July 9th, 2018

Hot, hot, hot…

And I'm not talking about the weather (although that would be apropos), I'm talking about the slate of U.S. economic data that was reported last week. Let me walk you through what I'm referring to:

- ISM manufacturing index bumped up 1.5 points in June to 60.2 from May's 58.7 reading. For context, a reading above 60 on this metric is a rather astounding feat with the June print representing only the third time the ISM manufacturing index has breached this level since early 2011. There's two sides to this coin in that this is about as good as it gets for the manufacturing side of the economy, so it's a good bet to expect this measure to moderate over the balance of the calendar year. However, given the manufacturing sector is operating with such verve, there is a long way to come down before we reach a level (in the low 50's) that would set off growth concerns in this part of the economy.

  As for the report itself, it wasn't as solid as the headline may suggest. Yes, the production index, new export orders, and import indexes all increased over the prior month, while new orders and the employment indexes were little changed. What really caught my eye was the 6.2-point surge (to 68.2) in supplier delivery delays. If not for this component then the headline index would have printed below 60. But even more bothersome is the message such a rise conveys about the growing capacity constraints within the industrial sector – it's a classic characteristic of inflationary forces at work and symptomatic of late-cycle activity.

- June U.S. light vehicle sales increased 1.4% YoY to 17.4 million SAAR units, up from 16.8 million in May and besting the consensus expectations for 17.0 million. So far this year auto sales continue to track above year ago levels (consensus estimates coming into the year were for sales growth to be negative), however it looks as though we are just entering the early innings of a moderate downturn driven by affordability, tougher comps, and waning demand.

- ISM non-manufacturing index edged up to 59.1 in June from 58.6 last month and came in slightly better than expectations. The internals of this report were rather upbeat with both business activity and new orders rising while the employment index and supplier deliveries ticked down. All told, business confidence remains elevated as strong domestic economic fundamentals continue to offset downside risks from rising trade tensions. One area where we did see some indication that the trade turmoil is starting to have some effect was in the JP Morgan Global Composite PMI where new export orders retreated to their worst level in 23 months.

- Finally, on Friday we got the June payroll report which saw the U.S. economy add +213k jobs, handily above consensus expectations for +195k. Add in the +37k in upward revisions to the previous two months and we're talking about a total add of +250k jobs. The employment gains were broadly based as highlighted by the 65.5% diffusion index and while the unemployment rate rose to 4.048% from 3.755% (to the third decimal place) it did so for the right reasons (as they say). The labor force increased by 601k (tied for the second largest increase this cycle) causing an uptick in the labor force participation rate to 62.9% from 62.7%. However, this is one of the few head scratching items in this report: given the large rise in the labor force, there was only a modest 0.2% increase in wage growth (keeping the year over year rate at a rather weak +2.7%). Furthermore, the voluntary 'quit' rate (interpreted as a confidence metric for workers' willingness to quit their job in anticipation of easily being able to find another) receded to 12.4% from 13.8%. One last non-confirmation metric in this report was the household survey showing a decline of -89k full-time jobs last month.

  Nevertheless, when all is said and done, this was a really solid employment report. Yes, there were one or two warts, but that is coming from this analyst that is critical of every data point he combs over.

What I found most interesting last week was the capital market action following such a solid jobs report. The Treasury market didn't sell-off (meaning yields didn't move meaningfully higher as one would have expected if this was interpreted as a pro-growth report), the dollar declined, the Dow Jones Utilities Index outperformed the Transports, and the Industrials sector was the third weakest performer on the day. However, perhaps that was the aberration as I see in today's trading activity the exact opposite price action – so maybe it's a bit of a delayed reaction.

The biggest question this strong economic backdrop poses to investors is what does the Fed do in such an environment? Following last week's data, economists have re-upped their Q2 GDP forecasts to 4% – I'm seeing some shops as high as 5% (Barclays) – yet Fed Funds futures are still only pricing in 50/50 odds that the Fed hikes 2 more times this year. We'll get a bit more clarity on this front this week with Chairman Powell set to testify in his semiannual address to Congress.

I liken the current interplay between investors and the Fed as a cross between Game Theory and Pavlov's Dogs. You see, investors have learned after nine years of global central bank liquidity creation that it pays to not get shaken out of risky assets because on every occasion that the U.S. equity market in particular has experienced a meaningful correction (in the order of 10-15%) the Fed (or more recently, another major developed-market central bank) has always stepped in with another iteration of monetary stimulus – be it another rendition of QE, using forward guidance to walk back forecasted rate hikes, or drawing out the gradual interest rate normalization path even further. Investor psychology has evolved beyond just a conditional response function (a la Pavlov's Dogs understanding it's feeding time when the bell rings), but also to encapsulate the belief that with the U.S. stock market trading at 150% of GDP (this is Warren Buffet's preferred valuation metric where he considers a reading north of 100% stock market cap to GDP to be overvalued), the U.S. economy has become the stock market. Therefore, any meaningful decline in the equity market has meaningful negative implications for the economy. Hence the highly complex and dynamic real-life Game Theory at play between investors and the Fed.

The Fed has attempted to go out of its way since the summer of 2016 to express that financial stability (asset prices) is reaching a point where it could impose risks to the economy. However, these warnings have for the most part been ignored (for a multitude of reasons, and rightfully so) by investors mostly because even though the Fed began to try and normalize monetary policy in December 2015, its moves were never aggressive enough to actually tighten financial conditions until just recently in Q1 of this year. So now at this point investors are acting like this is just another idle threat by the Fed where investors expect that in the not too distant future they will relent on their rate hiking and liquidity draining path. Given the investor experience over this cycle this is a plausible and reasonable assumption, but to me it seems as though this is the first time this cycle that investors may want to hedge their bets on this call.

The overriding reason driving me to this conclusion is that this cycle is starting to fall into close steps with the late stages of previous cycles. Not only do you have important fundamental economic data at peak cycle levels like the unemployment rate at 4%, ISM manufacturing in the high 50's, corporate profit margins at all-time highs, and global debt at all-time highs, but you also have a yield curve (which has always been a solid arbiter of economic cycles) narrowing to its tightest levels of the cycle. The 2s/10s curve was at 100 basis points a year ago, 50 basis points three months ago, and just last week slid to under 28 basis points – the same level it reached in 2007. Want a couple more interesting data points that coincide nicely with the 2007 cycle peak? Merger and acquisition activity this year is at the same level it reached in 2007, stock buybacks are where they were back in 2007, and investor complacency is on par with where it was in 2007.

One last data point to highlight given its late cycle tendency, and that is inflation. Inflation is a notoriously lagging economic data point in that it cements the Fed on its rate hiking path and continues to build until it applies too much pressure on consumer pocketbooks, burgeoning debt levels (via higher interest rates), and corporate profit margins which assist in tipping the economic cycle over. While most investors take the tame wage readings in last week's employment report as a sigh of relief that inflation pressures are not building in the system, the latest reading on the NY Fed's 'Underlying Inflation Gauge' (UIG) just reached its highest level (3.27%) of the cycle. The following chart plots the UIG against Core CPI with a 15-month lead time for the former and suggests that should this correlation continue to hold, then Core CPI could be as high as 2.8% in the second half of the year. That would match the highest reading since 2006 for the Core CPI when the Fed Funds rate was around 5%.

Today, like back in 2007, investors were eager to dismiss the notion that the business cycle still existed and similar to today, made extrapolations that the '03 – '07 cycle would never end. But end it did and in time a similar fate will play out for this cycle. Yet it seems so many investors are intent on just living in the moment which is one of the most dangerous things an investor could do right now from an investment standpoint. A year from now no one is going to be talking about last month's employment report or the 60 reading on the ISM, unless under the guise of envious reflection. More than likely what we will be assessing with a bit more anxiety is the global impacts of a world economy mired in the after effects of a trade war that carries many more unknowns than knowns. What does seem most likely should we continue down this path is real growth will slow and cost push inflation will be on the rise – in such an environment I have serious doubts that gold will still be in its current state of malaise and that the rest of the world won't be going through a more accelerated state of de-dollarization.

There is no better time than the present to continue preparing for the most challenging part of a business cycle (the downturn). That doesn't mean you should expect to time it perfectly or get yourself in the unenviable position of being all in or all out at any point in time. Remember it's 'time in the market' not 'timing the market' that is the best path to long-term investing success. But what also needs to be included in that view is that there are times when one should have a high level of exposure to risk assets and there is a time when one should maintain a low level of overall portfolio exposure to risk assets. We're at a point where it favors the latter approach.

Take this recent rally in the S&P 500 back up near the 2,800 level as an opportunity to reposition yourself into a more stable and defensive posture. Keeping in mind that we could very well still see another strong push on the part of the bulls that lifts us to new all-time highs, however capturing every basis point of that move should not be the objective of most investors outside of keen technical traders. What's important is to not ignore history and resist adopting a disciplined, prudent investment strategy at this moment. Unfortunately, too many investors push the envelope in this regard as they are overcome with greed or necessity which drives them to feel as though they can time the peak. If you've noticed, this strategy hasn't worked so well this year (i.e. no one knows at this time, but it could very well be that the stock market peaked on January 26th) and what we have been in the midst of over the last six months is a very prolonged topping process as we transition away from the near-decade long cyclical bull market.

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