June 4th, 2018

Too much of a good thing…

Taken at face value, the economic data releases from last week show a U.S. economy that is firing on all cylinders. Sure, the housing data over the last couple of months has been feeble, but that should be expected with interest rates on the rise and affordability at the worst levels of this expansion due to the increase in home prices having doubled the rate of wage growth for several years running at this point. And yes, the bloom is coming off of the rose that is the auto sector boom that saw its cycle peak extended due to the buying spree set off by the hurricanes that hit last

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summer, wiping out over 600k vehicles that needed replacing. But last week's employment report was one of those rare economic reports where any objective analyst had a hard time finding a blemish.

Job gains for May came in at a healthy clip of +223k, exceeding consensus expectations for a print of +190k. In addition to the strong May payroll figure, there were positive revisions of +15k to the prior two months, and the job gains were broad based as suggested by the diffusion index for total private payrolls increasing to 67.6% from 64.0%. The headline print of +223k new jobs was corroborated by an equally impressive print in the household survey of +293k jobs being created. While the household survey is known for being a much more volatile series, it's hard to be dismissive of the fact that full-time jobs soared by +904k in May which more than

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replaced the 625k part time jobs that were lost. Over the last twelve months the number of full-time workers has increased by roughly 3 million while part-timers have dropped by 457k.

The good news didn't stop there as the unemployment rate dipped further to 3.8% from 3.9%, and that actually understates the improvement when one takes these readings to the second decimal place which shows a U3 unemployment rate that declined from 3.93% to 3.76%. The last time the unemployment rate was this low was December of 1969 – ironically a recession began that very month (more on this later). The broader U6 jobless rate declined a full two-tenths of a percent to 7.6% from 7.8% and now stands at a seventeen year low.

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As for wages, average hourly earnings rose an above expected 0.3% and pushed the YoY trend higher to 2.7% from 2.6%. This wasn't a large bump by any means, but with a labor market that is looking more drum-tight by the month, it's only logical to expect that wage pressures intensify from this point forward. An example that this trend is well under way can be found in the YoY wage trend for nonsupervisory production workers which increased to +2.8% from +2.6% and the annualized rate over the last 3 months has accelerated to +3.6%. This is a cycle high for this group (a group that comprises 80% of the jobs pie), and strongly suggests that the bargaining power of labor has finally taken its seat at the table.

So now that we're through the formality of laying out all the data and praising its awesomeness, let's actually peel back the

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onion with a bit of analysis and get into some context as to what it means for markets. As solid as the labor market looks at this moment (and don't get me wrong this was as fine of a jobs report as you'll find) there is a darker side to this data and that is that the U.S. is running out of skilled workers. If this is the case, and there is faint evidence to suggest it's not, then we're looking at a U.S. economy that has moved excessively above its full-employment potential. Heck, according to the Fed's own forecast they estimated the unemployment rate hitting 3.8% by year end and we're already fractionally below that at this point. On top of that, the Fed is already on the record with their estimate of 4.5% as being the level of a sustainable unemployment rate.

The fact of the matter is that this employment report had late cycle thumbprints all over it, and as such, investors should constrain

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themselves from extrapolating what is occurring in the labor market today too far into the future. For those with a curious mind, wondering what a late cycle employment report looks like, read the comments below from a prior BLS report and then have a look at the date accompanying it.

> *With the unemployment rate at a 30-year low and employment continuing to expand at a robust pace, many economists and policy makers are scrutinizing labor statistics for signs of tightness in the labor market. Some are concerned that the demand for labor will outstrip supply, leading to upward pressure on wages that could possibly ignite inflation. Many economists wonder how long wage gains can remain moderate in the face of strong employment growth, low unemployment,*

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and, presumably, a dwindling supply of potential workers.

Bureau of Labor Statistics (BLS) dated June 13, 2000

In June of 2000, wages were growing at the same pace as they had been since 1997, even though the unemployment rate had dwindled all the way down to a multi-decade low of 3.8% in April of 2000. It was just six months later that wage growth had picked up to +4.3%, thereby applying upward pressure to the inflation statistics, inflicting margin pressures on corporate America, and keeping the Fed in play. Lo and behold, as is par for the course in the late stage of an economic cycle, these pressures proved to have a tipping point and by March of 2001 the recession had commenced.

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The other economic data point that stood out to me last week was the ISM Manufacturing PMI which came in at 58.7 for May and bested consensus expectations for a print of 58.2. To say that the manufacturing sector is ripping is not a stretch by any means, even if the May print is a bit below the cycle peak of 60.8 turned in back in February. Look folks, the ISM doesn't get much better than the 60 level and when it reaches that point it typically doesn't stay at that level for long. The fact that we've been hanging around this 55 – 60 level for the better part of six months is quite impressive. Besides inventories, all of the components that comprise the headline print improved during the month and, like the employment report, there was hardly a blemish in the details as it relates to economic activity.

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One item that did stand out, and fits in with a tightening labor market, is further signs of burgeoning price pressures with all the inflation metrics in this report coming in higher than prior readings:

- Supplier deliveries increased to 62.0 from 61.1 (an eight-month high)
- Order backlogs rose to 63.5 from 62.0 (only once before in the history of this data series has this metric been higher)
- Prices moved up marginally to 79.5 from 79.3, but this is the highest reading on this front since April of 2011

I took the liberty of pulling out a couple comments from the "What Respondents Are Saying" section – use your own judgement as to whether or not you think pricing pressures

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and higher inflation expectations are on the horizon.

- *"We are currently overselling our forecast and don't see an end to the upswing in business. We are very concerned, however, about the tariffs proposed in Section 301 and are focusing on alternatives to Chinese sourcing." (Transportation Equipment)*

- *"Very difficult to hire skilled and unskilled labor." (Food, Beverage & Tobacco Products)*

- *"We are concerned about the strong dollar affecting our export orders as well as the steel tariffs, which are causing domestic steel prices to rise." (Fabricated Metal Products)*

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- *“Strong demand from (agricultural) business; solid demand in all other business segments.” (Chemical Products)*

- *“Sales remain strong. Lead times and direct material costs are soaring.” (Machinery)*

- *“Suppliers are seeing price increases and trying to pass them on.” (Miscellaneous Manufacturing)*

- *“Continued talk around steel tariffs has resulted in price increases for domestic line pipe, while HRC seems to be moving sideways. Temporary exemptions for allies and an agreement with South Korea have not calmed the market.” (Petroleum & Coal Products)*

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- *"Growth seems to be coming in the construction industry, but at a slower pace than expected with delays due to weather in the U.S. Business in (Latin America) is way up, and Canada is off to a decent start." (Nonmetallic Mineral Products)*

- *"Industry demand is causing price increases. Fuel prices are also on the rise, and there have been (price) increases associated with that." (Primary Metals)*

- *"Severe allocation, long lead times and upward price pressure, particularly in the electronic components market, continue to hamper our ability to meet customer demand and our shipping schedule." (Computer & Electronic Products)*

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The strength in the economy, the rise in inflationary pressures, and the amount of fiscal stimulus still yet to be deployed through the government's fiscal year end in September all screams to me of a Fed that should be growing increasingly concerned about falling too far behind the curve in tightening policy. I know this isn't what investors want to hear, nor do I wish we were in this predicament, where for the entirety of this bull market cycle investors could always fall back on the belief that 'the Fed put' was never too far behind and all an investor had to do was wait out the storm for the Fed to blink, backstopping stocks from falling any further which then restarted the levitation to new all-time highs. Well Toto, we're not in Kansas anymore, so barring a melt-down in an Emerging Market economy, a bank blow-up in the Eurozone, or another round of instability in Italy or Spain, we're looking at a Federal Reserve that is

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starting to look at running the risk of being meaningfully behind the curve in its interest rate hiking cycle. If the Fed is in the business of risk management, which they most definitely are, then they have no other choice than to start preparing the market for more rate hikes, not less, and I say this with all deference to the seemingly dovish FOMC minutes we got last week.

After the data we've received over the last week, these minutes look fairly stale at this time. If the latest updates for Q2 GDP estimates from the economist community are in the vicinity of being correct (Atlanta Fed +4.8%, Macroeconomic Advisers +4.1%, and the NY Fed +3.3%) then the Fed is very likely going to have to pick up the pace on its rate hiking path. The Fed Funds Futures market is pricing better than 90% odds that the Fed hikes by 25 basis points in a couple weeks at

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their June meeting, and what remains up for debate is how many more hikes do they want to guide the markets to price in for the rest of this year (1 or 2) and for all of next year.

It was last summer when I had an epiphany and realized that it would be economic strength that would inevitably sow the seeds for the end of this cycle. It took me some time to realize why the market would continue to move higher in the face of weak fundamental data, but then it dawned on me that investors were acting that way to front run the Fed – knowing that as long as the fundamental backdrop was fragile then there was little risk of them removing the punchbowl. Now we are reaching a point where from Q4 2016 through the 2nd or 3rd quarter of this year a strong confluence of events from fiscal policy, coordinated economic strength, an abundance of liquidity (global QE), and cheap money

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was the perfect mix to ignite a strong tailwind of economic momentum. With that momentum, investors have enjoyed an extension to what was already one of the strongest and longest bull markets in the history of capital markets. But, like they say, all good things must come to an end and that inevitably will be the case this time as well.

Already we're seeing repercussions reverberate through the capital markets for the tightening in financial conditions that have occurred since last September. Keep in mind monetary policy works with a lag so the strength in the dollar and increase in interest rates is starting to have an impact, and it's in the most fragile of markets that you see these cracks first come to the surface. In this instance it's Turkey and Argentina which should serve as a reminder to investors of just how interconnected the world is today. Go

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back to 1998 when the Asian currency crisis was in full bloom and yet that was enough to cause a 20% sell-off in the S&P 500 that summer even in the face of a U.S. economy that was ripping and an unemployment rate at cycle lows. Fast forward to the last cycle and it was early 2007 when Ben Bernanke was assuring investors that "subprime was contained", yet it wasn't and it almost capsized the entire financial system. Folks, these are the things that occur late in an economic cycle and in the midst of a Federal Reserve removing liquidity and raising rates. Neither they nor any of us in this profession know precisely what level of interest rates are too much for the system to handle, but ultimately we find out in hindsight after something breaks.

Yet here we are, with Chief Economic Advisor Larry Kudlow on the front page of

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this weekend's NYT raving about how we are in "a prosperity era". I've always liked and respected Kudlow and found his optimism at times contagious, but it seems like anyone who hooks up with this administration loses all sight of rationality. I get the excitement and enthusiasm over the current strength in the economy, but even the 'not fake news' WSJ ran a story on page A1 this morning, titled "Global Growth Loses Steam", calling to attention the "moderate but unmistakable slowdown in economic momentum in Europe and elsewhere". What so many of the cheerleaders often conveniently overlook about this cycle is that it's been built off a credit bubble that makes the 2003 – 2007 cycle look like child's play. Take a look at the numbers and you tell me what I'm missing: at the peak of the last cycle in 2007, total non-financial debt outstanding in the U.S. (government, corporations, and households)

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stood at $33 trillion, or 228% of GDP. Compare this with today where we have $48 trillion in non-financial debt outstanding and this stands at 251% of GDP. The amount of debt that has been taken on to sustain this cycle is unprecedented, mind you it doesn't have the same make-up as was the case leading up to the credit crisis (meaning it's not as concentrated in mortgages), but this doesn't mean it's not there.

There's one other bone I have to pick with the cheerleaders while I'm at it, and it relates to the earnings picture and just how great it is with investors salivating over the 26% YoY earnings picture for the S&P 500 constituency. Last week we got the second iteration of Q1 GDP which includes the corporate profits numbers. Keep in mind NIPA profits (National Income and Product Accounts), which come out of the GDP accounting,

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encompass corporate earnings for the entire economy, not just the small sample set of Corporate America that resides in the S&P 500. Don't get me wrong – this isn't a knock against S&P 500 companies, nor do I want to diminish the great numbers they've been putting up, but those profits are skewed by share buybacks and a more favorable corporate tax backdrop. If you want to truly assess what is happening in the overall economy, we got some answers last week and they weren't nearly as flattering as what we've been seeing on Wall St. In aggregate, pre-tax profits (meaning before the tax cut impact) actually dropped fractionally in the first quarter relative to the fourth quarter of last year. On a year-over-year basis, profits before-tax inched up +4.3% from +2.7% in Q4, but to illustrate the impact of the corporate tax cut, after-tax corporate profits

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ripped a hefty +14.0% YoY from +4.8% in Q4.

So, it depends on how you want to look at the data, as there is no doubt that the benefits from the corporate tax cut are falling to the bottom line, but remove that one-off change and the overall profit picture isn't all that much different than the run rate it has been on – we are talking low single digit terrain.

The overall setup looks to be a bit precarious at the moment because I see a reasonably plausible scenario where asset prices (stocks in particular) are in a bit of a sweet spot with a bit of runway left through the summer months. The economic backdrop is solid and looks as though it will remain that way into (if not through) Q3 of this year – after all, there remains a lot of fiscal stimulus on the back of the Federal budget that will be spent by fiscal

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year end in September. Additionally, inflation is rising but it’s not getting to a level yet that will inflict a lot of pain on corporate profits. The consumer, while starting to experience the effects of rising prices, will in aggregate remain somewhat insulated with aggregate wage growth taking some of the sting out of a moderation in job growth which should be expected in the months ahead.

Lastly, we have the trade war that this administration seems committed to pushing forward, which will eventually filter through to the economy and is already starting to have some impact in global supply chains, but it’s still too early to tell whether this is just “Art of the Deal” negotiating where the bark’s worse than the bite or if this is the real deal. The fact that trade sensitive companies like Caterpillar and Boeing continue to trade within 10% of their all-time highs suggests that the market is

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not yet taking the threat too seriously. However, should we get deeper into this, and my guess is we've already reached the point of no return, then according to estimates from economists that have done the work (and whom I have a lot of respect for) we're talking about an impact that would trim as much as 1% off of world GDP growth. Just for perspective, this amounts to roughly $800 billion in lost output – so we're talking about more than couch cushion money here. There was another interesting piece in today's Wall St. Journal on this front, "*U.S. Levies Are Taxing Some American Steel Consumers*":

> *"U.S. steel producers are benefiting from tariffs that make it more expensive for companies to buy the metals overseas. But some U.S. firms that use the metals to make everything from refrigeration parts to wheels say the tariffs have led to higher*

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materials prices that are forcing them to charge more for their products. These firms say that in some cases, customers are turning to foreign suppliers that use cheaper, tariff-free metals to make the same products they can then export to the U.S. without bumping up against the new trade barriers. (...)"

As I started to get at above, the stock market and economy look to have enough momentum at the moment that could push the S&P 500 back above 2,800 and maybe even to new all-time highs sometime this summer. But make no mistake, when this momentum begins to fade and with the build-up of tailwinds that are transitioning to headwinds – central bank liquidity, cost pressures both from labor and input costs, beginning stages of walking back six decades of a move towards globalization,

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interest rate hikes, an ageing business cycle that is more and more resembling past cycles (looking its best just before it crests), and growing concentration within the stock market (Tech sector now makes up more than 25% of the S&P 500) – the negative impact this will have to asset prices will not be pretty. It's my view that too many cracks have opened up and the worst thing an investor could do at this point is to ignore them.

As of this moment, everything on the surface suggests all is well as the Volatility Index is back down to the low teens, oil prices and interest rates have come off their recent highs, and the Fed will not be implementing its next round of QT until the end of June. So my advice is to take this time of tranquility and stability to perform an autopsy on your portfolio and begin positioning for what looks

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likely to be a more challenging environment come fall.

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