March 12th, 2018

A picture-perfect employment report…
It's a rare occurrence within an economic construct that you come across a data release that was as unblemished as Friday's jobs report. On almost every level this report delivered what investors, policy makers, and economists were hoping to see:

- Solid and continued job creation? CHECK. The U.S. economy added +313k jobs in February (well above the consensus expectation for +200k) and this was the strongest monthly jobs gain since July 2016. The corresponding Household Survey showed job growth clocking in at +785k with 729k of those jobs being of the full-time variety. Last but not least, the breadth of the increase in jobs was impressive with the diffusion index increasing to 68.6% from 58.9% in January.

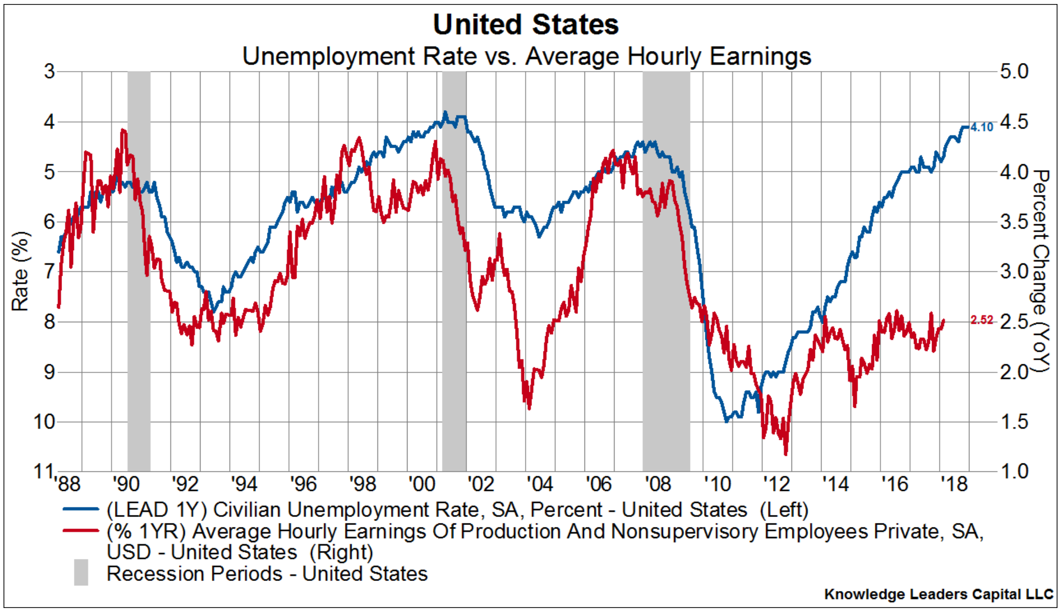
- Maintaining an already low unemployment rate? CHECK. The U-3 unemployment rate remained at 4.1% with the broader U-6 rate also holding serve at 8.2%. It's worth pointing out that the 4.1% unemployment rate didn't decline further for all the right reasons, as the workforce swelled by 806k in February (the biggest jump in 15 years) and this caused the labor force participation rate to increase to 63.0% from 62.7%. More individuals entering the labor force is welcome news to those Fed members that continue to believe that ample labor slack remains in the system.

- Wage growth (not too hot, but not too cold)? CHECK. Average hourly earnings came in at +0.1% for the month (just below consensus estimates) which was a sigh of relief for investors following the hot wage number in January that many investors suggest set-off the equity market correction in early-to-mid February. The year-over-year pace in wage growth moderated to +2.6% from the attention grabbing +2.9% pace in January (this number was revised down to +2.8%). Additionally, the aggregate hours worked index rebounded by a not-so-shabby +0.6% with factory overtime reaching a cycle-high 3.6 hours from 3.5 in January.

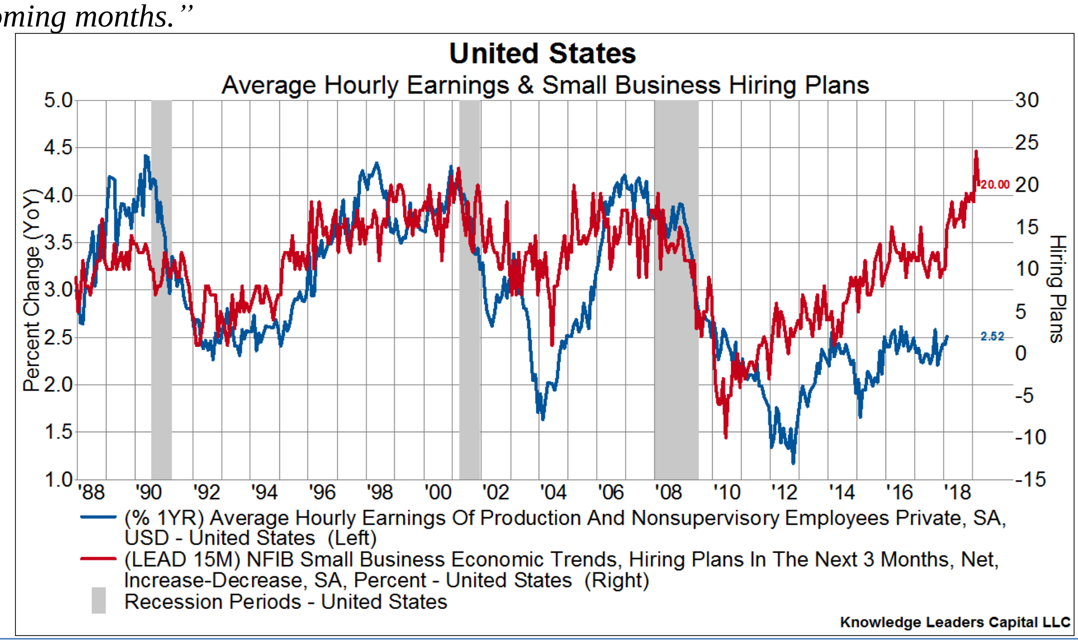
So, as you can see, there is little in this report not to like. However, I'm going to take a stab at highlighting a couple items that may have been overlooked in all the hype and excitement following what really was a stellar employment report. First of all, on the wage front: I don't share the complacency of the majority out there believing that February's wage numbers were nearly as tame as they look on the surface. Average hourly earnings in the production / nonsupervisory segment (80% of the workforce) increased by 0.3% on the month, sending the YoY trend up to 2.5% from 2.4%. It's worth noting that last month's hot 2.9% wage reading was driven almost entirely by strength in the supervisory component (less than 20% of the workforce), whereas this month is virtually the opposite and much more telling of potential broad-based wage pressures. What's more is that the trend in wage growth for this 80% of the labor pie has accelerated at over a 3% annual rate according to the data over the last three months.

All I'm getting at is that investors should retain some vigilance in regards to dismissing the wage pressure backdrop as a broadening number of data points indicate that we may be just at the start of a more prolonged rise in wage growth. Knowledge Leaders Capital put out an interesting piece on Friday highlighting three indicators that historically lead wage growth by about a year with all of them signaling an acceleration in wage growth in the coming months (see accompanying link for the full write-up).

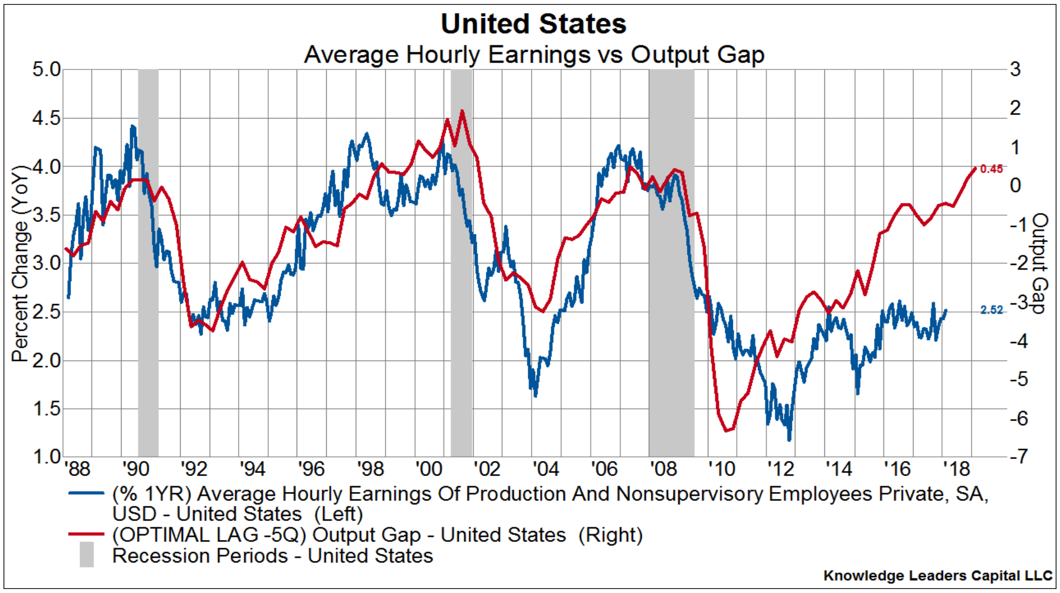
> *"The first chart below shows the unemployment rate (blue line, left axis, inverted) plotted against average hourly earnings of non-supervisory employees (red line, right axis). The unemployment rate leads wage growth by about one year, and the break lower in the unemployment rate that started in early 2017 looks set to feed through to wages in the coming months."*



> *"Next, we show the relationship between NFIB small business hiring plans (blue line, right axis) and wage growth (red line, left axis). Small business hiring plans lead wage growth by about fifteen months, so the breakout in those hiring plans that started in early 2017 suggests an uptick in wages in the coming months."*



"This third chart compares wage growth (blue line, left axis) to the output gap (red line, right axis). The output gap measures whether an economy is operating below, at, or above potential growth. A positive output gap (something that occurred beginning in early 2017) is an indication that the economy is running at a faster pace than it is able to without igniting some pricing pressure. The output gap leads wage growth by about five quarters, and its recent uptick portends higher wages in the coming months."



Why all of this attention on wage growth? After all, aren't rising wages a good thing for the economy? Yes, they surely are, but it's my opinion that we are at a critical junction where what's good for Main St. (the average worker) is not good for Wall St. (asset prices). You see, we still have a Federal Reserve and other central banks around the world that are operating emergency-style monetary policy with an economy that is very late cycle. Add to this a very aggressive fiscal stimulus package just getting under way and you have all the makings of a toxic mix of counter acting forces – the Fed being forced to accelerate monetary tightening as a result of a fiscal stimulus package that is unfunded. Moreover, all of this is taking place with interest rates still near historic lows (while having doubled off the 5,000-year lows they reached in the summer of 2017), debt levels across the household, corporate, and government sectors at all-time highs, and equity valuations having rarely been more stretched.

This is the corner the Fed has painted themselves into with their attempt over the duration of this cycle to use asset prices as an implicit third mandate beyond full employment and price stability. As a result, too much of the economic edifice has become financialized where any further extension of this expansion, or the onset of the next contraction, is highly dependent on the direction of asset prices.

It is for this reason that I think it is so important to pay attention to the change taking shape this year in monetary policy with the Fed implementing QT (a gradual reduction in the size of their balance sheet that accelerates throughout the balance of this year) and a newfound determination to normalize interest rates (via rate hikes). Anyone who remains in doubt that the Fed will get cold feet again (as they did back in early 2016) should really have a read of the speech by Fed Governor Lael Brainard ([Navigating Monetary Policy as Headwinds Shift to Tailwinds]) delivered at the Money Marketeers of New York University last week. Keep in mind Mrs. Brainard was long believed by investors to be one of the most notorious Fed doves for years (outside of former Chair Yellen), and in this speech it seems reasonably clear that she is changing her tune (underlined text is from yours truly).

> *Many of the forces that acted as headwinds to U.S. growth and weighed on policy in previous years are generating tailwinds currently.*
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> *Financial conditions are currently supportive of economic growth despite the recent choppiness in financial markets and some tightening since the beginning of the year. Various measures of equity valuations remain elevated relative to historical norms even after recent movements, and corporate bond spreads remain quite compressed.[3] This compares with the period from mid-2014 through the second half of 2016, when equity prices were flat and the dollar rose steeply. The Federal Reserve Bank of Chicago's National Financial Conditions Index provides a useful summary statistic.[4]According to this measure, financial conditions tightened significantly from the middle of 2014 to early 2016. By comparison, financial conditions today remain near the accommodative end of the range since the financial crisis, even with the recent tightening in conditions.*
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> *The most notable tailwind is the shift in America's fiscal policy stance from restraint to substantial stimulus in an economy close to full employment. In the earlier period, the economy had just weathered a challenging adjustment to a sharp withdrawal of fiscal support. Today, from a position near full employment, the economy is poised to absorb $1-1/2 trillion in personal and corporate tax cuts and a $300 billion increase in federal spending. Estimates suggest December's tax legislation could boost the growth rate of real gross domestic product (GDP) as much as 1/2 percentage point this year and next.[5] On top of that, the recently agreed-to budget deal is likely to raise federal spending by around 0.4 percent of GDP in each of the next two years.[6]*
> *Although last year we faced a disconnect between the continued strengthening in the labor market and the step-down in inflation, mounting tailwinds at a time of full employment and above-trend growth tip the balance of considerations in my view. With greater confidence in achieving the inflation target, continued gradual increases in the federal funds rate are likely to be appropriate.*
>
> *We also seek to sustain full employment, and we will want to be attentive to imbalances that could jeopardize this goal. If the unemployment rate continues to decline on the current trajectory, it could fall to levels that have been rarely seen over the past five decades. Historically, such episodes have tended to see elevated risks of imbalances, whether in the form of high inflation in earlier decades or of financial imbalances in recent decades.*
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> *However, we do not have extensive experience with an economy at very low unemployment rates and cannot be sure how it might evolve. In particular, we will want to remain attentive to the risk of financial imbalances.*
>
> *What do these considerations imply for the path of monetary policy? Continued gradual increases in the federal funds rate are likely to remain appropriate to ensure inflation rises sustainably to our target and to sustain full employment, keeping in mind that interest rate normalization is well under way and balance sheet runoff is set to reach its steady-state pace later this year.[13]*
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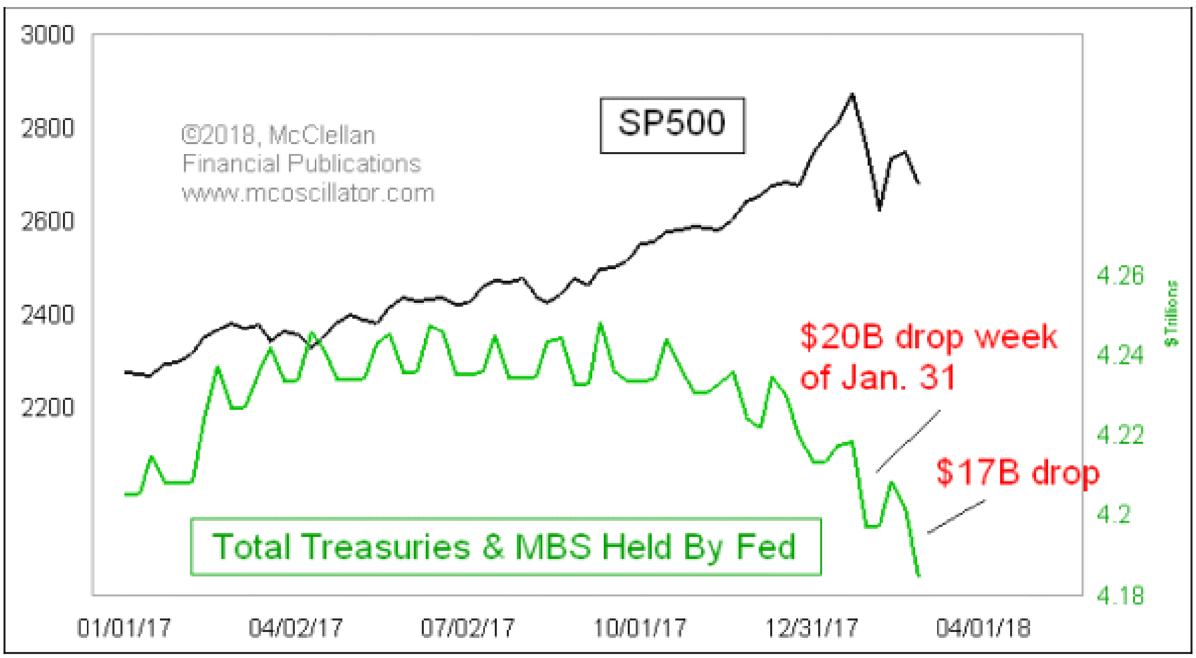
> *In many respects, the macro environment today is the mirror image of the environment we confronted a couple of years ago. In the earlier period, strong headwinds sapped the momentum of the recovery and weighed down the path of policy. Today, with headwinds shifting to tailwinds, the reverse could hold true.*

Draw your own conclusions, but the shift in the way the majority of the Fed board members view the economy, inflation, and financial stability relative to two years ago is clear – they are less worried about choking off the recovery by tightening policy and more worried about financial imbalances building up in the system. Kansas City Fed President Esther George couldn't have been any clearer in her remarks last Thursday:

> "*Asset prices may have become distorted relative to the economic fundamentals and the very slow pace of our balance sheet normalization may still be contributing to a buildup of various financial imbalances.*"

This Fed is sending a message in as clear and transparent a fashion as they can (which, mind you, is as clear as a frosted over windshield…): this Fed is not nearly as concerned with being a backstop to asset prices as were the Bernanke and Yellen led Feds.

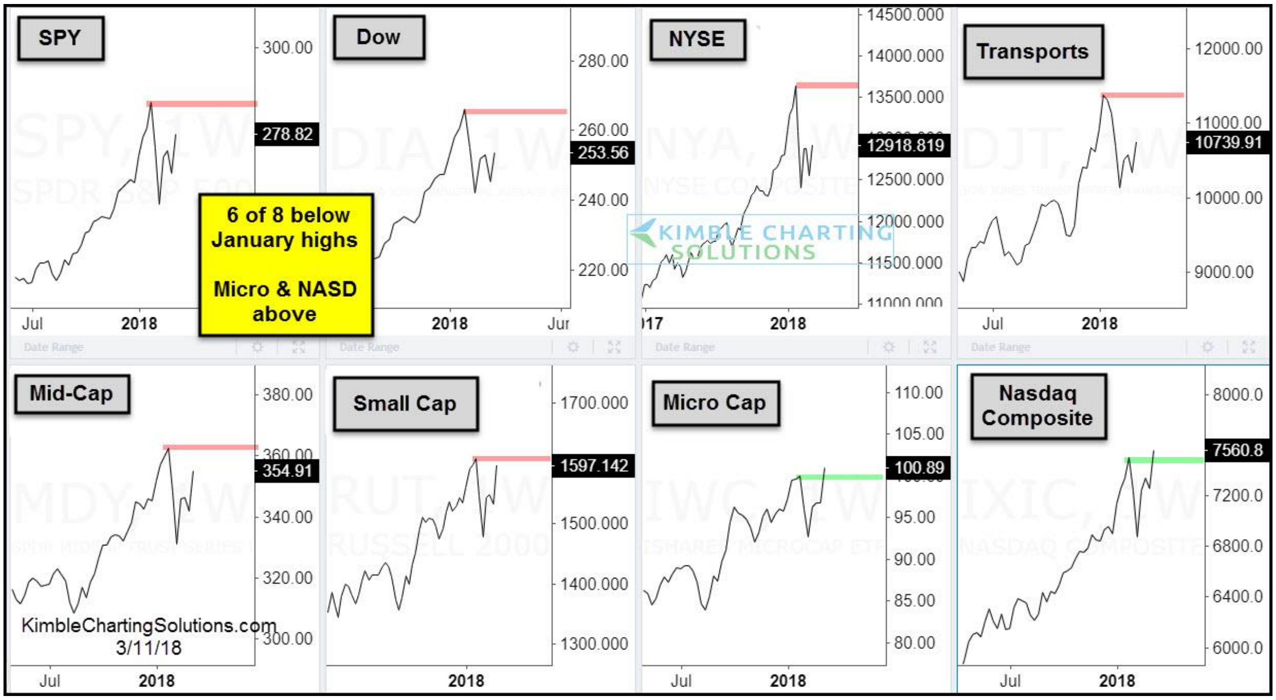
Which brings me to the capital markets, in particular stocks and bonds. It's the bond market that is now in the driver's seat and will dictate when, where, and in what direction stocks move going forward. In my opinion it was interest rates (in tandem with liquidity being withdrawn from the system) that caused the stock market to sell-off in February. Have a look at the below chart put together by Tom McClellan for his blog correlating the decline in the Fed's balance sheet since the turn of the year (the big step changes occurring at the end of January and again at the end of February) against the price movement in the S&P 500.



Why this should come as a surprise to anyone given the lock-step movement between the stock market and the Fed's balance sheet expansion from 2009 – 2014 is beyond me. This is like watching a movie where you know what the ending is, but you just don't know how long it is until we get there.

We remain in an environment where the forces that move interest rates are pressuring them higher, even in the face of what has been a multi-week consolidation period. The yield on the 10-year Treasury finally broke out above the 2.65% level on January 26th which just so happened to be the day the stock market peaked, and since February the 10-year yield has not closed below 2.77% and closed as high as 2.94%. Should we break-out of the upper end of this trading range then my guess is it puts downside pressure on a host of asset prices and a we will likely see a further levitation of volatility.

As for the rally in the stock market over the last couple weeks, which admittedly has moved beyond the 2,750 level I was expecting, it still has too many non-confirmations at present to truly buy into the notion that new all-time highs are just around the corner. First and foremost, the majority of major market averages remain below their January highs. As you can see in the following chart only the Nasdaq Composite and the Micro-Cap index have managed to make new highs.



As for the Nasdaq, outside of Netflix, Amazon, Alphabet, Microsoft, and Apple there really isn't a whole lot going on. Speaking of Amazon, in the last 90 days its market cap has gained over $300 billion which is equivalent to the size of Walmart, Target, and Best Buy combined. Look, I know and understand that Jeff Bezos and the Amazon machine gets the benefit of the doubt that it could conquer whatever industry it wanted to get into, but really? After all, Amazon's cash cow is Amazon Web Services (AWS), and it's the cash cow that funds the majority of its other not-so-profitable business endeavors. But Amazon's recognition and its bread-and-butter notoriety stems from its online marketplace. So, what have we learned in the last several weeks on this front?

- Big Lots surprised analyst expectations with a drop in same-store sales (stock is down 16% for the month of March and down 14% on the year)
- Kroger guided for full year results to be light and noted weakening margins (stock is down 11.5% this month and down 12% on the year)
- Dollar Tree's results disappointed across the board (earnings, sales, and guidance) and the stock is down 8% in March and 14% for the year
- Walmart had disappointing results a couple weeks ago and its stock price is down 20% since January 29th
- Target delivered weak guidance recently and Costco missed estimates last week, however these two stocks look to be the outliers in the bunch with Costco up 2% on the year and Target up a little over 8%. However, neither of these solid long-term operators can hold a candle to the 37% gain in Amazon year-to-date.

Don't even get me started with the fact that 50k jobs were generated in the retail sector in February's employment report (in the face of what looks like a very broadly weak retail backdrop), yet few investors look at this accumulation of evidence as even remotely negative for Amazon. Oh well, I'll get off my soapbox on this issue.

I'll end this week's missive on an indecisive note – I know, what a travesty in an environment where so many speak with such certainty and conviction about what lies ahead. On the surface, very little looks worrisome in the stock market or the U.S. economy. The biggest positive drivers for stocks at the moment are the technical backdrop with the S&P 500 being able to reclaim all of its major moving-averages. Fundamentally speaking the earnings backdrop should remain a tailwind into the second half of the year when the focus will then shift to 2019 earnings which aren't nearly as robust (not negative mind you, but a meaningful deceleration in growth). As for the economy, the survey data continues to come in white hot, the manufacturing sector looks to be as strong as it's been at any point in this expansion, job growth is solid, wage growth is picking up, and inflation (for now) remains in check.

Below the surface in both the stock market and economy, things don't look nearly as rosy. Breadth and market internals indicate the stock market is moving higher on the back of fewer and fewer companies. Over 50% of stocks in the S&P 500 remain below their 50-day moving averages even though the index has moved back above the 50-day. Stock buybacks and the reduction in the corporate tax rate are the main drivers behind the earnings growth story, and without these there is very little organic growth occurring. The tech sector now makes up over 25% of the weighting in the S&P 500, so as an index this is becoming a more concentrated basket of stocks with reduced diversification benefits. The credit markets are starting to show some cracks, the interbank market in particular with OIS spreads continuing to rise on a daily basis which is indicative of dollar funding pressures building around the globe.

On the economic front, the housing market looks to have rolled over, the consumer is packed to the gills with debt with little savings to fall back on (so they are nearing a tapped-out point), the auto sector's best days look to be in the rearview following the one-time sales bump from last year's hurricanes, and a potential tit-for-tat trade war is a concern as it will stymie growth in the near-term (even if this administration is able to pull a rabbit out of its hat and produce something accretive over the long-term).

So, invest accordingly as this isn't the same one-directional investment backdrop from the last several years. Be selective, have some risk management strategies in place, and be open minded to being a little more tactical in your investment process versus a set-it-and-forget strategy that has worked so well in the recent past.

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