August 6th, 2018

Quick Takes…

Short note this week as I'm a bit crimped on time and my trusty editor is out enjoying some well-earned time off.

July Employment Report:

- In a nutshell – it doesn't pass the smell test. Yeah, all of the headline numbers look solid with 157k jobs added in the month (although below consensus estimates for 190k), but when you consider the positive 59k in revisions to the prior two months, the headline miss isn't a miss at all. The U3 unemployment rate receded to 3.9%

versus 4.0% last month and the broader U6 measure fell to 7.5% from 7.8% in June – which represents a fresh 17-year low. Average hourly earnings (AHE) came in at 0.3% MoM for the second time in the past three months, and while the YoY rate held steady at 2.7%, when you annualize the last three months it shows wage growth tracking +3.0% – a slight acceleration from the year-over-year numbers and a good sign for consumers, perhaps not so much for corporate profit margins.

- So, what is it that leaves me with the impression of a low-quality jobs report?
    1. The 'birth-death' model (a 'guesstimate' of the number of new businesses created less the number of businesses closing) added a seasonally adjusted 78k of the total 157k new jobs in July (so half of the jobs created in July were from a model).

2. The work week shrank by 0.2% on the month which is a rather meaningful metric given that this is equivalent to roughly 350k in job losses. As a result, the Index of Aggregate Hours Worked (the sum of the hours worked by all employed people) slowed on a YoY basis to 2.2% in July from 2.5% in June. This is a must watch metric in future reports as the impact of a continued decline in aggregate hours morphs the impact of new job creation.
3. This report screams of an economy scraping the bottom of the barrel to fill job openings (and I don't mean this in any negative connotation whatsoever) – the unemployment rate for people without a high-school diploma dropped to a record low of 5.1% from 5.55%. The unemployment rate for those with only a high school diploma slid to 4.0%

from 4.2% (the cycle low is 3.9%). If you have a college degree, the unemployment rate is below 2%. Looking at the past three months you find that those individuals with a high school diploma or less have filled 1.1 million jobs while employment for those with at least some post-secondary school education has declined by 233k. Once again folks, this is what the data says and any comment I make has nothing to do with social class warfare, but this does provide some context for why wage and productivity growth has been so lackluster. Generally speaking, the less skilled and less educated (doesn't imply at all that they lack intelligence or work ethic) are not valued with a premium wage in today's society

4. If productivity growth is 0 – 1% at best and aggregate hours worked is tracking 2.0 – 2.5%, then it's not rocket science to conclude that the natural rate of growth for the U.S. economy is around 2.0 – 2.5%. This puts the second quarter 4% GDP print into context and shows just how much of an impact the fiscal stimulus is having, but above trend growth is likely to prove just as fleeting this time as was the case following the four quarters of 4% GDP growth experienced under President Obama.

ISM Manufacturing and Non-Manufacturing Surveys:

- The ISM Manufacturing PMI fell 2.1 points (the biggest decline since August 2016) to 58.1 versus expectations for a print of 59.4. This is the lowest level for this index in three months, but to be fair 58.1 is still a very strong showing. Like the employment report, what stood out was the visible rate of change slowdown in economic momentum. The new orders index fell by 3.3 points to a 14-month low of 60.2 and the orders-to-inventories ratio continued its declining trend to 1.129 from 1.250 in June and 1.269 in May. None of this at all suggests that the economy is falling off a cliff, but it very clearly is signaling that momentum is waning and that is a material change from what has been an eight-quarter trend in improvement.

- As for the Non-Manufacturing survey, it fell a rather consequential 3.4 points to 55.7 in July from 59.1 in June (consensus was expecting 58.6). The business activity sub-index plunged from 63.9 in June to 56.5 in July in what (relative to history) is a rather monumental one month fall. Folks, I’m not using the term ‘‘plunge to sound hyperbolic, but you have to go back to the start of 2008 to find the last time we’ve seen a fall of this magnitude and what we do know is that the history books mark January 2008 as the start of the Great Recession. The collection of economic data today indicates that a recession isn’t something investors should fear at the moment, but when you see new orders falling 6.2 points, export bookings ticking down 2.5 points, and backlogs sliding 5 points, you have to step back and dig a bit deeper.

Last week we got an employment report, manufacturing data, and service sector results that corroborates what we’ve seen out of the bulk of the July economic data – and that is that the economy has downshifted from the pace it was running at in Q2. Whether it's due to trade wars, the lags from tightening monetary policy starting to bite, or late cycle exhaustion starting to set in – the 'why' doesn't matter nearly as much as recognizing what is occurring.

Anyone still holding on to last year's narrative about 'globally synchronized growth' needs to have a look at the latest Global Manufacturing PMI, where activity slowed again in July to a 12-month low of 52.7. This index is still in expansionary territory with a reading above 50, but the new orders index is down to 52.5 (weakest pace since Sept. 2016), the orders-to-inventories ratio fell to 1.069 (the worst level since November 2016), and new export orders at 50.3 fell to their lowest reading in two years.

I’m hearing more and more about how the U.S. is winning the trade war (just look at the stock market…), cooler heads will prevail before a trade war really gets going, or the impacts for the U.S. economy will be minimal because we are a closed economy. All of these comments have some merit, but I’m fearful that they are a bit naïve and way too complacent about the impacts a trade war would have on globally integrated supply chains. We’re talking about a four-decade progression towards globalization (with the majority of that change coming in the last two decades) being put at risk with what on the surface looks to be a hasty shoot-from-the-hip strategy adrift of long-term vision. I’m not saying I disagree that an adjustment is necessary, but a transition of this magnitude, should it unfold, is sure to create both short-term and long-term ripple effects that can’t be accurately measured in real-time. It’s fascinating to come across talking heads espousing such confidence that they have this all figured out and how dismissive they are about the potential impacts on global growth from a breakdown in emerging markets when nearly two-thirds of global GDP growth over the last decade has come at the hands of emerging markets. Don't get me wrong, these economies just like Developed Markets have been the beneficiaries of (and fueled) this growth on the back of central bank liquidity and cheap money (as a result, imbalances have been built up in these regions that must ultimately be cleansed) but to think this will have no impact on the rest of the world is foolish (in my opinion).

So far, the U.S. is the beneficiary of the pain being felt throughout the rest of the globe as capital flows into our financial system in a typical flight to safety bid. The U.S. dollar appreciating by 8% since its low earlier this year is a confirmation of this and these flows are finding their way into the equity and fixed income markets. However, while the U.S. vacuuming up the excess capital from around the world is a short-term positive for U.S. assets, it will ultimately serve as a meaningful tourniquet that suffocates economic momentum. What I mean by this is that the U.S. economy and the rest of the world can’t handle a meaningfully higher U.S. dollar and you just have to go back to 2014 – 2015 for a reference, when during that period the dollar appreciated over 20% and nearly sent the world into a recession at the start of 2016. It took the Fed backing off of its forecasted four rate hikes that year, a $1 trillion credit injection by the Chinese, and ramped up QE by the ECB and BOJ to arrest the global economy from slipping into a recession.

So right now, we continue to celebrate the benefit corporations are reaping from the recent tax cuts and how these tax cuts, along with strong operating results, have ramped EPS growth up over 20% for the last two quarters, but we have overlooked that roughly 50% of S&P 500 revenues are derived from overseas. If the rest of the world is choking on a strong U.S. dollar and growth in these regions materially weakens then U.S. corporations need the U.S economy to strengthen that much just to offset the weakness from these regions.

Not to mention that a stronger U.S. dollar is a significant variable that feeds into tightening financial conditions which when combined with the amount of tightening by the Fed will be sure to have an impact on the economy (albeit with a lag). Some of these lagged impacts, which I believe are beginning to show through in the economic data, are: housing data rolling over on the back of higher interest rates, copper prices down 18% for the year, lumber prices off 34% since mid-May, Chinese stocks in a bear market, and currency crises arising in fragile economic regions like Turkey and Argentina. All of these data points pose a constraint to investors increasing portfolio risk exposure, just as the continued strength in the U.S. (albeit moderating) validates maintaining some risk exposure until something changes in a more material way.

As for the stock market, all looks well on the surface, and while some breadth measures are confirming the major averages recent advance, others are not. With the S&P 500 within 1% of its January 26th all-time high, only 4% of the constituents in the index are at 52 week highs, while about half are not even within 10% of their respective highs.

Contrast this with the January 26th high in the S&P 500, when 33% of constituents were making 52-week highs. Or have a look at the Russell 3000 which is within 0.5% of its all-time high with less than 5% of the index hitting 52-week highs versus January when

16.5% were hitting 52-week highs. So yes, the market can definitely make a run at new all-time highs, but the broad mosaic of the data doesn't comport with adding more risk to investment portfolios.

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