't good: +233k in February, +186k in March, +123k in April, and +38k in May. This took the three month trend in job growth to +116k from +170k over the last six months and nearly +200k per month over the last twelve months (another obvious trend going in the wrong direction).

U.S. Nonfarm Payrolls



Source: U.S. Labor Department



The details of the report highlight a labor market where the weakness is broadening out rather dramatically with the diffusion index collapsing to 51.3% in May from 53.8% in April, 56.3% in March and a far cry from the cycle high of 71.2% reached back in November 2014. This is the lowest print in the diffusion index since February 2010 when,

back then, it was still unclear whether the U.S. economy was out of the ‘Great Recession’.

The unemployment rate did fall to 4.7% (its lowest level since November 2007) from 5.0% in each of the last two months, but this decline was for all the wrong reasons. Job growth in the Household survey came in at +26k and this followed a decline of -316k in April, while the labor force shrank -458k and this followed a decline of -362k in April. So we’ve seen over 800k people disengage from the labor force over the last two months, a clear signal of growing frustration among those seeking a job. This caused the labor force participation rate to tick down to a six month low of 62.6% from 62.8% in April as the broad U-6 unemployment rate stayed stuck at 9.7%.

All told there are currently 7.4 million people officially identified as unemployed, but if one were to include all the underemployed, the number would be much closer to 20 million. This is why wage growth remains stuck at +2.5% year-over-year (came in at +0.2% month-over-month in May) and firmly in the range it has trended in over the past several years.

This morning's release of the change in the labor market conditions index puts an exclamation point on the broad based weakening in the jobs market. Recall this is a collection of 19 metrics that track the health (or lack thereof) of the labor market and is a data series that Chair Yellen follows closely – it has now declined for seven straight months, been in negative territory for five consecutive months, and the rate of deterioration is picking up steam.

SHARP FALL: JANET YELLEN'S FAVORITE INDEX



THE LAST 5 MONTHS HAVE REGISTERED LOWEST READINGS SINCE JUNE, 2009.

The bottom line is that this job report is yet another confirmation of what will go down as the most muted economic expansion in the post WWII era – roughly 1 million full-time jobs have been added since 2007 while the population in the U.S. has risen by 23 million people. So job creation has recovered quite admirably from the crater formed at the bottom of the ‘Great Recession’, but net progress from before the occurrence of the

credit crisis is pathetic. The main stimulant to growth has been the proliferation of debt, seeing as U.S. government debt is up by \$10 trillion since 2007 and corporate debt has increased by \$3 trillion (that's a doubling), and this my friends is a situation that is not sustainable.

Along with the jobs report the data deluge left much to be desired. The ISM manufacturing index garners a lot of attention as it pertains to measuring and tracking the U.S. economy, not because manufacturing is a large part of the economy, but because of its cyclical characteristics and strong historical relationship with real GDP growth. So, the sequential improvement in the ISM manufacturing Index to 51.3 in May from 50.8 in April (surprising consensus estimates of 50.3) was a welcome relief in that the manufacturing sector continues on its

stabilization path. This result contrasted with the deterioration seen consistently across the earlier regional manufacturing surveys, but that's why investors should never peg their forecasts to any one data series. On the plus side was 12 of the 18 manufacturing subcomponents reporting growth (up from 11 in April) – the best reading since May 2015.

However, the internals of the report were not as constructive as the headline would suggest with the supplier deliveries (the least significant of the five components in the report) jumping 5 points and accounting for the bulk of the overall monthly increase. Nevertheless, the results from the other components were okay and overall the reading would have still held above the key 50 breakeven level. Call it stabilization or stagnation, which are both preferable to the

five successive months of contraction we were seeing this past fall into the start of this year.

We also got the ISM non-manufacturing index which continued on its decelerating trend, falling 2.8 points from 55.7 in April to 52.9 in May. While this number checks in on the expansionary side of the 50 breakeven level, the downshift over the last several months is notable as the 52.9 reading in May is well off the twelve month peak of 59.6 in July and definitively below the 12-month average of 56.0. The internals of the report were quite weak as well with business activity, new orders, employment, backlog of orders, new export orders, imports and inventory all contracting on the month. Only two components (supplier deliveries and prices) registered gains on the month which is not a constructive sign for profit margins – prices up, activity down.

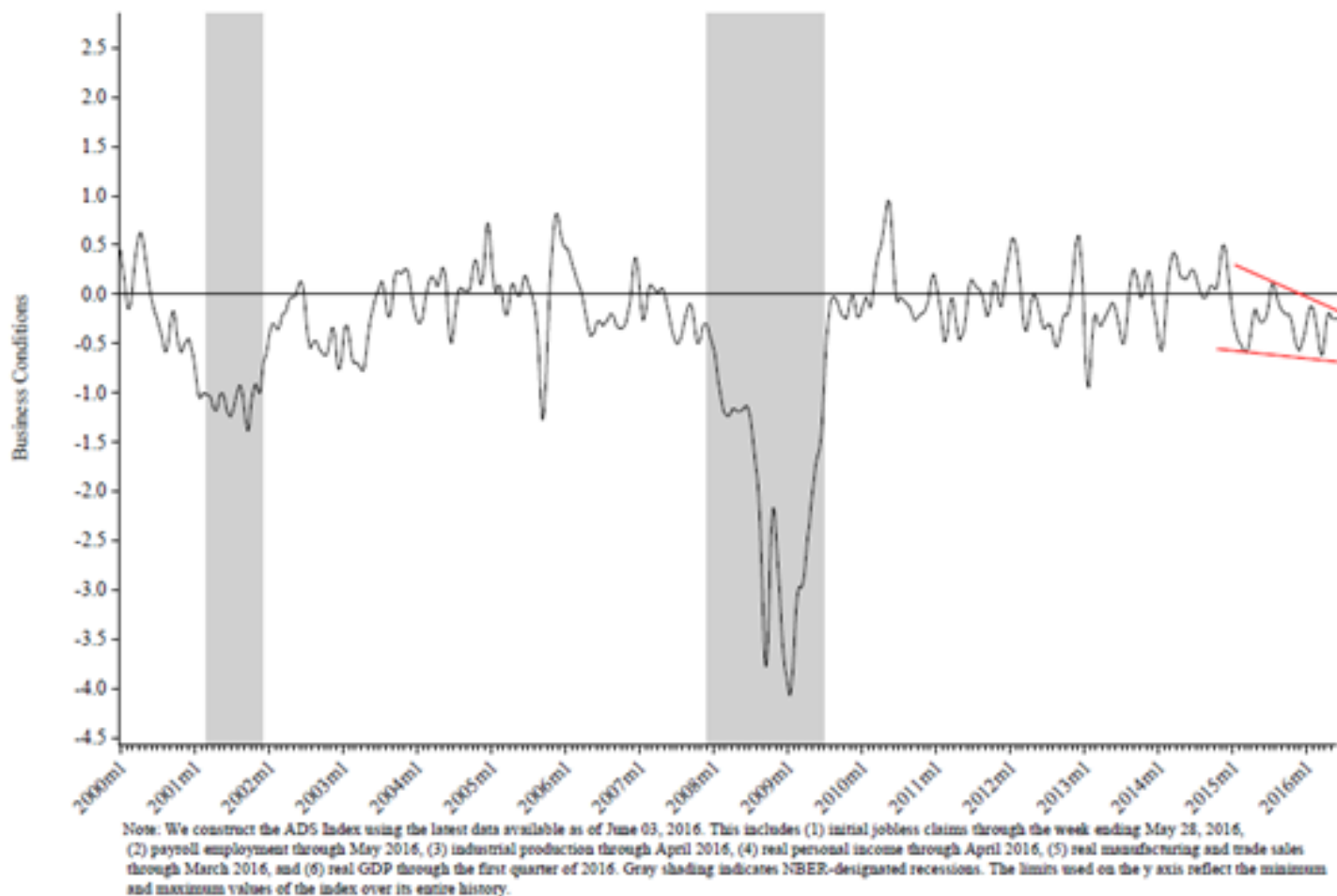
The global PMI data was very similar to what is playing out in the U.S. – muddling along. The JPMorgan Global PMI, compiled by Markit from its worldwide business surveys, fell from 51.6 in April to 51.1 in May, it's second-lowest reading since the end of 2012 (with a low of 50.8 having been seen in February). The data points to global GDP rising at an annual rate of just 1.5% in the second quarter, assuming no material change is seen in June, below the long run average of 2.3%. That's almost unchanged on the rate of growth signaled in the first quarter. Emerging markets once again led the slowdown, with the PMI signaling a return to slight contraction after two months of marginal growth. Developed world growth also remained firmly in the doldrums in May, having slowed to the second-lowest level in just over three years.

The overall picture is therefore one of steady but disappointing growth, with little indication of a major cyclical acceleration at present. In particular, growth in the U.S. remains subdued, and seems to be running at or below the 2% level with the latest PMI results suggesting that Q2 GDP growth in the U.S. is at risk of disappointing the recently raised estimates of 2.5 -3.0%. So we are a long way from the spike in recessionary risks that permeated the narrative during the early part of the year as the improvement in growth experienced through March and April seems to have stalled in the past few weeks, with hopes of a strong cyclical rebound once again proving unfounded so far.

Which brings me to the Fed and this game of cat and mouse it is playing with trying to normalize interest rates while keeping asset prices elevated. Outside of the Fed reaching

what are perceived to be acceptable absolute levels on its dual mandate (unemployment rate hitting its low of the cycle at 4.7% and PCE inflation starting to move toward its 2.0% target) I can't for the life of my buy into the narrative that the fundamental underpinnings of the economy are strong enough to justify it. Just look at the trend in the below chart from the Philly Fed which updates the inputs to this data after every major economic release. This is a clearly identifiable deceleration in business conditions, so perhaps the brain trust taking residence in Washington for the Fed may want to brave the 140 mile road-trip to Philly so they can have a constructive debate on what is driving this concerning decline.

Aruoba-Diebold-Scotti Business Conditions Index (1/1/2000 - 05/31/2016)



The Fed tightened in the fourth quarter of 2015 when real GDP growth came in at a 1.4% annual rate and now seems compelled to hike once again in a quarter where growth looks to be tracking around 2.0% (don't forget that we had a 0.8% growth print sandwiched in between). Looking at prior tightening cycles, real GDP growth on average was

tracking 4.3% when the Fed raised interest rates. Over the last thirty years the Fed tightened rates in quarters with a growth rate as shallow as we are currently experiencing a meagre 10% of the time.

So here investors stand at this juncture with a myriad of economic and capital market indicators flashing amber warning signals, suggesting caution is warranted: the Treasury yield curve at its flattest level since just before the last recession, job growth is waning, S&P 500 earnings growth has declined for three consecutive quarters, valuations are at cycle highs, and more than \$10 trillion in global sovereign debt carries a negative yield – what's there to worry about, the Fed's got this.

Call me a skeptic at best, but I have a very difficult time carrying out my fiduciary responsibility in stewarding other people's

capital on the premise that the Fed will be able to thread this needle of unwinding seven plus years of experimental monetary excess. For those lacking a historical context, we are talking about a Federal Reserve that has a long history of being mistake prone:

- A Fed that thought that in 2001 the economy was being slowed by bloated inventories and failed to recognize the massive deflationary shock that was coming down the pipe from the technology boom.
- The same central bank that believed home prices could never go down and the sub-prime mortgage crisis was contained.
- A central bank that firmly holds to the view that you can only see a bubble once it bursts

- A Federal Reserve that has consistently overestimated growth throughout the last five years of this expansion

Yes, this Fed. Don't get me wrong, I don't for one minute question the intellect and collective brain power that constitutes the make-up of the Federal Reserve. But this is an independent and unelected government agency that inherently has to exude confidence and control at all-times. This is precisely why they've never forecasted an economic recession and anyone relying on them to do so will be waiting a long-time.

I'm empathetic to investors today as they are undoubtedly faced with a challenging set-up. Stocks are trading at the top end of their 18-month trading range and the risk of a melt-up in the major averages is material. Career risk is nearing a high with returns across the global

capital markets narrowing, frustration is mounting, and the belief that the Fed can bend and smooth economic gravity is reaching a fever pitch.

As such, now is precisely the time when investors need to exercise discipline and prudence because very few asset classes are priced for a bump in the road – let alone a material detour to the plotted course.



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