<u>Monthly Outlook, August, 2017:</u>

"Hold tight, Wait 'til the party's over, Hold tight, We're in for nasty weather, There has got to be a way, Burning down the house!"

Talking Heads, an American Rock Band (1975 – 1991)

With apologies to the Talking Heads, we do feel that these lyrics are reflective of our views on the US economy. The US economy ought to be like a home; a place that is safe, warm in the winter, cool in the summer, predictable, and stable. While recent economic data have generally been positive, some of the innards suggest our sturdy home is nothing more than a ***house of cards doused in gasoline*** with Janet Yellen dancing around it holding a lit match.

The US economy added a greater than expected ***209,000 jobs during July***. Private sector payrolls accounted for 205k jobs: Leisure and hospitality (+62k), and education and health services (+54k) led the way, while the beleaguered information sector (+4k) and construction (+6k) brought up the rear. The twelve month average gain in jobs sits at 179.8k per month, well below the peak gain of 260.75k per month we witnessed in February, 2015.

The politically sensitive ***unemployment rate*** dropped another one-tenth to ***4.3%.*** The U-6 measure of underemployment (in our opinion, a more realistic picture of unemployment as it takes into account disaffected workers as well) remained unchanged at 8.6%. The Average Hourly Earnings figure rose a seasonally adjusted 0.1% (m/m; y/y: 2.5%) and the Average Weekly Earnings figure rose 0.8% (m/m; y/y: 3.10%) suggesting further ***worries about wage inflation in the pipeline.***

While the jobs data have been better than expected lately – even in the face of anecdotal reports of more firms finding it difficult to fill vacant or open positions, as indicated in the JOLTS reports, we do detect a marked ***loss of momentum*** in the labor market. Whether this loss of momentum is as a result of the economy running out of workers (which is patently inflationary), or due to some other reason remains to be seen.

The Bureau of Economic Analysis of the Department of Commerce pegged ***GDP growth for 2Q2017 at 2.6%*** (Seasonally Adjusted Annual Rate), a big improvement from the first quarter's pace of 1.2% (also SAAR). Personal Consumption Expenditures (the vaunted strength in the US economy) rose 2.8%, gross private domestic investment increased 2.0%, exports gained 4.1% while imports rose 2.1% and government expenditures increased 0.7% (all SAAR).

The Conference Board Survey of ***Consumer Confidence*** posted a nice gain in July to a level of 121.1 (from June's reading of 117.3). The Present Situation component increased to 147.8 (from June's 143.9), and the Expectations Index also posted a gain to 103.3 (from June's 99.6). However, the University of Michigan's readings declined slightly to 93.4 (from June's level of 95.1) and the long term (5 to 10 year) inflation expectations remains anchored around 2.5% for now.

However, there appears to be some softening in ***high end housing prices*** as well as in ***automobile sales.*** New car lots seem to have more small cars rather than larger utility vehicles (especially as more consumers feel that gasoline prices are likely to stay low for quite a while) sitting in inventory. It goes without saying that these indicators ***bear watching (pun intended!)***.

This week marks the ***tenth anniversary*** of the beginning of the Great Financial Crises (in August 2007, when a couple of leveraged mortgage hedge funds went belly up). Since the Great Depression (from the late 1920s), the longest we have gone without a recession is 10 years due to pro-growth legislation unleashed by the Reagan administration. The US economy typically sees a recession every five to seven years (on average).

It is entirely possible that the four Trillion Dollars that the Federal Reserve pumped into the system through Quantitative Easing ***(QE)*** has skewed the business cycle (although we are unwilling to bet that the laws of supply and demand are yet to be repealed!). However, that does not explain why this has been the slowest expansion phase of the business cycle since the Great Depression. More importantly, if (QE) put upward pressure on equity prices, what happens when the Fed starts to implement ***Quantitative Tightening (QT)*** – perhaps as early as this September?

Speaking of Janet Yellen, the Federal Reserve is ***stuck between a rock and a hard place.*** The Federal Reserve would really like to increase interest rates over time as well as shrink its vast balance sheet and do so without being disruptive to the "normal" functioning of markets. It is quite obvious from many of the speeches as well as testimonies, that the ultimate peak in interest rates might be considerably lower than the last few cycles: In other words, we are unlikely to see administered rates anywhere close to 6.0% as we did in 2007.

Amongst all this, ***inflation readings*** (inconveniently, we might add), continue to come in ***below the 2.0% threshold*** set by the FOMC to be indicative of "stable prices". Indeed, June's CPI reading of ex-food and energy prices is at 1.7 (y/y) while the Personal Consumption Expenditures' deflator ex-food and energy measure logged in at a tame 1.5% (y/y). Try as they might the Fed is having a hard time boosting inflation at the consumer level – although they do believe that the recent declines ***are "transitory".***

News from ***Europe*** has generally been positive – despite worries about stalled ***Brexit talks***. Growth momentum, in general, has been better of late with IFO surveys and PMI data pointing to better outcomes going forward. It is therefore not at all a surprise that the MSCI Developed Markets Index has started to outperform its US counterpart (the S&P500). We have therefore made a small allocation to an ***international ETF*** (at an expense ratio of 8bp!), by reducing exposure to small and mid-capitalization names in the US.

Another concern of ours is the ***lack of volatility*** in financial markets in general and equity markets in particular. Indeed, during the past month, equity market volatility (as measured by the famous VIX index – a gauge of volatility using the options markets) has hit lows not seen for over 60 years! June marks the seventh month in a row where volatility has declined on a month on month basis. Stints of such ***unusually low volatility*** also speak to the ***level of complacency*** prevailing among market participants.

The US Congress started their summer recess last week (meaning Senators and House of Representatives returned to their constituencies), without passing legislation to "repeal and replace" the so called Obamacare. The ***failure of the Obamacare legislation*** in the Senate (after much hemming and hawing and despite multiple attempts to do so), calls into question the majority's ability to get much done from a tax or infrastructure spending stand point.

Despite all of this, equity prices continue to climb and indices seem to hit new highs regularly. Data from 1928 through June 2017 suggests we typically experience a 5%, 10%, and 20% correction every 50 days, 262 days, and 635 days on average. We have not had a 5% correction in 263 days, a 10% correction in 356 days, and a 20% correction in over 2100 days! In other words, we are due for some ***"nasty weather".***

We think it is ***wise to "hold tight"*** and keep ***excess cash*** on hand until ***this "party's over".*** Given all the uncertainties with respect to elevated earnings expectations, stretched valuations amidst low volatility, and the Fed shrinking its balance sheet, we will merely sing the praises of ***The Talking Heads, rather than "burning down the house!"***

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